October 17, 2003

The Post-Enron Corporate Governance Environment: Where are We Now?

The Sarbanes-Oxley Act became effective on July 30, 2002. Since then, many rules have been enacted, proposed or discussed by the Securities & Exchange Commission, the New York Stock Exchange, Nasdaq and the Public Company Accounting Oversight Board, and there are still more to come. In addition, non-regulatory bodies such as the rating agencies, financial accounting standards board, international organizations and business roundtables have been making numerous public pronouncements focusing on improving accounting disclosures and corporate governance.

In light of the prevailing zeitgeist and constant developments in the rules, companies need to continuously review the impact of the Sarbanes-Oxley Act and the other regulatory actions and proposals on their organizations. Companies should continue to consider what has changed, what more they need to do, what other companies are doing, and what remains to be wrestled with in the future. In order to help companies evaluate the impact of the Sarbanes-Oxley Act and related rules and proposals, we have included in this memorandum the following materials:

- A series of questions and topics that public companies should be considering
- A detailed narrative of each of the major new rules and proposals in the areas of disclosure, boards of directors, auditors and auditing, ethics/compliance and compensation
- A detailed chart reviewing the status, effective dates and transition periods for all of the principal outstanding regulations
- An index of Fried Frank memoranda on the various Sarbanes-Oxley provisions which provide in-depth discussions of particular provisions

We also review certain procedures that some corporations have implemented or are considering implementing in light of the Sarbanes-Oxley Act and related rulemaking and, perhaps even more importantly, market pressures. Many additional rules have yet to be proposed and/or adopted and companies will need to continue to review the questions and concepts described herein. Best practice norms are also developing as companies reconsider their disclosure.
processes and director oversight and market pressures to improve these areas continue to escalate. In many cases the details of the new rules will need to be played out over time as market practices develop and the SEC and courts begin to interpret the new provisions.¹

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¹ The principal focus of this memorandum is on U.S. companies. For a detailed view of the impact of the regulatory changes on foreign private issuers, please consult our firm memo, “Sarbanes-Oxley Act Expands Corporate Governance and Accounting Requirements for SEC-Registered Non-U.S. Companies,” which can be accessed at http://www.ffhsj.com/cmemos/030709_corp_gov_non_us.pdf.
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Part I: Questions for Companies to Consider

1. Disclosure

The new disclosure requirements focus on causing the CEO and CFO to take full responsibility for their companies’ disclosures. Other new rules focus on improving disclosure processes and controls, improving disclosure of off-balance sheet and other obligations that may have previously been undisclosed or not disclosed clearly, requiring enhanced real-time disclosures, shortening the time period for many disclosures, regulating the use of non-GAAP financial measures including EBITDA-type measures and special/nonrecurring charges, and emphasizing that compliance with GAAP is not sufficient if the financial information does not present a complete picture of a company’s financial condition. The new rules also test the use of electronic means to satisfy disclosure requirements. Key questions companies need to review include the following:

- What procedures must we use to back up our CEO/CFO certifications? Should we obtain sub-certifications by multiple officers?
- Do we need to modify our disclosure controls and procedures? Do we need written disclosure guidelines? How should they be updated? Who is responsible for our various disclosure documents? Who is responsible for understanding and developing procedures to comply with the new rules? Who should review all or part of our public filings? Should we have a disclosure committee? Do we need a disclosure controls monitor? Should we prepare a disclosure calendar or timetable?
- How will we comply with any new Form 8-K requirements? Who in the organization will need to be involved in real-time disclosure? What procedures should we put in place in order to be able to make real-time disclosure?
- Have we identified all of our off balance sheet liabilities and contingent liabilities not fully reflected in the financial statements? What are our obligations under any off-balance sheet liabilities? Are these items properly disclosed?
- How should we structure the process of disclosing quarterly earnings results? Does any information need to be posted on our website in connection with the release of earnings? Should we change the use of non-GAAP financial measures in our earnings releases and SEC filings? How should press releases be reviewed to ensure compliance with the new rules? Are we reconciling these measures to GAAP measures? Are our non-recurring charges appropriate?
- What are our critical accounting policies? Do others in our industry use the same policies? What are the key assumptions underlying these policies? What would our results be with different policies and
assumptions? Have we adequately disclosed the impact on our results of our using different policies and assumptions?

- Do we have adequate procedures in place in order to prepare internal control reports? What procedures must we establish so that our CEO and CFO can provide certifications on our internal controls when those provisions become effective?
- Do we need to modify our corporate website to include periodic reports, insider trading information and other corporate governance documents?
- Do we need to adopt a policy, or amend our current policy, regarding communications with analysts?

2. Board of Directors

The Sarbanes-Oxley Act, SEC audit committee rules and proposals of the NYSE and Nasdaq focus on improving the independence of boards and as proposed would require that a company have a majority of independent directors, require an audit committee of only independent directors, narrow the definition of "independence," mandate independent nominating and compensation committees (or, in Nasdaq's case, require decisions in these areas to be decided only by independent directors), and increase the responsibilities and rights of the audit committee. Audit committees will be given access to counsel, advisors, funding and additional information, but will need to be actively involved in the accounting decision-making and processes, appoint and oversee the external auditors and review non-audit services provided by auditors. The new rules also encourage at least one audit committee member to be a "financial expert." Key questions companies need to review include the following:

- Do we have a majority of independent directors?
- Do the directors that we consider to be independent meet the new tests for independence? Do any of our directors have any current or prior relationships, or have any of them or their affiliated companies or charities received any payments, which call into question their independence?
- Should we adopt standards or presumptions regarding independence?
- Should we increase the size of the board, or remove non-independent board members?
- Who will preside at executive sessions of the board and what procedure will be utilized to determine this person?
- Should we separate the positions of chairman and CEO?
- Do we have audit, nominating and compensation committees with only independent directors?
- Do we have a nominating committee charter, and does it need to be updated?
- Do we have a compensation committee charter, and does it need to be updated?
- Should we limit the number of other boards or audit committees on which our directors may serve?
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- Should our board have a mandatory retirement age, term limits, or a provision that directors who change their primary occupation must tender their resignation?
- What type of director evaluation procedures should we utilize?
- Do we need more D&O insurance, and how high will our new premium be? Do our D&O insurance limits impact our ability to attract independent directors? Do we need separate D&O insurance or separate baskets or sublimits for independent directors?
- Do our audit committee members meet the heightened tests for independence?
- Does our audit committee charter need to be revised? Does our audit committee have the authority and funding to hire outside counsel and advisors?
- Should our audit committee members serve on more than three audit committees?
- Does our audit committee have one or more "financial experts" based on the new rules?

3. Auditors and Auditing

The SEC's new rules in this area focus on ensuring auditor independence by limiting (or prohibiting in some areas) the provision of non-audit services by auditors, limiting the hiring by companies of their auditor’s employees, imposing mandatory audit partner rotation, limiting certain audit partner compensation related to non-audit services, requiring additional auditor reports to the audit committee, and enhancing disclosure of audit fees. The Sarbanes-Oxley Act also created the Public Company Accounting Oversight Board, which has issued a series of regulations governing auditors. The NYSE proposals also focus on improving the internal audit function and enhancing the direct lines of communications from the auditors to the audit committee. Key questions companies need to review include the following:

- What procedures should we adopt for approving audit and non-audit services provided by our external auditors? Have we prepared a written audit committee pre-approval policy for auditor services?
- Should we adopt a policy governing the hiring by the company of our auditor's employees?
- Do we need specific procedures to confirm that audit partners and others are being rotated as required?
- Should we regularly rotate our auditors?
- What procedures will we need so that our auditors can attest to our internal controls and discuss any weaknesses therein?
- Do we have an adequate internal audit function? To whom does this function report? Does it have direct contact with the audit committee?
- Is our audit committee sufficiently overseeing the preparation of our financial statements?
The new rules and proposals focus on causing companies to adopt codes of ethics and comply with these codes. Companies are now required to disclose waivers from the guidelines for certain senior officers, which may tend to discourage any such waivers. New SEC rules require companies to create internal procedures for persons to confidentially inform the audit committee about financial frauds. Moreover, SEC rules require lawyers in some cases to act as whistleblowers and report questionable conduct to CLO's, CEO's, the audit committee and the board of directors until satisfied that their concerns are being appropriately considered. Key questions companies need to review include the following:

- Do we have a code of ethics, who does it cover, and does it need to be revised? Should the code be specific or general in nature? Does it comply with the SEC's specific requirements? Does it comply with the NYSE's and Nasdaq's proposed requirements?
- Should we develop a separate code of ethics specifically for senior financial officers in order to satisfy the separate Sarbanes-Oxley Act requirement? Should we have just one code or multiple codes?
- Who under the ethics code will be the “appropriate person” to receive notice of code violations?
- How can our code of ethics be waived? How will that be disclosed?
- Do we have corporate governance guidelines, and do they need to be revised?
- Should we set up a qualified legal compliance committee in order to receive attorney allegations of material violations of securities laws? Should we instead give the audit committee that responsibility?
- Does our audit committee have procedures for the confidential receipt of complaints regarding auditing or internal control matters? Should company employees be part of the procedures or should the entire procedure be outsourced? Do we have or need procedures to protect employees who provide information in an investigation?

5. Compensation

The new provisions and proposals significantly accelerate disclosure of insider equity transactions, impose a new insider trading scheme during pension fund blackout periods, and require CEO’s and CFO’s to disgorge compensation and profits in some circumstances. The Sarbanes-Oxley Act also bans certain transactions, such as personal loans, compared to the prior regulatory scheme which focused only on disclosure of material terms of related party transactions. The ban on personal loans has also called into question the legality of various ordinary course transactions such as the cashless exercise of options and split-dollar life insurance. New NYSE/Nasdaq rules require shareholder approval of almost all equity compensation plans and eliminate exceptions for broad-based plans. Key questions companies need to review include the following:
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- Should we institute a pre-clearance policy for all equity transactions by directors and officers, in light of the Section 16 two-day filing requirement? What procedures should we use with brokers executing stock sales? Should we require use of a single captive broker? Should we centralize preparation of Section 16 forms? Do we need new powers of attorney conferring authority to sign Section 16 reports and have we properly filed them? Do our executive officers and directors have their own Edgar access codes?

- Do we have any existing loans to officers and directors or transactions which could be deemed "personal loans" or "arranging" of such loans? Are they grandfathered or otherwise permissible? Do we need to modify our cashless option exercise programs? Do we have split dollar life insurance? Do we allow advances for indemnification payments or expenses? Do we need to change our policies for advancing expenses for directors and officers?

- How should we amend our insider trading policy to reflect the new pension fund blackout period insider trading prohibition affecting directors and officers?

- Should we expense stock options?

- How should we update our standard directors & officers questionnaire to make sure we can comply with all of the new rules and market-driven initiatives?

Part II: Disclosure

1. CEO/CFO Certification

   A. Section 906 of the Sarbanes-Oxley Act

   The Sarbanes-Oxley Act contains two different sections regarding certification, Section 906 and Section 302. The existence of the two sections means that periodic reports of domestic and foreign private issuers generally must all be certified twice, with somewhat different wording.

   The first provision, Section 906, applies to each "periodic report containing financial statements filed by an issuer" with the SEC. The Sarbanes-Oxley Act defines the term "issuer" as an issuer, the securities of which are registered under section 12 of the Securities Exchange Act or that is required to file reports under section 15(d) of the Securities Exchange Act, or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 and that it has not withdrawn. On November 8, 2002 the SEC issued a series of interpretative questions and answers which discussed various issues under the Sarbanes-Oxley Act. Among other things, the SEC confirmed that a company was not an "issuer" if it registered debt securities under the Securities Act of 1933, its Section 15(d) reporting obligations were statutorily suspended because it had less than...
requires the CEO and CFO of each issuer to certify that (1) the report "fully complies" with section 13(a) or 15(d) of the Securities Exchange Act and (2) the information contained in the periodic report "fairly presents" in all material respects the financial condition and results of operations of the issuer. The Sarbanes-Oxley Act imposes a statutory criminal penalty of up to $1 million and up to 10 years imprisonment for knowing violations of the Section 906 certification requirement ($5 million and 20 years for willful violations).

On June 5, 2003, the SEC issued new rules and guidance with respect to the Section 906 certification requirement.

- **Exhibit Requirement.** The Section 906 certification must be filed as a separate exhibit to periodic reports containing financial statements filed by an issuer. The exhibit requirement is effective for reports due on or after August 14, 2003.

- **Forms 8-K, 6-K and 11-K.** The SEC's March 2003 proposing release stated that the Section 906 certification requirement applied to annual reports on Forms 10-K, 20-F and 40-F and quarterly reports on Form 10-Q, but did not apply to reports that are current reports, such as reports on Forms 6-K and 8-K. However, the SEC's June 2003 adopting release noted that on April 11, 2003, Senator Joseph Biden introduced a statement into the Congressional Record which takes the position that Section 906 was intended to apply to any financial statement filed by a publicly traded company, which would include financial statements included in current reports on Forms 8-K and 6-K and annual reports on Form 11-K. The SEC stated in the June 2003 adopting release that "[w]e are . . . concerned that extending Section 906 certifications to Forms 6-K or 8-K could potentially chill the disclosure of information by companies" and that "[i]n light of these developments, we are considering, in consultation with the Department of Justice, the application of Section 906 to current reports on Forms 6-K and 8-K and annual reports on Form 11-K and the possibility of taking additional action." On October 8, 2003, a senior SEC staff person is reported to have announced at a conference that the SEC and the Department of Justice had jointly concluded that Section 906 does not apply to Forms 6-K, 8-K and 11-K.

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300 security holders at the beginning of its fiscal year, and it continued to file periodic reports only in accordance with an indenture. Therefore, such a company would not be subject to Section 906 of the Sarbanes-Oxley Act, which only applies to "issuers." However, such a company would still need to provide CEO/CFO certifications pursuant to Section 302 of the Sarbanes-Oxley Act because that section applies to "each annual or quarterly report filed or submitted" to the SEC by a "company" whether or not it is an "issuer."
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- **Failure to File.** The Section 906 certification is a Regulation S-K requirement. Accordingly, failure to furnish the Section 906 (or Section 302) certification will cause the periodic report to be incomplete and violate Section 13(a) of the Exchange Act. In addition, the SEC stated in the June 2003 adopting release that an individual who willfully fails to submit the Section 906 certification may be subject to criminal prosecution under Section 32 of the Securities Exchange Act.

- **Furnished, Not Filed.** The SEC permits the Section 906 certification to be “furnished” rather than “filed.” This means that the certification (1) is not subject to liability under Section 18 of the Exchange Act and (2) is not automatically incorporated by reference into an issuer’s Securities Act registration statements, which are subject to liability under Section 11 of the Securities Act, unless the issuer takes steps to include the certifications in the registration statements. The Section 302 certification would still be deemed “filed.”

- **Single Certification for Both Officers.** The SEC allows Section 906 certifications to take the form of a single statement signed by an issuer’s chief executive and financial officers (unlike the Section 302 certification which requires separate statements).

- **Amendments to Periodic Reports.** Amendments to periodic reports that do not contain financial statements (e.g., where the amendment itself does not contain financial statements) do not require a new Section 906 certification, but such amendments require a new Section 302 certification.

- **Sections 302 and 906 Require Separate Certificates.** The SEC has not combined the Section 302 and 906 certifications into one. Therefore, the rules do not provide that both requirements can be satisfied with one certification.

- **Signature Requirement.** The Section 906 certification is subject to the signature requirements of Rule 302 of Regulation S-T. Among other things, this rule requires that an issuer maintain manually signed certifications or other authenticating documents for five years.
B. Section 302 of The Sarbanes-Oxley Act

A second provision, Section 302, requires the CEO and CFO to certify "each annual or quarterly report filed or submitted" to the SEC. The language of the certification was specified in the Sarbanes-Oxley Act and modified by SEC rulemaking on August 29, 2002 and June 5, 2003. The SEC has clarified that Section 302 certifications must be included in Forms 10-Q, 10-K, 20-F, and 40-F but not in Forms 8-K, 6-K or 11-K. Beginning with reports due on or after August 14, 2003, the Section 302 certification is required to be filed as an exhibit to the applicable report (previously it had to be included immediately following the signature page).
The following table illustrates the text of the Section 302 certification as approved by the SEC on June 5, 2003 (effective for reports due on or after August 14, 2003) and as approved by the SEC on August 29, 2002 (applicable to earlier reports):

<table>
<thead>
<tr>
<th>NEW (for reports due on or after August 14, 2003)</th>
<th>OLD (for reports prior to reports due on or after August 14, 2003)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. I have reviewed this [specify report] of [Identify registrant].</td>
<td>Same</td>
</tr>
<tr>
<td>2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report.</td>
<td>Same</td>
</tr>
<tr>
<td>3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report.</td>
<td>Same</td>
</tr>
<tr>
<td>4. The registrant’s other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:</td>
<td>The registrant’s other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rule 13a-15 and 15d-15) for the registrant and have:</td>
</tr>
<tr>
<td>(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated Subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;</td>
<td>(a) Designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the time period in which this report is being prepared;</td>
</tr>
</tbody>
</table>
### The Post-Enron Corporate Governance Environment: Where are We Now?

<table>
<thead>
<tr>
<th>NEW (for reports due on or after August 14, 2003)</th>
<th>OLD (for reports prior to reports due on or after August 14, 2003)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;</td>
<td>No Equivalent Provisions</td>
</tr>
<tr>
<td>(c) Evaluated the effectiveness of the registrant’s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and</td>
<td>(b) Evaluated the effectiveness of the registrant’s disclosure controls and procedures as of a date within 90 days prior to the filing date of this report (the “Evaluation Date”); and</td>
</tr>
<tr>
<td>(d) Disclosed in this report any change in the registrant’s internal control over financial reporting that occurred during the registrant’s most recent fiscal quarter (the registrant’s fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant’s internal control over financial reporting.</td>
<td>(c) Presented in this report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date.</td>
</tr>
</tbody>
</table>

### 5. The registrant’s other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant’s auditors and the audit committee of the registrant’s board of directors (or persons performing the equivalent functions):

The registrant’s other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant’s auditors and the audit committee of the registrant’s board of directors (or persons performing the equivalent functions):
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(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant’s ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant’s internal control over financial reporting.

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

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant’s internal control.

The new language (in the left column above) is effective for reports due on or after August 14, 2003. However, with respect to the Section 302 certification, an extended compliance period applies to certain portions of the certification. Specifically, compliance with the portion of the introductory language in paragraph 4 of the Section 302 certification that refers to the responsibility of certifying officers for establishing and maintaining internal control over financial reporting, as well as paragraph 4(b) of the certification, will only be required (1) for “accelerated filers,” beginning with the annual report due on or after August 14, 2003.

Section III(E) of the Adopting Release states that the revised language of the Section 302 certification, as well as the new exhibit requirement, generally become effective on August 14, 2003. In addition, the Adopting Release states that the "Effective Date" of the release is August 14, 2003. However, under "Compliance Dates," the release states that a company must comply with the new certification requirements "in its quarterly, semi-annual or annual report due on or after August 14, 2003."

“[The registrant’s] other certifying officer(s) and I are responsible for establishing and maintaining . . . internal control over financial reporting . . . .” See Regulation S-K, Item 601, Exhibit 31.

“The registrant’s other certifying officer(s) and I . . . have . . . [d]esigned such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.” See Regulation S-K, Item 601, Exhibit 31.

The term "accelerated filer" means an issuer after it first meets the following conditions as of the end of its fiscal year: (i) the aggregate market value of the voting and non-voting common equity held by non-affiliates of the issuer is $75 million or more, (ii) the issuer has been subject to the requirements of Section 13(a) or 15(d) of the Act for a period of at least twelve calendar months, (iii) the issuer has filed at least one annual report pursuant to Section 13(a) or 15(d) of the Act; and (iv) the issuer is not eligible to...
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report for its first fiscal year ending on or after June 15, 2004, and (2) for other companies, including foreign private issuers, beginning with the first annual report for a fiscal year ending on or after April 15, 2005.

The Section 302 certification includes a statement that the filing "fairly presents in all material respects" the required information. The SEC believes that the "fairly presents" standard is broader than mere GAAP compliance and includes "the selection of appropriate accounting policies, proper application of appropriate accounting policies, disclosure of financial information that is informative and reasonably reflects the underlying transactions and events and the inclusion of any additional disclosure necessary to provide investors with a materially accurate and complete picture of an issuer's financial condition, results of operations and cash flows."

Officers who provide a false Section 302 certification potentially could be subject to SEC action for violating Section 13(a) or 15(d) of the Exchange Act, and to both SEC and private action for violating Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5. The SEC's August 2002 adopting release regarding Section 302 also states that a false Section 302 certification could give rise to liability under Sections 11 and 12(a)(2) of the Securities Act of 1933 in cases where a report on Forms 10-K, 20-F, 40-F or 10-Q is incorporated by reference into a registration statement on Forms S-3 or F-3 or into a prospectus filed pursuant to Securities Act Rule 424(b).7

C. Items 307 and 308(c) of Regulation S-K

Item 307 of Regulation S-K currently requires disclosures in Form 10-K and Form 10-Q which relate to the CEO and CFO certifications. This item requires disclosure of (1) the CEO's and CFO's conclusions about the effectiveness of the issuer's disclosure controls based on their evaluation as of a date within 90 days of the filing of the report and (2) whether there were any significant changes in internal controls since the most recent evaluation of the internal controls, including any corrective actions with regard to significant deficiencies and material weaknesses. Forms 20-F and 40-F were also revised to include comparable disclosures.

The disclosure requirements were amended on June 4, 2003. Beginning with reports due on or after August 14, 2003, Items 307 and 308(c) of Regulation S-K (and equivalent provisions in Forms 20-F and 40-F) require the following disclosure in annual reports and quarterly reports:


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- Registrants must disclose the conclusions of their CEO and CFO regarding the effectiveness of the disclosure controls and procedures "as of the end of the period covered by the report" (the old rule required the evaluation to be done within 90 days of the date the report was filed). While evaluations of disclosure controls and procedures must be performed on a quarterly basis, disclosure in an annual report that continues to be accurate need not be repeated in a quarterly report. Appropriate references to disclosure in annual reports along with disclosure of any material changes during the quarter would satisfy the final rules.

- Registrants must disclose any change in the registrant's internal control over financial reporting identified in connection with the quarterly evaluation that occurred during the registrant's last fiscal quarter (the fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting. Since foreign private issuers continue to be subject to a different periodic reporting regime, the comparable provisions in Forms 20-F and 40-F require only an annual evaluation in respect of changes that have occurred during the fiscal year. This rule does not explicitly require a company to disclose or otherwise elaborate on the reasons for the material changes, but the SEC's June 2003 adopting release notes that companies should use a “facts and circumstances” test to determine whether that information is necessary to make the disclosure about the change not misleading.

In its June 2003 adopting release, the SEC noted that some companies have indicated in their periodic reports that disclosure controls and procedures are designed to provide only "reasonable assurance" that the controls and procedures will meet their objectives. Although the SEC has not objected to this type of disclosure, it has requested companies that make this disclosure to state, if true, the conclusions of the principal executive and principal financial officer that the disclosure controls and procedures are, in fact, effective at the "reasonable assurance" level.

The SEC has, however, requested clarification from companies that have included disclosure that there is "no assurance" that the disclosure controls and procedures will operate effectively under all circumstances. In such cases, the SEC has requested companies to clarify that the disclosure controls and procedures are designed to provide reasonable assurance of achieving their objectives and to set forth, if true, the conclusions of the principal executive and principal financial officers that the controls and procedures are, in fact, effective at the "reasonable assurance" level.
D. The NYSE Proposed Certification Requirement

On August 16, 2002, as amended on April 4, 2003 and October 8, 2003, the NYSE proposed to require each listed company CEO to certify to the NYSE each year that he or she is not aware of any violation by the company of the NYSE's corporate governance listing standards. The NYSE would require that this certification, and any CEO/CFO certifications filed with the SEC, be disclosed in the listed company's annual report to shareholders or, if the company did not prepare an annual report to shareholders, in the company's annual report on Form 10-K. The NYSE proposal would also require each listed company CEO to promptly notify the NYSE in writing after any executive officer of the listed company became aware of any material non-compliance with any applicable provisions of the NYSE corporate governance listing standard. This proposal was published by the SEC for comment on April 11, 2003. The proposal would be effective on the earlier of (1) the company's first annual meeting after January 15, 2004 and (2) October 31, 2004.

Nasdaq's corporate governance proposals provide that an issuer is required to provide Nasdaq with prompt notification after an executive officer of the listed issuer becomes aware of any material noncompliance by the listed issuer with the qualitative listing requirements contained in Rule 4350 (which include, among other things, the majority independence, nominations committee, compensation committee and audit committee composition and charter requirements). The proposal would be effective on the earlier of (1) the company's first annual meeting after January 15, 2004 and (2) October 31, 2004. Foreign private issuers would begin to comply on July 31, 2005.

E. New York Proposed Legislation

In early 2003 New York Attorney General Eliot Spitzer proposed a bill amending New York’s Not-For-Profit Corporation Law to protect the public against financial fraud and misconduct by not-for-profit corporations incorporated in or conducting activities in New York. Among other things, the proposal includes the following provisions relating to certifications.

- Under current New York law, the board of directors of a New York not-for-profit corporation is obligated to present at the annual meeting of members an annual report including certain financial information that may be either (1) verified by the president and treasurer or by a majority of directors or (2) certified by an independent public accountant or public accounting firm selected by the board.

- Under the Attorney General's proposed legislation, the president or the chief executive officer and the treasurer or the chief financial officer of any not-for-profit corporation (except for a private foundation) with less than $3 million in assets and that receives or accrues less than $1 million in revenue and support in any fiscal year, would be required to (1) sign the
annual report; (2) verify that the signing officer has reviewed the annual report; and (3) verify that, based on the signing officer’s knowledge, the financial information included in the annual report fairly presents in all material respects the financial condition and results of operations of the corporation for the periods presented in the annual report.

- The president or chief executive officer and treasurer or chief financial officer of any not-for-profit corporation (except for a private foundation or a Type A corporation\(^8\) that is not a charitable organization or charitable trust required to register and file annual reports with the Attorney General) with at least $3 million in assets or that receives or accrues at least $1 million in gross revenue and support in any fiscal year, would be required to sign the annual report and verify that the signing officer has reviewed the annual report. In addition, the signing officer would be required to verify that, (1) based on the signing officer’s knowledge, the annual report does not contain any untrue statement of a material fact or omit a material fact; (2) based on the signing officer’s knowledge, the financial information fairly presents in all material respects the financial condition and results of operations; (3) during the period covered by the annual report, the corporation maintained internal financial controls designed to reasonably ensure that material financial information is made known to the signing officers by others within the corporation; (4) during the period covered by the annual report, the signing officers have reviewed the effectiveness of the corporation’s internal controls and the conclusions of the evaluation are set forth in the annual report; and (5) the signing officers disclosed to the auditors, if any, and the audit committee any significant deficiencies in the operation of the internal controls and any fraud that involves management or other employees who have a significant role in the corporation’s internal controls.

- The president or the chief executive officer and the treasurer or the chief financial officer of any private foundation would be required to sign the annual report and verify that the signing officer has reviewed the annual report. In addition, the signing officer would be required to verify, based on the signing officer’s knowledge, that (1) the financial information included in the annual report fairly presents in all material respects the financial condition and results of operations of the corporation; and (2) the corporation has complied in all material respects with the requirements and prohibitions that are required to be included in the certificate of incorporation of private foundations (e.g., certain provisions of the Internal Revenue Code of 1986, as amended, relating to taxes on private foundations for failure to distribute income, self-dealing, excess business holdings, investments which jeopardize charitable purpose and taxable expenditures). For purposes of this section, a “private foundation” is

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\(^8\) A Type A corporation is in general a not-for-profit corporation formed for any one or more of the following non-pecuniary purposes: civic, patriotic, political, social, fraternal, athletic, agricultural, horticultural, animal husbandry or for a professional, commercial, industrial, trade or service association.
defined as a private foundation under Section 509 of the Internal Revenue Code.

- If there is willful or persistent failure of a corporation to file a complete and accurate report, the Attorney General would be authorized to bring action for remedies as provided by law, including the removal of any directors or officers of a domestic corporation (under existing law the only other remedy is dissolution of the corporation).

- This proposal for officer verification of annual reports would not apply to religious corporations.

2. Disclosure Controls

   A. Requirement to Maintain and Evaluate Disclosure Controls

   In addition to promulgating rules mandating certification, in August 2002 the SEC also adopted new rules which require all public companies including foreign private issuers to maintain "disclosure controls and procedures" which are designed to ensure that all material information about the business flows to those individuals responsible for preparing the company's public disclosure. Disclosure controls must be maintained by any issuer that has securities registered pursuant to Section 12 of the Exchange Act or that files reports pursuant to Section 15(d) of the Exchange Act.

   The SEC's original rules required each issuer's management to evaluate the effectiveness of the disclosure controls within the 90-day period of the filing of the quarterly or annual report containing disclosure of the evaluation. However, the SEC's June 2003 amendments (effective for reports due on or after August 14, 2003) provided that management should evaluate the effectiveness of the disclosure controls "as of the end of each fiscal quarter," except that in the case of a foreign private issuer the evaluation was only required as of the end of the fiscal year. The SEC's June 2003 adopting release also stated that, while the quarterly evaluation is of the controls’ overall effectiveness, a company's management can make judgments that evaluations - especially quarterly evaluations - should focus on developments since the most recent evaluation, areas of weakness or continuing concern or other aspects that merit attention.

   In the June 2003 adopting release, the SEC acknowledged that there was substantial overlap between disclosure control procedures and a company's internal control over financial reporting. However, the SEC concluded that there are both some elements of disclosure controls that are not subsumed within internal controls, and some elements of internal controls that are not subsumed by disclosure controls. By way of example, the SEC stated that some aspects of internal controls pertaining to the accurate recording of transactions and disposition of assets or to the safeguarding of assets might not be considered by a company in designing its disclosure controls (i.e., a dual signature requirement or
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limitations on signature authority of checks to safeguard assets might be part of internal controls but not part of disclosure controls and procedures).

B. Procedures Utilized as Disclosure Controls

As with the certification requirement, the disclosure controls requirement has focused many companies on their internal disclosure processes. Many of the new rules which have been proposed or adopted in effect revolve around the need for strong disclosure controls as a mechanic for improving disclosure generally. CEO's and CFO's are required to assess their company's disclosure controls prior to the filing of every periodic report and publicly disclose the results of the evaluation. This requires the CEO and CFO to take responsibility for the disclosure and makes it more difficult for them to disclaim knowledge of their company’s disclosure. The need for strong disclosure controls is highlighted further by the new accelerated deadlines for filing Form 10-K's and Form 10-Q's, the new two-business day deadline for filing Section 16 reports, and the SEC proposals regarding disclosure on Form 8-K of a host of significant business transactions within two business days of the transaction. Significantly, the SEC's Form 8-K proposals provide a limited safe harbor for companies that develop and comply with adequate disclosure controls. The SEC has even cautioned that companies with inadequate disclosure procedures may violate the disclosure control requirements even if their disclosures are not faulty.

The SEC has not mandated or identified any specific set of disclosure controls. There is no definitive checklist prescribed by statute, rule or lore. However, among the procedures which companies have considered implementing include the following:

- Set a tone at the top: senior management must actively encourage an open environment where employees throughout the organization are comfortable asking questions and raising potential disclosure or ethical issues.
- Set up a "Disclosure Committee."
- Prepare a charter for the Disclosure Committee.
- Designate a "Disclosure Controls Monitor" (or a Chief Ethics Officer).
- Prepare written "Disclosure Guidelines" that govern all SEC filings.
- Keep the Audit Committee involved in the disclosure process.
- Prepare a detailed disclosure preparation timetable or calendar.
- Establish definitive personal responsibility for portions of filings (create a checklist which indicates who is responsible for each section of a form).
- Assign specific responsibility for reviewing "risk factor" disclosure.
- Schedule internal "drafting sessions" for the company's periodic reports.
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- Clarify the involvement of the company's outside law firm.
- Clarify the role of the company's outside auditor.
- Focus attention particularly on the MD&A.
- Consider obtaining an SSAE No. 10 attestation for the MD&A from the outside auditors.
- Assign responsibility for reviewing competitors' filings and research reports.
- Focus attention particularly on the MD&A.
- Consider obtaining an SSAE No. 10 attestation for the MD&A from the outside auditors.
- Assign responsibility for reviewing competitors' filings and research reports.
- Prepare systems for significantly enhanced "real time" SEC disclosure.
- Develop procedures for distributing draft reports to senior management.
- Obtain certifications from company personnel regarding their areas of expertise.
- Review insider trading policies in light of changes to the disclosure process.
- Document the procedures used.
- Develop procedures for real-time information flow in order to enable the company to comply with the proposed two-business-day Form 8-K filing deadline for material events.

The linchpin development may be the new "Disclosure Committee" which the SEC has recommended, but not mandated, in various releases. Companies should consider preparing a charter outlining the committee’s responsibilities and membership criteria and should ensure that committee members obtain enough information to allow them to perform their responsibilities. The committee’s principal function may be developing procedures for funneling information to the committee, considering the materiality of information and determining disclosure obligations on a timely basis. The disclosure committee could be made responsible for establishing and supervising the company’s entire disclosure process—becoming, in effect, the company’s “watchman” for public disclosures.

Possible members of a disclosure committee may include, among others, the principal accounting officer or controller, the general counsel, the principal risk management officer, the investor relations officer, and possibly business unit heads. Significant international business units may also need representation. The chair of the committee may be a member of senior management—perhaps the CFO or general counsel. For efficiency and effectiveness, it may be best to avoid a large group—what one gains from a broader representation one loses in the ability of a small group to focus expeditiously on the real issues. In any event, the smaller group would be responsible for soliciting input from other officers throughout the organization. The disclosure committee process will likely evolve over time and its personnel and procedures should therefore be periodically reviewed.

The procedures employed for preparing CEO/CFO certifications are also a part of the disclosure controls. We have recommended that, in connection with
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preparing Section 302 and Section 906 certifications, CEO’s and CFO’s should consider some or all of the following:

- Receive copies of the reports further in advance of filing than previously received.
- Receive the reports with specified supplemental information that makes their review more meaningful.
- Review differences between the report and the company’s prior periodic report.
- Discuss critical accounting matters with the company's senior accounting staff.
- Discuss trends in the business with officers responsible for key divisions.
- Meet with the company's external auditors to discuss critical accounting policies, internal control issues, and disclosure matters.
- Meet with the company's audit committee.
- Meet with the internal auditors.
- Review recent management letters from the auditors and management's responses.
- Consider obtaining sub-certifications from other company personnel.
- Confirm whether there are any outstanding SEC comments.
- Confirm the effectiveness of the company's internal and disclosure controls.
- Request that counsel or the finance team perform a "rule check."
- Review analysts research reports on the company and on competitors.
- Ensure that any due diligence investigation is documented.

3. Internal Control Report

Contents of the Annual Internal Control Report

On June 5, 2003 the SEC issued rules pursuant to Section 404 of the Sarbanes-Oxley Act requiring each company subject to the reporting requirements of the Securities Exchange Act of 1934 to include an internal control report of management in its annual report on Form 10-K, 20-F or 40-F (as applicable). Under the final rules:

- The report must include a statement of management's responsibility for establishing and maintaining adequate internal controls over financial reporting for the company.

- The report must include a statement identifying the framework used by management to evaluate the effectiveness of the company's internal control over financial reporting.
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- The report must include management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including a statement as to whether the company's internal control over financial reporting is effective. In its Adopting Release, the SEC stated that management must state affirmatively whether the company's internal control over financial reporting is effective. A “negative assurance” to the effect that “nothing has come to the attention of management suggesting that internal controls are not effective” would not be acceptable.

- The report must disclose any "material weaknesses" identified by management in the company's internal control over financial reporting. If any material weaknesses in the company's internal control over financial reporting have been identified, management may not conclude that internal control over financial reporting is effective.

- The report must confirm that the registered public accounting firm that audited the financial statements included in the company’s annual report has issued an attestation report on management's assessment of the internal control over financial reporting. The company must also file the accounting firm’s attestation report as part of its annual report.

The requirement to include an internal controls report in the annual report and to obtain an auditor's attestation of management's conclusions is subject to an extended compliance period, which is discussed in more detail below.

Framework Used by Management

The internal control report must identify the "framework" used by management to conduct the required evaluation. Although the final rules do not mandate use of a particular framework to evaluate internal control over financial reporting, management must evaluate the effectiveness of the company's internal controls using a suitable, recognized control framework that has been established by a body or group that has followed due process procedures, including the broad distribution of the framework for public comment.

The SEC states that such a framework:

- must be free from bias;

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9 The SEC adopted the definition of “material weakness” set forth in Statement on Auditing Standards No. 60. Under that standard, a "material weakness" is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by errors or fraud in amounts that would be material relative to the financial statements being audited may occur and go undetected within a timely period by employees in the normal course of performing their assigned functions.
must permit reasonably consistent qualitative and quantitative measurements of a company's internal controls;

must be sufficiently complete so that those relevant factors that would alter a conclusion about the effectiveness of a company's internal controls are not omitted; and

must be relevant to an evaluation of internal control over financial reporting.

In its adopting release, the SEC noted that the internal control standards developed by the Committee of Sponsoring Organizations (COSO) satisfy the criteria for an acceptable framework. Several commenters had urged the SEC to mandate the COSO standards as a framework for evaluating internal control over financial reporting. The SEC observed, however, that other evaluation standards exist outside of the United States and that suitable frameworks other than the COSO standards may be developed within the United States in the future. Accordingly, the SEC chose to endorse the COSO standards but not to mandate their use as the sole standard by which a company's management must evaluate its internal control over financial reporting.

In its adopting release, the SEC noted that some foreign evaluation frameworks that otherwise would satisfy its criteria for a framework to assess the effectiveness of a company's internal control over financial reporting do not require a statement of the controls' effectiveness. In such cases, the SEC observed that management would still have an obligation to state affirmatively whether or not its internal controls were effective.

COSO is a private sector organization "dedicated to improving the quality of financial reporting through business ethics, effective internal controls and corporate governance" (according to COSO's website). COSO's sponsoring organizations include the AICPA, the American Accounting Association, the Financial Executives International, the Institute of Internal Auditors and the Institute of Management Accountants. COSO's internal control standards are reflected in Internal Control-Integrated Framework (1992) and in a 1994 addendum to the Reporting to External Parties volume of the 1992 report. In summary, COSO's report states that internal controls consist of five interrelated components: a control environment, identification and analysis of risks, policies and procedures that help ensure management directives are carried out, identification and communication of pertinent information, and monitoring of the quality of the system's performance over time.

In the adopting release, the SEC stated that Guidance on Assessing Control, published by the Canadian Institute of Chartered Accountants, and the Turnbull Report, published by the Institute of Chartered Accountants in England & Wales, were examples of other suitable frameworks.
**Definition of "Internal Control"**

The final rule defines "internal control over financial reporting" as a "process designed by, or under the supervision of, the registrant's principal executive and principal financial officers, or persons performing similar functions, and effected by the registrant's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the registrant;

- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the registrant are being made only in accordance with the authorization of management and directors of the registrant; and

- Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the registrant's assets that could have a material effect on the financial statements."

In its proposing release, the SEC had proposed to define "internal controls and procedures for financial reporting" as controls pertaining to the preparation of financial statements for external purposes that are fairly presented in conformity with GAAP as addressed by Codification of Auditing Standards Section 319. Some commenters suggested that the SEC adopt instead the broad definition of internal controls included in the COSO Report, which covered financial reporting objectives, the effectiveness and efficiency of a company's operations and a company's compliance with laws and regulations. Ultimately, the SEC elected to include as its final definition of "internal controls" the elements of internal controls addressed by the COSO Report relating to financial reporting objectives, but not the broader COSO Report definition.

**Method of Evaluating**

The final rules do not prescribe specific methods or procedures to be performed in an internal controls evaluation. The SEC recognized that the methods by which each company evaluates its internal controls should be tailored to its particular needs. Nevertheless, the SEC’s adopting release indicated that management’s assessment must both evaluate the design of internal controls and test their effectiveness. Controls subject to evaluation and testing include, but are not limited to:
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- controls over initiating, recording, processing and reconciling account balances, classes of transactions and disclosure and related assertions included in the financial statements;

- controls related to the initiation and processing of non-routine and non-systematic transactions;

- controls related to the selection and application of appropriate accounting policies; and

- controls related to the prevention, identification and detection of fraud.

Although testing procedures may vary according to the company's circumstances, the adopting release states that "inquiry" by management, by itself, is not an adequate basis for management's assessment.\textsuperscript{12}

The SEC also stated that a company is required to maintain evidence, including documentation, to reasonably support management's assessment of the effectiveness of the company's internal control for financial reporting. This evidence should provide reasonable support:

- for the evaluation of whether the control is designed to prevent or detect material misstatements or omissions;

- for conclusions that tests were appropriately planned and performed; and

- that the results of the tests were appropriately considered.

\textit{Location of Internal Controls Report}

The final rules do not specify where management's internal controls report must appear within the annual report. In the adopting release, however, the SEC stated that the report should be in close proximity to the corresponding attestation report issued by the firm's registered public accounting firm. The SEC further noted its expectation that many companies would choose to place the report near the MD&A disclosure or immediately preceding the financial statements.

\textit{Auditor Independence Issues}

The SEC's adopting release acknowledged that, because the auditor must attest to management's assessment, management and the external auditor will

\textsuperscript{12} The Adopting Release notes that this statement should not be interpreted to mean that management personally must conduct the necessary activities to evaluate the design and test the operating effectiveness of the company's internal control over financial reporting. Such activities may be conducted by non-management personnel acting under the supervision of management.
need to coordinate their processes for documenting and testing internal controls. The release elaborates that auditors may assist management in documenting internal controls, but that management must be actively involved in the process and cannot delegate its responsibility to assess its internal controls to the auditor. The SEC further noted that management's mere acceptance of final responsibility for the documentation and testing performed by the auditor would not satisfy the auditor independence requirements.

Auditor's Attestation on Management's Internal Control Report

The new rules require the company to include in any annual report required by Section 13(a) or 15(d) of the Exchange Act, in addition to management's assessment of internal control over financial reporting, an attestation report from the company's registered public accounting firm on management's assessment. The SEC defines such an attestation report as a report in which a registered public accounting firm expresses an opinion, or states that an opinion cannot be expressed, concerning management's assessment of the effectiveness of the registrant's internal control over financial reporting in accordance with standards on attestation engagements. If a registered public accounting firm is unable to express such an opinion, the accounting firm must explain why not.

The attestation by a registered public accounting firm must be dated, signed manually, identify the period covered by the report and clearly state the opinion of the accountant as to whether management's assessment of the effectiveness of the registrant's internal control over financial reporting is fairly stated in all material respects (or state why such an opinion cannot be given). This attestation report may be separate from the accountant's report.

Under the Sarbanes-Oxley Act, the new Public Company Accounting Oversight Board (PCAOB) is responsible for establishing standards for the attestation reports that registered public accounting firms must provide on management's assessment of internal control over financial reporting. On October 7, 2003 the PCAOB proposed a new standard to govern the auditor's attestation reports in connection with management's assessment of the internal controls.

Requirement to Maintain and Evaluate Internal Controls

The new rules require companies with a class of securities registered pursuant to Section 12 under the Exchange Act or which file reports under Section 15(d) of the Exchange Act to maintain "internal control over financial reporting." Management must evaluate the effectiveness, as of the end of each fiscal year, of the internal controls, with the participation of the company's principal executive and financial officers, or persons performing similar functions.
Under the proposed rules, management also would have been required to evaluate the effectiveness of the company's internal controls as of the end of each quarter. In response to comments that quarterly evaluations would prove too burdensome, the final rules instead require only quarterly evaluation of changes that have materially affected, or are reasonably likely to materially affect, the company's internal control over financial reporting. The final rules also clarify that a foreign private issuer's management is only required to report these material changes in its annual report.

The requirements to maintain internal controls, evaluate the internal controls on an annual basis and evaluate changes in the internal controls on a quarterly basis are subject to the extended compliance period described below.

Timetable for Compliance with Internal Control Report Requirement

In light of the expected expense and effort that will be required in order to prepare the internal controls report, the SEC adopted an extended compliance period for the rules:

- A company that is an "accelerated filer"\(^\text{13}\) as of the end of its first fiscal year ending on or after June 15, 2004 must begin to comply with the management report on internal control over financial reporting disclosure requirements in its annual report for that fiscal year.

- Non-accelerated filers, including smaller companies, companies with no public equity and foreign private issuers, must begin to comply with the disclosure requirements in annual reports for their first fiscal year ending on or after April 15, 2005.

- A company must begin to comply with the quarterly evaluation of changes to internal control over financial reporting requirements for its first periodic report due after the first annual report that must include management's report on internal control over financial reporting.

Consistent with this extended compliance period for management's internal control report and the related attestation, and for the subsequent evaluation of changes in internal control over financial reporting, the following provisions of the new rules are subject to the extended compliance period:

\(^{13}\) The term "accelerated filer" means an issuer after it first meets the following conditions as of the end of its fiscal year: (i) the aggregate market value of the voting and non-voting common equity held by non-affiliates of the issuer is $75 million or more, (ii) the issuer has been subject to the requirements of Section 13(a) or 15(d) of the Act for a period of at least twelve calendar months, (iii) the issuer has filed at least one annual report pursuant to Section 13(a) or 15(d) of the Act, and (iv) the issuer is not eligible to use Forms 10-KSB and 10-QSB for its annual and quarterly reports.
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- The provisions of Items 308(a) and (b) of Regulations S-K and S-B and the comparable provisions of Forms 20-F and 40-F requiring management's internal control report and the related auditor attestation;

- The amendments to Rules 13a-15(a) and 15d-15(a) under the Exchange Act which require companies to maintain internal control over financial reporting; and

- The provisions of Rules 13a-15(c) and (d) and 15d-15(c) and (d) under the Exchange Act which require companies to perform annual evaluations of internal control over financial reporting and quarterly evaluations of changes thereto.

4. Off-Balance Sheet Transaction Disclosures

A. Off-Balance Sheet Disclosures

Pursuant to the Sarbanes-Oxley Act, the SEC adopted new rules with respect to disclosure of off-balance sheet arrangements in the MD&A section of SEC filings. Both domestic and foreign private issuers would have to comply with the new rules.

Required Disclosure About Off-Balance Sheet Arrangements

Under the new rules, companies must include in the MD&A a discussion of off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on the registrant's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors. Under the rules, an issuer would be required to disclose information necessary for an understanding of the off-balance sheet arrangement and its effect, including, to the extent necessary:

- the nature and business purpose of its off-balance sheet arrangement;

- the importance to the issuer of such off-balance sheet arrangements in respect of its liquidity, capital resources, market risk support, credit risk support or other benefits provided by the arrangement to the issuer;

- the amounts of revenues, expenses and cash flows of the issuer arising from such arrangements;

- the nature and amounts of any interests retained, securities issued and other indebtedness incurred by the issuer in connection with such arrangements;
the nature and amount of any other obligations or liabilities (including contingent obligations or liabilities) of the issuer arising from such arrangements that are or are reasonably likely to become material and the triggering events or circumstances that could cause them to arise; and

any known event, demand, commitment, trend or uncertainty that will result in or is reasonably likely to result in the termination, or material reduction in availability to the issuer, of its off-balance sheet arrangements that provide material benefits to it, and the course of action that the issuer has taken or proposes to take in response to such circumstances. For example, an issuer must disclose any material contractual provisions that result in the termination or material reduction of an off-balance sheet arrangement.

In addition, an issuer must provide any other information that it believes to be necessary for an understanding of its off-balance sheet arrangements and the material effects of these arrangements on the issuer’s financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.14

**Definition of Off-Balance Sheet Arrangements**

The SEC's definition of "off-balance sheet arrangement" is narrower in the final rules than in the proposed rule. The SEC's final rules define the term "off-balance sheet arrangement" as any transaction, agreement or other contractual arrangement to which an entity that is not consolidated with the issuer is a party, under which the issuer has:

- any obligation under certain guarantee contracts identified in paragraph 3 of FASB Interpretation No. 45 (November 2002) (including standby letters of credit, guarantees of stock prices, guarantees of the collection of scheduled contractual cash flows from individual financial assets, performance guarantees, agreements to indemnify based on changes relating to assets, liabilities or equity securities of the indemnified party and keepwell agreements);

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14 The rules instruct issuers to aggregate off-balance sheet arrangements in groups or categories that provide information in an efficient and understandable manner and avoid repetition and disclosure of immaterial information. Issuers must analyze common or similar effects that may result from a number of different off-balance sheet arrangements in the aggregate to the extent that the aggregation increases understanding of the arrangements. For example, if particular triggering events or circumstances (such as a change of control or ratings decline) would either require an issuer to become directly obligated, or accelerate its obligations, under a number of off-balance sheet arrangements, and the overall obligations would be material, then the final rules require an analysis of the circumstances and their aggregate effect to the extent it increases understanding of the issuer’s off-balance sheet arrangements.
• a retained or contingent interest in assets transferred to an unconsolidated
title or similar arrangement that serves as credit, liquidity or market risk
support to that entity for such assets;
• any obligation, including a contingent obligation, under a contract that
would be accounted for as a derivative instrument, except that it is both
indexed to the registrant's own stock and classified in stockholders' equity
in the registrant's statement of financial position, and therefore excluded
from the scope of FASB Statement of Financial Accounting Standards No.
133 (June 1998) pursuant to paragraph 11(a) of that Statement; or
• any obligation (including contingent obligations) arising out of a variable
interest (as referenced in FASB Interpretation No. 45) (January 2003) in
an unconsolidated entity that is held by and material to the issuer, where
the unconsolidated entity provides financing, liquidity, market risk or
credit risk support to, or engages in leasing, hedging or research and
development services with, the issuer.15

The final rules include an instruction to make it clear that contingent
liabilities arising out of litigation, arbitration or regulatory actions are not treated
as off-balance sheet arrangements. The rules also include an instruction that no
obligation to make disclosure of an off-balance sheet arrangement shall arise until
an unconditionally binding definitive agreement, subject only to customary
closing conditions, exists or, if there is no such agreement, until settlement of the
transactions occurs.

Disclosure Threshold for Off-Balance Sheet Arrangements

The rules require the disclosure of off-balance sheet arrangements that
"have or are reasonably likely to have" a current or future effect on the issuer’s
financial condition, changes in financial condition, revenues or expenses, results
of operations, liquidity, capital expenditures or capital resources that is material to
investors.

Under the SEC’s 1989 Interpretive Release on MD&A disclosure,
"reasonably likely" is the existing disclosure threshold under which information
that could have a material effect on financial condition, changes in financial
condition or results of operations must be included in the MD&A. In the
proposed rules, the SEC stated that it interpreted the language of Section 401(a) of
the Sarbanes-Oxley Act to require the SEC to mandate a standard for disclosure
of off-balance sheet items more stringent than the "reasonably likely" standard.
Accordingly, the proposed rules would have required disclosure of off-balance

15 The proposed definition of "off-balance sheet arrangement" was much broader and
included (1) any obligation under a direct or indirect guarantee, (2) a retained or
contingent interest in assets transferred to an unconsolidated entity, (3) derivatives to the
extent the fair value thereof is not fully reflected as a liability or asset in the financial
statements, or (4) any obligation or liability to the extent it is not fully reflected in the
financial statements. The SEC significantly narrowed the definition in response to many
comment letters.
sheet arrangements that "may" have a material current or future effect where management concluded that the likelihood of the occurrence of a future event and its material effect on the issuer is **higher than remote**. In response to comments, the SEC backed away from this proposal and adopted for off-balance sheet arrangement disclosures the "reasonably likely" disclosure threshold that currently applies to other portions of the MD&A.\(^{16}\)

**Separate Disclosure Section**

The rules require an issuer to present the disclosure of off-balance sheet arrangements set apart in a separately-captioned section of the MD&A. To eliminate unnecessary repetition, issuers are allowed to include within their MD&A section a cross-reference to information in the footnotes to the financial statements. The cross-reference must clearly identify specific information in the footnotes and must integrate the substance of those footnotes into the MD&A discussion in a manner designed to inform the reader of the significance of the information that is not included within the body of the MD&A.

The disclosure regarding off-balance sheet arrangements is required in each issuer’s disclosure document that contains an MD&A, including annual reports on Form 10-K, Form 20-F and Form 40-F, quarterly reports on Form 10-Q (to the extent there have been changes since the fiscal year end), registration statements on Forms S-1, S-2, S-3, S-4, F-1, F-2, F-3 and F-4 and proxy or information statements which require MD&A. The Sarbanes-Oxley Act had only required the disclosure to be included in annual and quarterly reports.

**Foreign Private Issuers**

The SEC’s requirements regarding disclosure of off-balance sheet arrangements apply to foreign private issuers that file annual reports on Forms 20-F and 40-F in the same manner as they apply to U.S. domestic issuers. The new MD&A rules also apply to registration statements filed by foreign private issuers on Forms F-1, F-2, F-3 and F-4, as such forms reference the Form 20-F disclosure requirements, but do not apply to registration statements filed by Canadian issuers under the Multi-Jurisdictional Disclosure System (or MJDS). These rules do not apply to Form 6-K reports submitted by foreign private issuers.

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\(^{16}\) To apply this disclosure threshold, management must assess the likelihood of the occurrence of any known trend, demand, commitment, event or uncertainty that could affect an off-balance sheet arrangement (e.g. performance under a guarantee, an obligation under a variable interest or equity linked derivative instrument, or recognition of an impairment). If management concludes that the known trend, demand, commitment, event or uncertainty is not reasonably likely to occur, then no disclosure is required in the MD&A. If management cannot make that determination, it must objectively evaluate the consequences of the known trend, demand, commitment, event or uncertainty on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the issuer’s financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources is not reasonably likely to occur.
Several items in the definition of "off-balance sheet" arrangements refer to U.S. GAAP. In general, a foreign private issuer’s MD&A disclosure should focus on its primary financial statements and include a discussion of the reconciliation to U.S. GAAP if it is necessary for an understanding of the financial statements as a whole. However, to identify the types of arrangements that are subject to disclosure under the rules as adopted, a foreign private issuer must assess its guarantee contracts and variable interests pursuant to U.S. GAAP.

**Compliance Deadline**

Issuers must comply with the off-balance sheet arrangement disclosure requirements in registration statements, annual reports and quarterly reports and proxy or information statements that are required to include financial statements for their fiscal years ending on or after June 15, 2003. Based on a conversation with the SEC staff, companies with calendar year fiscal years are not required to include the off-balance sheet arrangement disclosure in their Form 10-Qs for the quarters ending June 30, 2003 or September 30, 2003, but will be required to include the disclosures in their Form 10-Ks for the year ending December 31, 2003 and in quarterly reports thereafter.

**B. Contractual Obligations Disclosures**

The SEC also adopted new rules requiring disclosure of contractual obligations in tabular format in the MD&A. Prior SEC releases had recommended but not required use of this type of table. The table must disclose, as of the end of the latest fiscal year, information in each of the following categories: (1) long-term debt obligations, (2) capital lease obligations, (3) operating lease obligations, (4) purchase obligations, and (5) other long-term debt liabilities reflected on the company’s balance sheet under GAAP.17

The table must show, aggregated by category of obligations, payments due in at least the following time periods: total, less than one year, one to three years, three to five years and more than five years. To provide some flexibility, the

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17 For purposes of the new requirements, (1) "long-term debt obligation" means a payment obligation under long-term borrowings referenced in FASB Statement of Financial Accounting Standards No. 47, Disclosure of Long-Term Obligations (March 1981), as may be modified or supplemented; (2) "capital lease obligation" means a payment obligation under a lease classified as a capital lease pursuant to FASB Statement of Financial Accounting Standards No. 13, Accounting for Leases (November 1976), as may be modified or supplemented; (3) "operating lease obligation" means a payment obligation under a lease classified as an operating lease and disclosed pursuant to FASB Statement of Financial Accounting Standards No. 13, Accounting for Leases (November 1976), as may be modified or supplemented; and (4) "purchase obligation" means an agreement to purchase goods or services that is enforceable and legally binding on the registrant that specifies all significant terms, including: fixed or minimum quantities to be purchased; fixed, minimum or variable price provisions; and the approximate timing of the transaction.
specific categories of obligations can be disaggregated using categories more suitable to the issuer’s particular business, but all of the obligations that fall under the categories specified by the rule must be included. The tabular presentation may be accompanied by footnotes, if necessary for an understanding of the timing and amount of the issuer’s obligations.

Both domestic and foreign private issuers must include the table of contractual obligations in registration statements, annual reports and proxy or information statements that are required to include financial statements for fiscal years ending on or after December 15, 2003. The full tabular presentation is not required in quarterly reports, where disclosure of material changes to the previously disclosed tabular information outside the ordinary course of business is sufficient.

C. Forward-Looking Statements

The SEC's new rules provide that the safe harbors provided in Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 apply to forward-looking information provided as part of the off-balance sheet arrangement and contractual obligation disclosures. The safe harbors apply so long as the disclosure is made by an issuer, a person acting on behalf of the issuer, an outside reviewer retained by the issuer making a statement on behalf of the issuer, or an underwriter, with respect to information provided by the issuer or information derived from information provided by the issuer.

The SEC rules also clarify that all information required by the off-balance sheet and contractual obligation disclosure requirements is deemed to be a "forward looking statement" under the statutory safe harbors, except for historical facts. In addition, with respect to the off-balance sheet disclosures, the meaningful cautionary statements element of the statutory safe harbors will be deemed satisfied if a registrant satisfies all requirements of the off-balance sheet disclosure rule.

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18 In general, the safe harbors included in Section 27A and 21E provide that, in any private action based on an untrue statement of a material fact or omission of a material fact necessary to make the statements not misleading, a company will not be liable with respect to any forward-looking statement, whether written or oral, if (1) the forward-looking statement is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially, or (2) the forward-looking statement is immaterial, or (3) the plaintiff fails to prove that the forward-looking statement if made by a natural person was made with actual knowledge that it was false or misleading and if made by a business entity was made by or with approval of an executive officer and made or approved with actual knowledge by that officer that the statement was false or misleading.
Section 5. Non-GAAP Financial Measure Disclosures

A. Regulation G

Pursuant to the Sarbanes-Oxley Act, the SEC adopted new rules which regulate the use of "non-GAAP financial measures" such as EBITDA, "adjusted" data or earnings before "non-recurring charges." These rules build on the SEC's December 4, 2001 cautionary advice and many of the best practices recommended by the National Investors Relations Institute in April 2001. The effective date of these rules was March 28, 2003. Accordingly, Regulation G applies to all disclosures and press releases issued after March 28, 2003.19

Required disclosure accompanying non-GAAP financial measures

Regulation G applies whenever an issuer, or a person acting on behalf of an issuer, publicly discloses material information that includes a non-GAAP financial measure. This includes information disclosed, for example, in a press release or an earnings conference call. Any entity that has a class of securities registered under Section 12 or that is required to file reports pursuant to Section 15(d) of the Exchange Act, including foreign private issuers (but excluding registered investment companies), is required to comply with Regulation G.20

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19 On June 13, 2003 the SEC issued "Frequently Asked Questions Regarding the Use of Non-GAAP Financial Measures." Some of the matters discussed include transition issues. For example, if a registration statement is filed after March 28, 2003 but incorporates by reference a Form 10-K or 10-Q filed before March 28, 2003, the registration statement must comply with Regulation G by either (1) amending the periodic report, (2) adding appropriate disclosure into the registration statement or (3) adding appropriate disclosure into a Form 8-K. However, the SEC stated that it would not object where a registration statement on Form S-8 filed after March 28, 2003 did not include the required reconciliation of non-GAAP financial measures included in a document filed before March 28, 2003 and incorporated by reference into that Form S-8. In addition, if a company filed a Securities Act registration statement (which contained non-GAAP financial measures) before March 28, 2003, and amended it after March 28, 2003, the SEC said that the non-GAAP measure need not comply with Regulation G, but any non-GAAP financial measure added to, revised, amended or updated directly in the amendment must comply with Regulation G, and in any event the issuer needs to consider whether its disclosure is misleading if it does not comply with Regulation G, particularly where a non-GAAP financial measure is the same as, or similar to, a non-GAAP financial measure that is in the registration statement and subject to Regulation G. In its June 13, 2003 frequently asked questions on Regulation G, the SEC noted that Regulation G technically would not apply to voluntary filers. A voluntary filer is an issuer of debt securities whose obligation to file reports has been statutorily suspended under Section 15(d) of the Exchange Act but which continues to file periodic reports with the SEC due to indenture covenants. The SEC said that the application of Regulation G to voluntary filers "presents a difficult dilemma, as those companies technically are not subject to Regulation G but their continued filing is intended to and does give the appearance that they are a public company whose disclosure is subject to the Commission's regulations." The SEC concluded that while Regulation G technically does not apply to voluntary filers, the failure of a voluntary filer to comply with all
Regulation G requires an issuer to disclose together with any non-GAAP financial measure (1) a presentation of the most directly comparable financial measure calculated and presented in accordance with GAAP and (2) a reconciliation (by schedule or other clearly understandable method), which must be quantitative for historic non-GAAP measures, and quantitative, to the extent available without unreasonable efforts, for forward-looking information, of the differences between the non-GAAP financial measure disclosed or released with the most directly comparable financial measure or measures calculated and presented in accordance with GAAP. If the reconciliation to the most directly comparable financial measure calculated and presented according to GAAP is not available for a forward-looking non-GAAP financial measure, an issuer must disclose that fact, explain why it is not available on a forward-looking basis and provide any reconciling information that is available without an unreasonable effort. The issuer must identify any information that is unavailable and disclose its probable significance.

Regulation G also provides that a non-GAAP financial measure, taken together with the accompanying information, may not contain an untrue statement of a material fact or omit to state a material fact necessary to make the presentation of the non-GAAP financial measure not misleading, in light of the circumstances under which it is presented.

**Definition of non-GAAP financial measure**

Regulation G defines a non-GAAP financial measure as a numerical measure of an issuer's historical or future financial performance, financial position or cash flow that:

- excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the most directly comparable measure calculated and presented in accordance with GAAP in the statement of income, balance sheet or statement of cash flows (or equivalent statements) of the issuer; or

- includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable measure calculated and presented in accordance with GAAP.

Non-GAAP financial measures include all numerical measures of historical or future performance, financial position or cash flows that have the effect of being different from the measures calculated in accordance with GAAP. Examples of non-GAAP financial measures include (1) a measure of operating income that excludes one or more expense or revenue items that are identified as "non-recurring," (2) EBITDA (earnings before interest, taxes, depreciation and
amortization), which could be calculated using elements derived from GAAP financial presentations but, in any event, is not presented in accordance with GAAP, and (3) a ratio, with either one or both of the components calculated other than in accordance with GAAP.

Non-GAAP financial measures do not include financial information that does not have the effect of providing numerical measures that are different from the comparable GAAP measures, e.g., (1) operating and other statistical measures (such as unit sales, numbers of employees, numbers of subscribers or numbers of advertisers) and (2) ratios or statistical measures that are calculated using only one or both of (a) financial measures calculated in accordance with GAAP or (b) operating measures or other measures that are not non-GAAP financial measures.21

**Business combination transactions**

As proposed, Regulation G would have applied to disclosures of non-GAAP financial measures in connection with business combination transactions. After consideration of relevant comments, the SEC added to Regulation G an exception for non-GAAP financial measures included in disclosure relating to a proposed business combination transaction, the entity resulting from the business combination transaction or an entity that is a party to the business combination transaction if the disclosure is contained in a communication that is subject to the SEC's communications rules applicable to business combination transactions (e.g., Exchange Act Rules 14a-12 and 14d-2(b)(2), Securities Act Rule 425 and Item 1015 of Regulation M-A).

**Foreign private issuers**

Regulation G applies to foreign private issuers. However, the SEC included a significant exemption that will permit many foreign private issuers to use press releases and other information without being subject to Regulation G. A foreign private issuer is exempted if (1) the securities of the issuer are listed or quoted on a securities exchange or inter-dealer quotation system outside the United States, (2) the non-GAAP financial measure is not derived from or based on a measure calculated and presented in accordance with U.S. GAAP, and (3) the disclosure is made by or on behalf of the issuer outside the United States, or is

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21 Other examples of financial measures to which Regulation G does not apply include (1) disclosure of amounts of expected indebtedness, including contracted and anticipated amounts, (2) disclosures of amounts of repayments that have been planned or decided upon but not yet made, (3) disclosures of estimated revenues or expenses of a new product line, so long as such amounts were estimated in the same manner as would be computed under GAAP, (4) measures of profit or loss and total assets for each segment required to be disclosed in accordance with GAAP, and (5) ratios and measures calculated in accordance with GAAP, such as sales per square foot (with sales figure calculated in accordance with GAAP) or same store sales (with sales figures calculated in accordance with GAAP).
The SEC clarified in its adopting release that this exemption applies even where any one or more of the following circumstances are present: (1) a written communication is released in the United States as well as outside the United States, so long as the communication is released in the United States contemporaneously with or after the release outside the United States and is not otherwise targeted at persons located in the United States, (2) foreign journalists, U.S. journalists or other third parties have access to the information, (3) the information appears on one or more web sites maintained by the issuer, so long as the web sites, taken together, are not available exclusively to, or targeted at, persons located in the United States, or (4) following the disclosure or release of the information outside the United States, the information is included in a submission to the SEC on Form 6-K.

For purposes of Regulation G, GAAP refers to generally accepted accounting principles in the United States. As adopted, Regulation G provides that, in the case of foreign private issuers whose primary financial statements are prepared in accordance with non-U.S. generally accepted accounting principles, GAAP refers to the principles under which those primary financial statements are prepared. In the case of foreign private issuers that include a non-GAAP financial measure derived from a measure calculated in accordance with U.S. generally accepted accounting principles, GAAP refers to U.S. generally accepted accounting principles for purposes of the application of the requirements of Regulation G to the disclosure of that measure.

B. SEC Filings

The SEC also amended Regulation S-K to impose requirements regarding the use of non-GAAP financial measures in SEC filings. While Regulation G applies to every disclosure of non-GAAP financial measures, the new Regulation S-K requirement applies only to non-GAAP financial measures disclosed in SEC filings. The Regulation S-K amendments also apply to foreign private issuers when filing Form 20-Fs (but filers on Form 40-F are not subject to these requirements).

The Regulation S-K requirements are similar to, but tougher than, those in Regulation G. The amendments to Regulation S-K provide that issuers using non-GAAP financial measures in SEC filings must include:

- a presentation, with equal or greater prominence, of the most directly comparable financial measure calculated and presented in accordance with GAAP (Regulation G lacks the "equal or greater prominence" requirement);
• a reconciliation (by schedule or other clearly understandable method), which shall be quantitative for historic non-GAAP measures presented, and quantitative, to the extent available without unreasonable efforts, for forward-looking information, of the differences between the non-GAAP financial measure disclosed or released with the most directly comparable measure or measures calculated and presented in accordance with GAAP;

• a statement disclosing the reasons why the issuer's management believes that presentation of the non-GAAP financial measures provides useful information to investors regarding the issuer's financial condition and results of operations (this is not included in Regulation G);\(^\text{22}\) and

• to the extent material, a statement disclosing the additional purposes, if any, for which the issuer's management uses the non-GAAP financial measures (this is not included in Regulation G).

In addition to the mandated disclosure requirements, the SEC amended Item 10 of Regulation S-K to **prohibit** the use of certain kinds of non-GAAP financial measures either generally or in specified contexts. The prohibitions cover the following:

• excluding from non-GAAP liquidity measures (other than EBIT and EBITDA) charges or liabilities that required, or will require, cash settlement, or would have required cash settlement absent an ability to settle in another manner;\(^\text{23}\)

• adjusting a non-GAAP performance measure to eliminate or smooth items identified as non-recurring, infrequent or unusual, when (1) the nature of the charge or gain is such that it is reasonably likely to recur within two years or (2) there was a similar charge or gain within the prior two years (unfortunately, the determination of whether something should have been deemed to be reasonably likely to recur is often made in hindsight a number of years after the original disclosure);\(^\text{24}\)

\(^{22}\) With regard to the issuer's statement as to why management believes the non-GAAP financial measure provides useful information to investors, the SEC stated that the fact that the non-GAAP financial measure is used by or useful to analysts cannot be the sole support for presenting the non-GAAP financial measure. Rather, the justification for the use of the measure must be substantive.

\(^{23}\) In the June 13, 2003 frequently asked questions, the SEC said that the "Adjusted EBITDA" measure would be permitted where the credit agreement contains a material covenant utilizing Adjusted EBITDA. The SEC said that disclosure of the covenant may be misleading absent a discussion of the materiality of the credit agreement and the covenant, the amount or limit required for compliance with the covenant, and the actual or reasonably likely effects of compliance with the covenant on the company’s financial condition and liquidity.

\(^{24}\) In its June 13, 2003 frequently asked questions on Regulation G, with respect to the possibility of eliminating or smoothing items that are identified as "recurring," the SEC
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- presenting non-GAAP financial measures on the face of the issuer’s financial statements prepared in accordance with GAAP or in the accompanying notes;

- presenting non-GAAP financial measures on the face of any pro forma financial information required to be disclosed by Article 11 of Regulation S-X (the rule does not say "or in the accompanying notes"); and

- using titles or descriptions of non-GAAP financial measures that are the same as, or confusingly similar to, titles or descriptions used for GAAP financial measures.

A non-GAAP financial measure that would otherwise be prohibited in an SEC filing is permitted in a Form 20-F filing of a foreign private issuer if the measure is required or expressly permitted by the standard-setter that is responsible for establishing the GAAP used in those financial statements and is included in the issuer’s annual report or financial statements used in its home country jurisdiction or for distribution to its security holders. However, the SEC noted in the adopting release that this exception is intended to cover only situations where the foreign standard-setter affirmatively acts to require or permit the measure, and not situations where the measure was merely not prohibited.25

The amendments to Item 10 of Regulation S-K and Form 20-F apply to any annual or quarterly report filed with respect to a fiscal period ending after March 28, 2003.

C. Non-GAAP Financial Measures in Earnings Releases

In addition to Regulation G and the amended disclosure requirements for filings of periodic (annual and quarterly) reports with the SEC, the SEC added

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25 In its June 13, 2003 frequently asked questions on Regulation G, the SEC clarified that a measure is "expressly permitted" if the particular measure is clearly and specifically identified as an acceptable measure by the standard setter that is responsible for establishing GAAP used in the company's primary financial statements. Where non-U.S. GAAP standard setters permit or require subtotals in financial statements that are not calculated consistently with those required or permitted by U.S. GAAP, or specify a minimum level of caption detail for financial statement presentation, the "expressly permitted" condition is not intended to prohibit inclusion of those subtotals or those captions.
Item 12 to Form 8-K to cover earnings releases. The specific requirements of Item 12 of Form 8-K are described further below. If non-GAAP financial measures are included in an earnings release, however, issuers will need to comply with Regulation G as well as the Form 8-K requirements. In addition to Regulation G, Item 12 of Form 8-K requires disclosure of the following:

- a presentation, with equal or greater prominence, of the most directly comparable financial measure calculated and presented in accordance with GAAP;

- a statement disclosing the reasons why the issuer's management believes that presentation of the non-GAAP financial measures provides useful information to investors regarding the issuer's financial condition and results of operations; and

- to the extent material, a statement disclosing the additional purposes, if any, for which the issuer's management uses the non-GAAP financial measures.

Issuers can satisfy these additional requirements by including the disclosure either in the Form 8-K or in the release or announcement that is included as an exhibit to the Form 8-K. Issuers can also satisfy these additional requirements by including the disclosure in their most recent annual report filed with the SEC (or a more recent filing) and by updating those statements, as necessary, no later than the time the Form 8-K is furnished to the SEC.

The Form 8-K requirement does not apply to foreign private issuers that utilize Form 6-K rather than Form 8-K. However, such foreign private issuers would still have to file any material information publicly released in their home jurisdiction under cover of Form 6-K.

6. Real Time Issuer Disclosures

A. The Sarbanes-Oxley Act Provision

The Sarbanes-Oxley Act provides that each issuer must disclose to the public on a "rapid and current basis" such additional information concerning material changes as the SEC determines by rule is necessary or useful for the protection of investors and in the public interest.

This provision codified the SEC's authority to require issuers to provide more real-time disclosure and reflects a growing trend toward more immediate disclosure. The SEC has already adopted rules which (1) require earnings releases to be filed within five business days of their public release, (2) require waivers of ethics codes to be disclosed within five business days of the waiver and (3) generally require notices of individual account plan blackout periods to be filed within five business days after the receipt of notice of the blackout period. The SEC also currently has outstanding proposals which would (1) require additional items to be filed on Form 8-K within 2 business days of the event, (2) require disclosure of 10b5-1(c) plan information and permitted insider loans
within two business days of the event, and (3) require companies to disclose certain notices from attorneys within two business days of receipt.

B. SEC Form 8-K Proposal

On June 17, 2002, prior to the adoption of the Sarbanes-Oxley Act, the SEC proposed a substantial revision and expansion of Form 8-K. Significantly, virtually all Forms 8-K would have to be filed within two business days of the event being reported, rather than the current five business days or 15 calendar days for most items. Overall, as originally proposed, the following 15 items would be added as required 8-K disclosures:

- Entry into a material agreement
- Termination of a material agreement
- Termination or reduction of a business relationship with a customer which results in lost revenue of 10% or more of the company's revenue
- Creation of a direct or contingent financial obligation that is material to the issuer
- Events triggering a direct or contingent financial obligation that is material
- Exit activities including material write-offs and restructuring charges
- Material impairments
- Rating agency decisions
- Notice of delisting or failure to satisfy listing standards
- Unregistered sales of equity securities (moved from Form 10-Q)
- Material modifications to rights of security holders (moved from Form 10-Q)
- Non-reliance on previously issued financial statements or a related audit report
- Departure of directors or principal officers; election of directors; appointment of principal officers (expansion of existing item)
- Amendments to charter or bylaws; changes in fiscal year (expansion of existing item)
- Material events regarding the issuer's employee benefit, retirement and stock ownership plans (this may be superseded by the addition of Item 11 to Form 8-K which requires disclosure of pension fund blackout periods)

The SEC proposed a “good faith” safe harbor for companies that could not timely file a required Form 8-K. As proposed, a company would not be liable under Sections 13 and 15(d) for failure to file a Form 8-K if (1) the company maintained “sufficient procedures” to provide reasonable assurances that the company is able to collect, process and disclose the information required to be disclosed on Form 8-K, (2) no officer, employee or agent of the company knew, or was reckless in not knowing, that a Form 8-K was required, and (3) once an
executive officer of the company became aware of the company's failure to file, it promptly (and no later than two business days after becoming aware of the failure to file) filed the required Form 8-K with the SEC containing the required information and stating the date on which the form should have been filed. The proposing release notes that part of the company’s procedures might be a disclosure committee that oversees the collection of information for the company’s periodic reporting. The safe harbor as proposed would not preserve the company's Form S-3 eligibility upon the failure to file a Form 8-K in a timely manner.

In addition, the SEC proposed to allow companies to use Form 12b-25 to extend the deadline of a Form 8-K. Currently Form 12b-25 can only be used to extend the filing deadline for Forms 10-K, 20-F, 10-Q and 11-K. As proposed, in the event a company could not file a Form 8-K within the required two-business-day time period, a company would be permitted to file a Form 12b-25 no later than the first business day after the date the Form 8-K is due, describing the reasons for the inability to timely file “without unreasonable effort or expense” and the item numbers to be covered by the Form 8-K. The Form 12b-25 would be public when filed and available on the SEC’s website. The Form 8-K would be deemed timely filed so long as it was filed within two business days of the date such form was originally due. This would protect the company’s eligibility to use Form S-3. In effect, the Form 8-K ultimate deadline would become four business days.

The comment period on the SEC's Form 8-K proposal expired on August 26, 2002. The SEC received significant comments on the proposal, many of them critical. The SEC has not yet taken formal action with respect to the proposal. However, once it is adopted, companies will need to review their internal procedures to make sure necessary information is directed in real time (including before the transaction or event happens) to company personnel responsible for SEC reporting so that companies can satisfy the two-business-day requirement. Depending on what gets adopted, many companies will likely need to improve their internal flow of information to enable them to comply, particularly considering that some disclosure items could result from a series of transactions occurring throughout the organization (such as the reduction of a business relationship with a key customer) as opposed to a large transaction being overseen at corporate headquarters.

C. 10b5-1(c) Plans and Insider Loans

In addition to the June 2002 Form 8-K proposal, on April 12, 2002 the SEC issued a proposal which would require the disclosure of three additional matters on Form 8-K: (1) each director's and executive officer's transactions in company equity securities; (2) each director's and executive officer's adoption, modification or termination of a contract, instruction or written plan for the purchase or sale of company equity securities intended to satisfy the affirmative defense condition of Rule 10b5-1(c); and (3) loans and loan guarantees made by
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a company or an affiliate of the company for the benefit of any director or executive officer. On August 6, 2002, the SEC announced that it would no longer pursue the portion of its April 2002 proposal that dealt with insider equity transactions (clause (1) above) but that it was still considering amendments that would require Form 8-K disclosure of information about 10b5-1(c) plans and insider loans not prohibited by the Sarbanes-Oxley Act. The SEC has not yet taken formal action with respect to this proposal.

D. Earnings Releases

In connection with the adoption of Regulation G, the SEC adopted Item 12 of Form 8-K, entitled "Disclosure of Results of Operations and Financial Condition." Item 12 requires issuers to "furnish" to the SEC a Form 8-K within five business days of any public announcement or release disclosing material non-public information regarding an issuer’s historical results of operations or financial condition for a completed annual or quarterly fiscal period. The original proposal had been two business days. This rule applies regardless of whether the release or announcement includes disclosure of a non-GAAP financial measure. Item 12 requires the issuer to identify briefly the announcement or release and include the announcement or release as an exhibit to the Form 8-K.

The requirement to furnish a Form 8-K under Item 12 does not apply to issuers that make historical earnings announcements and disclosures only in their quarterly reports filed with the SEC on Form 10-Q or their annual reports filed with the SEC on Form 10-K. Item 12 does not require that companies issue earnings releases or similar announcements, but if an earnings release is issued it would have to be filed on a Form 8-K. Earnings guidance about a current or future period is not be required to be reported on Form 8-K so long as it is not part of a release about a historical period.

Repetition of information that was previously publicly disclosed or release of the same information in a different form does not trigger the Form 8-K requirement. However, release of additional or updated material non-public information regarding the issuer’s results of operations or financial condition for a completed fiscal year or quarter will trigger an additional filing requirement. Issuers that make earnings announcements or other disclosures of material non-public information regarding a completed fiscal year or quarter in an interim or annual report to shareholders are permitted to specify which portion of the report contains the information required to be filed.

Earnings releases and similar disclosures that trigger the requirements of Item 12 are subject to Regulation FD. The application of Item 12 differs from Regulation FD, however, in that the requirements of Item 12 would always implicate Form 8-K for those disclosures, while Regulation FD provides that Form 8-K is an alternative means of satisfying its requirements. Further, a Form 8-K furnished to the SEC pursuant to Item 12 would satisfy an issuer’s obligation under Regulation FD only if the Form 8-K were furnished to the SEC within the time frame required by Regulation FD. Also, Regulation FD could be satisfied by
public disclosure other than through the filing of a Form 8-K meeting Regulation FD’s requirements. In such cases, Item 12 would require that a Form 8-K be furnished to the SEC within the five business day timeframe of Item 12. A Form 8-K furnished within the timeframe required by Regulation FD and otherwise satisfying the requirements of both Item 9 (applicable to filings made to satisfy Regulation FD) and Item 12 could be furnished to the SEC once, indicating that it is being furnished under both Item 9 and Item 12, and satisfy both requirements.

If non-public information is disclosed orally, telephonically, by webcast, by broadcast or by similar means in a presentation that is complementary to, and initially occurs within 48 hours after, a related written release or announcement that triggers the requirements of Item 12, an issuer is not required to furnish an additional Form 8-K if:

- the related written release or announcement has been furnished to the SEC on Form 8-K pursuant to Item 12 prior to the presentation;\(^{26}\)
- the presentation is broadly accessible to the public by dial-in conference call, by webcast, by broadcast or by similar means;
- the financial and statistical information contained in the presentation is provided on the issuer’s website, together with any information related to non-GAAP financial matters that would be required under Regulation G;\(^{27}\) and
- the presentation was announced by a widely disseminated press release that included instructions as to when and how to access the presentation and the location on the issuer’s website where the information would be available.

The Form 8-K filing requirement applies only to publicly disclosed or released material non-public information concerning an annual or quarterly fiscal period that has ended. Item 12 does not apply to public disclosure of earnings estimates for future or ongoing fiscal periods, unless those estimates are included in the public announcement or release of material non-public information regarding an annual or quarterly fiscal period that has ended.

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\(^{26}\) As the deadline for furnishing the Form 8-K to the SEC is five business days, this exception is available only to issuers that furnish that Form 8-K to the SEC in advance of the deadline specified in Item 12.

\(^{27}\) In its June 13, 2003 frequently asked questions on Regulation G, the SEC stated that an audio file of the initial webcast would satisfy this condition, provided that (1) the audit file contains all material financial and other statistical information included in the presentation that was not previously disclosed and (2) investors can access it and replay it through the company’s website. Alternatively, slides or a similar presentation posted on the website at the time of the presentation containing the required, previously undisclosed, material financial and other statistical information would satisfy the condition.
One significant change to the final rules relates to the status of the earnings press releases when submitted to the SEC on Form 8-Ks. After considering the comments to its proposed rules, the SEC adopted Item 12 to require that earnings releases or similar disclosures be "furnished" to the SEC rather than "filed" (as proposed). The most significant implications of "furnishing" rather than "filing" a Form 8-K to the SEC are:

- information that is "furnished" to the SEC is not considered "filed" for purposes of liability under Section 18 of the Securities Exchange Act of 1934, as amended, unless the issuer specifically states that the information is to be considered "filed";

- information that is "furnished" to the SEC is not incorporated by reference into a registration statement, proxy statement or other report (including Form S-8s) unless the issuer specifically incorporates that information into those documents by reference; and

- information that is "filed" with the SEC is subject to the requirements of amended Item 10 of Regulation S-K (Item 10 includes rules governing non-GAAP financial measures) whereas information that is "furnished" is not subject to most of the requirements of amended Item 10 of Regulation S-K.

The requirement to furnish earnings releases and similar materials to the SEC on Form 8-K applies to any releases or announcements made after March 28, 2003. Foreign private issuers that utilize Form 6-K rather than Form 8-K are not subject to these requirements.

E. Waivers of Code of Ethics

The SEC adopted new rules regarding (1) disclosure in annual reports of whether a company has a code of ethics for its senior financial officers and chief executive officer and (2) disclosures of waivers of such codes of ethics which are granted to such officers. As adopted, issuers (other than foreign private issuers that file their annual reports on either Form 20-F or Form 40-F) are required to disclose changes to, or waivers from, the code of ethics for their senior financial officers and principal executive officer within five business days on Form 8-K (new Item 10). The original proposal had been two business days. Alternatively, these issuers may disclose such changes or waivers on the issuer’s Internet website, if the issuer’s most recent annual report on Form 10-K provided the issuer’s Internet address and stated that the issuer intended to disclose these events on its website. The website disclosure would need to be made within five business days of the event, would have to be maintained on the website for at least 12 months, and would have to be retained by the issuer for at least five years. Foreign private issuers are only required to disclose such changes or waivers in their annual report on Form 20-F or 40-F, although the SEC strongly encourages
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prompt disclosure by foreign private issuers under cover of Form 6-K or on the foreign private issuer’s website.

The issuer must disclose the nature of (i) any amendment to its code that applies to its principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions; and (ii) any waiver, including an implicit waiver, from a provision of its code granted by the issuer to one of these specified officers, the name of the person to whom the issuer granted the waiver and the date of the waiver. Also, in response to several comments, the final rules defined the terms “waiver” and “implicit waiver”. A “waiver” is the approval by the issuer of a material departure from a provision of its code. An “implicit waiver” is the issuer’s failure to take action within a reasonable period of time regarding a material departure from a provision of its code that has been made known to at least one of the issuer’s executive officers. The rules also clarify that only amendments or waivers relating to the specified elements of the code of ethics and the specified officers must be disclosed. This clarification is intended to allow and encourage issuers to retain broad-based business codes and codes of conduct that are more comprehensive than necessary to meet the new disclosure requirements. The rules are only applicable to amendments and waivers related to specified financial officers and the chief executive officer, but not to other executive officers, directors or affiliates.

Companies must comply with the requirements regarding disclosure of amendments and waivers to their ethics codes on or after the date on which they file their first annual report in which the code of ethics disclosure is required. Companies must comply with the code of ethics disclosure requirements in their annual reports for fiscal years ending on or after July 15, 2003.

F. Notice of Blackout Periods

The SEC adopted a new provision that requires U.S. issuers to disclose on Form 8-K the temporary suspension of trading in issuer equity securities under individual participant benefit plans. The Form 8-K (under new Item 11) would need to be filed no later than the date that notice is required to be transmitted to directors and executive officers. In addition, if there is a subsequent change in the actual or expected beginning or ending dates of the blackout period as provided in the notice to the SEC, an issuer must file another Form 8-K containing the updated beginning or ending dates of the blackout period, explaining the reasons for the change in the dates and identifying all material changes in the information contained in the prior report. The updated notice is required to be provided as soon as reasonably practicable. Foreign private issuers would only have to disclose the notice in their next annual report on Form 20-F or Form 40-F. In addition, although registered management investment companies are otherwise exempt from any Form 8-K filing requirement for any other purposes, the SEC's new rules require registered management investment companies to file Form 8-K solely for this purpose.
The Form 8-K requirement is triggered when notice is required to be delivered to directors and executive officers. Issuers must provide notice to their directors and executive officers (1) no later than five business days after receiving the notice of the blackout from the plan administrator required by Department of Labor regulations, or (2) if no such notice is received by the issuer, on a date that is at least 15 calendar days before the actual or expected beginning date of the blackout period. In some instances, however, it may not be practicable for an issuer to provide advance notice to its directors and executive officers -- e.g., where the commencement of a blackout period is due to events that are unforeseeable or circumstances that are beyond the reasonable control of the issuer. In such a case, the SEC will excuse an issuer from the advance notice requirement -- but only if the issuer determines in writing that the circumstances preclude compliance with the notice requirement and notifies the affected directors and executive officers of the blackout as soon as reasonably practicable.

The Form 8-K disclosure requirement became effective on March 31, 2003. However, because the pension fund insider trading rule itself became effective on January 26, 2003, the SEC provided that between January 26, 2003 and March 31, 2003, a company could provide the required notice to the SEC by disclosing the information described in Item 11 of Form 8-K instead under Item 5 ("Other Information") of Form 10-Q in the first quarterly period filed by the company after commencement of the blackout period.

G. Attorney Up-the-Ladder Reporting

On January 29, 2003, the SEC proposed a new Form 8-K requirement in connection with the attorney up-the-ladder reporting requirement (discussed in more detail below under "Ethics/Compliance--Attorney Up-the-Ladder Reporting Requirement"). As proposed, an attorney retained by the issuer would be required to withdraw from representing the issuer (and notify the issuer in writing that the withdrawal is due to professional considerations) if the attorney reasonably concludes that there is substantial evidence of a material violation that is ongoing or is about to occur and is likely to cause substantial injury to the financial interest or property of the issuer or investors. Under the same circumstances, an attorney employed by the issuer would have to cease any participation or assistance in the matter concerning the violation and notify the issuer in writing that the issuer has not provided an appropriate response in a reasonable time to his or her report of a material violation.

Within two business days of receipt of such written notice from either internal or external counsel, the issuer would be required to report such notice and the circumstances related thereto on Form 8-K (in new Item 13), 20-F or 40-F. Forms 20-F and 40-F would be amended to act in this one instance as a Form 8-K. If the issuer fails to file the Form 8-K as required, the proposed rule allows, but does not require, an attorney employed or retained by the issuer to inform the SEC that the attorney provided notice pursuant to the rule and that such action was based on professional considerations.
Comments on this proposal were due by April 7, 2003.

H. Nasdaq Going Concern Opinion Proposal

On June 11, 2002 Nasdaq proposed to add a requirement to its listing requirements for issuers to announce publicly the receipt of any audit opinion with a going concern qualification. Nasdaq would require the public announcement to be provided to Nasdaq StockWatch and released to the media not later than seven calendar days following the filing of such audit opinion in an SEC filing. This proposal was published for comment by the SEC on July 2, 2003.

I. IOSCO Statement on Ongoing Disclosure

In October 2002 the Technical Committee of the International Organization of Securities Commissions (IOSCO) issued a statement on principles for ongoing disclosure and material development reporting.28 IOSCO’s statement acknowledges the importance of ongoing disclosure but does not go so far as to mandate immediate real-time disclosures in a manner similar to Sarbanes-Oxley and the SEC proposals.

IOSCO's "International Ongoing Disclosure Standards" include the following:

- Listed entities should have an ongoing disclosure obligation requiring disclosure of all material information. This may be implemented either by (1) requiring disclosure of a specific list of material items (U.S. and Japan) or (2) generally requiring disclosure of all price-sensitive or material information (European Union).

- If an entity is listed in more than one jurisdiction, the information released in one jurisdiction should be released on an identical basis and simultaneously in all other jurisdictions where it is listed. Different time zones and trading hours should be considered.

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28 The International Organization of Securities Commissions (IOSCO) is a worldwide forum for securities regulators that promotes cooperation and high standards of regulation, allows for the exchange of information among regulators in order to promote development of domestic markets and aims to establish standards for international securities transactions. IOSCO currently has more than 170 members (securities regulators like the SEC and SRO's like the NASD) from more than 100 jurisdictions. IOSCO standards are not binding on any jurisdiction, securities regulator or company. IOSCO's Technical Committee has five working groups which meet several times each year to address issues related to multinational disclosure and accounting, regulation of secondary markets, regulation of market intermediaries, enforcement and investment management.
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- Information should be made available to the market by using efficient and timely means of dissemination.

- Information should not be disclosed to selected investors before it is released to the public, except for narrow exceptions where the recipient has a duty to keep the information confidential.

- Information must be disclosed on a "timely" basis. Timely may mean immediately or as soon as possible (or, as proposed in the U.S., within two business days) or may mean on a periodic basis (quarterly or annually).

7. Acceleration of Form 10-K/10-Q Deadlines

The SEC proposed on April 12, 2002 and adopted on September 5, 2002 new rules which will ultimately require a new category of large "accelerated filers" (essentially Form S-3 filers) to file their Form 10-K 60 days after the end of their fiscal year (compared to 90 days currently) and to file their Form 10-Q within 35 days after the end of each of their first three fiscal quarters (compared to 45 days currently). The new deadlines only apply to Form 10-K and Form 10-Q. No change has been made to Form 20-F, Form 40-F, Form 18-K, Form 6-K, Form 8-K or any other reports. Therefore, the new rules have no impact on foreign private issuers who file Form 6-K, Form 20-F and Form 40-F. Form 20-F is still due six months after the end of the fiscal year.

The accelerated deadlines will be phased in over a three-year period as follows:

<table>
<thead>
<tr>
<th>For Fiscal Years Ending On or After</th>
<th>Form 10-K Deadline</th>
<th>Form 10-Q Deadline</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 15, 2002</td>
<td>90 days after fiscal year end</td>
<td>45 days after fiscal quarter end</td>
</tr>
<tr>
<td>December 15, 2003</td>
<td>75 days after fiscal year end</td>
<td>45 days after fiscal quarter end</td>
</tr>
<tr>
<td>December 15, 2004</td>
<td>60 days after fiscal year end</td>
<td>40 days after fiscal quarter end</td>
</tr>
<tr>
<td>December 15, 2005</td>
<td>60 days after fiscal year end</td>
<td>35 days after fiscal quarter end</td>
</tr>
</tbody>
</table>

The rules require accelerated filers to disclose the following information in their Form 10-K for fiscal years ending on or after December 15, 2002:

- the issuer's Internet address, if it has one;

- whether the issuer makes available free of charge "on or through" its Internet website--either directly, through a hyperlink to a third party vendor, or via hyperlink to the SEC website--its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to the foregoing as soon as reasonably practicable after they are electronically filed with the SEC; and
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- if the issuer does not make filings available in this manner, the reasons why not, and whether it voluntarily will provide electronic or paper copies of the filings free of charge upon request.\(^{29}\)

The accelerated deadlines for Form 10-K and Form 10-Q were adopted despite significant opposing comments. The new deadlines highlight for companies the need to review and adjust their disclosure controls and procedures. For example, companies may need to review their financial software and hardware packages in order to make sure they can process information from sprawling bureaucracies quickly enough to allow them to meet the new deadlines. Audit committees may need to accelerate the timing of their review of reports. The new deadlines will also increase the pressure on CEO's and CFO's who must certify that their periodic reports contain all material information. Companies will need to obtain information from foreign operations, joint ventures and other partially-owned entities on a more timely basis. The new deadlines, as a general matter, will also make compliance more difficult for companies given the growing number of disclosure requirements involving, among other things, off-balance sheet transactions, contractual obligations, non-GAAP financial measures, the internal controls report, and critical accounting estimates. Companies may need to hire additional people, or involve more people, in order to satisfy the increasing number of disclosure requirements and the shortened timeframes.\(^{30}\)

8. Critical Accounting Estimates

On May 10, 2002, the SEC issued new proposals for enhanced MD&A disclosure of critical accounting estimates by domestic and foreign private issuers. The disclosure for each critical accounting estimate would include the following:

- Basic disclosures about critical accounting estimates, including:

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\(^{29}\) In addition, for fiscal years ending on or after December 15, 2002, the front page of the Form 10-K must indicate in a new checkbox whether the company is an "accelerated filer," and the disclosure of the company's equity market value must be "as of the last business day of the registrant's most recently completed second fiscal quarter."

\(^{30}\) The SEC rules also amended Rules 3-01 and 3-12 of Regulation S-X, which relate to the timeliness of financial information in SEC filings. The changes were made to conform the timeliness requirements for these filings made by accelerated filers to changes adopted to the deadlines for Forms 10-K and 10-Q for accelerated filers. On April 8, 2003 the SEC issued clarifying amendments to Rules 3-01 and 3-12 of Regulation S-X to clarify that the phase-in periods applicable to accelerated filers who need to update interim information in registration statements matches the phase-in periods for filing quarterly information on Form 10-Q. The corrections clarify that the updated interim information is required within 130 days after the end of the company's fiscal year for fiscal years ending on or after December 15, 2003 and before December 15, 2004, and within 125 days after the end of the company's fiscal year for fiscal years ending on or after December 15, 2004.
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- A description of the accounting estimate and the methodology underlying the estimate.

- The assumptions underlying the accounting estimate that relate to matters highly uncertain at the time the estimate was made and any other material assumptions.

- Any known trends or uncertainties that are reasonably likely to occur and materially affect the methodology or assumptions.

- Why different estimates that would have had a material impact on the company’s financial presentation could have been used.

- If applicable, why the accounting estimate is reasonably likely to change from period to period with a material impact on the financial presentation.

- An explanation of the significance of the estimate to the company’s financial condition and, if material, the line items in the financial statements affected by the estimate.

- A quantitative discussion of changes in overall financial performance, and, if material, specific line items, assuming that either (1) reasonably possible (“more than remote but less than likely”) near-term (“within one year”) changes occur in the most material assumption(s) underlying the accounting estimate (generally both a positive change and a negative change), or (2) the accounting estimate was changed to the upper end and the lower end of the range of reasonable possibilities determined by the company in the course of formulating its recorded estimate and, in either case, a discussion of the impact, if material, on the company’s liquidity if any of the changes being assumed were in effect.

- A quantitative and qualitative discussion of any material changes made to the accounting estimate in the past three years, the reasons for the changes and the effect on line items in the financial statements and overall financial performance.

- Whether the company’s senior management has discussed the development and selection of the critical accounting estimates and the MD&A disclosure with the audit committee and, if not, the reasons for not doing so.

- If the company operates in more than one segment, the segments that the accounting estimate affects.

The proposal would also require in every quarterly report on Form 10-Q by a U.S. company the following additional disclosures:
Disclosure regarding any new critical accounting estimate.

For any critical accounting estimate previously disclosed, any material change to that prior disclosure necessary to make that disclosure not materially misleading.

The SEC release acknowledged that the proposals will require greater disclosure of forward-looking information. The proposal would delete from the MD&A rules a statement that forward-looking information is not required and add a statement that "your response to this section requires you to make certain forward-looking statements." Because the release calls for the disclosure of new types of information, some of which is forward-looking, it raises the possibility of incremental liability for public companies and the officers who sign periodic reports.

The SEC proposal would also require disclosure regarding the initial adoption of an accounting policy that has a material impact on a company’s financial condition or results of operations. The initial adoption of an accounting policy may occur when events or transactions affecting the company occur for the first time, or were previously immaterial in their effect but become material, or events or transactions occur that are clearly different in substance from previous ones. The new disclosure requirement would not apply to the adoption by a company of new policies resulting from the adoption of new accounting literature by the FASB, AICPA, SEC or other recognized standard setter (which is already subject to existing disclosure requirements).

Comments on this proposal were due on July 19, 2002. The proposal is still pending at the SEC.

9. Repurchases of Equity Securities

On December 10, 2002, the SEC proposed to require companies to disclose in their annual report (10-K or 20-F) and quarterly reports information about repurchases by an issuer or an affiliated purchaser of the issuer’s equity securities that are registered pursuant to Section 12 of the Exchange Act. The SEC solicited comment as to whether the disclosure should be made on a more timely basis such as monthly or within 10 days of the transaction.

The disclosure would include, for each month in the quarterly period, the number of shares purchased (in open market purchases or otherwise), the average price paid per share, the identity of the broker-dealer used (except for foreign private issuers filing on Form 20-F), the number of shares purchased as part of a publicly announced program, and the maximum number or approximate dollar value of shares that may yet be purchased under the program. Footnote disclosure of the principal terms of publicly announced repurchase plans would also be required.
Comments on the SEC’s proposal were due by February 18, 2003.

10. Audit Committee Disclosures

On April 9, 2003, the SEC adopted rules regarding audit committees, including enhanced disclosures about audit committees.

A. Identification of Audit Committee Members in Annual Reports

An issuer subject to Section 14 of the Exchange Act is currently required to disclose in its proxy statement, if directors are to be elected, (1) whether the issuer has an audit committee, (2) the names of each committee member, (3) the number of audit committee meetings held and (4) the functions performed by the committee. The rules will require that listed issuers include or incorporate by reference in their Form 10-Ks (and proxy statements for an annual meeting of shareholders for the election of directors) disclosure of whether or not they have a separate audit committee or a committee performing similar functions and the names of the members of the audit committee. In addition, if the issuer has not separately designated an audit committee, the issuer must disclose that the entire board of directors is acting as the issuer's audit committee. Similar disclosure requirements would also apply to Forms 20-F and 40-F.31

B. Modifications to Existing Proxy Statement Audit Committee Disclosures

Proxy statements currently must disclose (1) an audit committee report with specified disclosures, (2) whether the audit committee has a charter (the charter must be filed once every 3 years) and (3) if the audit committee members are independent and whether one member of the committee is not independent due to an exceptional and limited circumstances exception in the applicable listing standards. In addition, issuers listed on the NYSE, Nasdaq or AMEX must disclose if their audit committee members are independent under those SROs’ listing standards. Issuers not listed on the NYSE, Nasdaq or AMEX must also disclose if they have an audit committee and must indicate if their audit committee members are independent but can choose the independence standards of any of the NYSE, Nasdaq or AMEX.

The new rules clarify that, in the absence of an audit committee, the entire board of directors will be considered to be the audit committee and the registrant must provide the audit committee disclosures (such as those relating to director independence) with respect to all members of its board.

31 Some issuers do not need to include these disclosures, including (1) subsidiaries listing non-equity securities when the parent has listed equity securities, (2) listings of certain security futures products and standardized options, (3) foreign governments, (4) certain trusts and unincorporated associations and (5) asset-backed issuers and unit investment trusts.
In addition, non-listed issuers that have separately designated audit committees will still be required to disclose whether their audit committee members are independent. In determining whether a member is independent, these registrants will be allowed to choose the definition for audit committee member independence from any national securities exchange or national securities association that has been approved by the SEC (i.e., they can use any SEC-approved definition and not just the NYSE, Nasdaq and AMEX definitions).

C. Disclosure Regarding Exemptions

Domestic and foreign private issuers that are relying on certain exemptions in the SEC's rules with respect to audit committee independence requirements must make specific disclosures in their annual report and proxy statement. Specifically, disclosures are required in connection with reliance on the exemptions related to (1) an issuer's IPO, (2) a foreign private issuer's non-executive employee, (3) a foreign private issuer's controlling shareholder representative, (4) a foreign private issuer's foreign government representative, (5) a foreign private issuer's board of auditors or (6) an audit committee member who is not independent for reasons outside of his or her reasonable control.

In general, issuers availing themselves of any of these exemptions must disclose their reliance on the exemption and their assessment of whether, and if so, how, such reliance would materially adversely affect the ability of their audit committee to act independently and to satisfy the other requirements of the rules. Such disclosure must be included in, or be incorporated by reference into, annual reports on Forms 10-K, 20-F or 40-F filed with the SEC. This disclosure also must be included in proxy statements or information statements for shareholders' meetings at which elections for directors are held.

D. Compliance Timetable

Issuers must comply with the new disclosure changes regarding use of exemptions, identification of audit committee members in annual reports and independence disclosure updates in the proxy statement beginning with reports covering periods ending on or after (or proxy or information statements for actions occurring on or after) the compliance date for the listing standards applicable to the issuer. Issuers, other than foreign private issuers, must be in compliance with the new listing rules by the earlier of (1) their first annual shareholders meeting after January 15, 2004 or (2) October 31, 2004. Foreign private issuers and small business issuers must be in compliance with the new listing rules by July 31, 2005. If the issuer is not a listed issuer, it should use the date that would apply if it was a listed issuer.
11. Regulation FD

A. SEC Regulation FD Enforcement Actions

When Regulation FD was adopted in August 2000 it caused angst among attorneys who feared SEC enforcement actions based on split-second determinations of materiality. The SEC and its staff went to great lengths at that time to assure companies that they would not second guess good faith determinations but would only bring enforcement actions in cases of clear, egregious violations.

In November 2002 the SEC announced its first Regulation FD enforcement actions. Four actions were announced simultaneously:

- Siebel Systems, Inc. was fined $250,000, and the SEC issued a cease-and-desist order, after an officer told participants at an investor conference (which was not webcast) that the company's business was doing better. The company's stock increased more than 20% the next day.

- The SEC issued cease-and-desist orders against Secure Computing Corp. and its CEO and Raytheon Co. and its CFO after company officers disclosed material information to institutional investors. Secure's CEO disclosed the existence of a significant OEM contract to two portfolio managers at institutional advisers, leading Secure's common stock to increase 35% over several days. Raytheon's CEO disclosed quarterly and semi-annual earnings guidance in one-on-one meetings with sell-side equity analysts, leading the analysts to reduce their first quarter earnings estimates. Commissioner Roel Campos dissented, stating that these companies should have received greater punishment.

- The SEC also issued a report of investigation regarding Motorola, where an officer called analysts to give them details about the company's sales and orders. Motorola was not fined, and a cease and desist order was not brought, because the offending officer apparently relied in good faith on advice of an internal counsel. The SEC's report of investigation notes that an officer cannot "seek out and rely on counsel's consent as a shield against liability. In many cases, an issuer's chief financial officer or investor relations officer may have a keener awareness than company counsel of the significance of information to investors."

On September 9, 2003, the SEC filed two settled Regulation FD enforcement proceedings against Schering-Plough Corporation and its former CEO. The SEC charged that the former CEO and the company's senior vice president of investor relations met privately with analysts and portfolio managers
of four institutional investors. The SEC said that "through a combination of spoken language, tone, emphasis, and demeanor," the CEO disclosed negative and material nonpublic information about the company's earnings prospects, including that analysts' earnings estimates for the company's 2002 third quarter were too high and that the company's earnings in 2003 would significantly decline. The SEC said that immediately after the meeting analysts at two of the firms downgraded their ratings on the company, and portfolio managers at three of the firms heavily sold Schering stock. The price of Schering's stock declined over the three days following the meeting by more than 17%, from $21.32 to $17.64 per share, on approximately four times normal volume. The company agreed to pay $1 million, the former CEO agreed to pay $50,000, and both agreed to cease-and-desist orders.

B. Nasdaq Regulation FD Harmonization Provision

On November 25, 2002, the SEC approved a Nasdaq proposal to harmonize Regulation FD with the Nasdaq rule requiring disclosure of material information by press release. The Nasdaq rule allows issuers to disclose material events by using Regulation FD compliant methods, such as conference calls, press conferences and webcasts, so long as the public is provided adequate notice (generally by press release) and provided access. Nasdaq also amended its rule requiring advance notice by issuers to Nasdaq of certain specified material information, such as earnings releases, earnings guidance, M&A activity, new products or discoveries, senior management changes, changes in control, resignation of auditors, events regarding the issuer's securities, significant legal developments, or any event requiring the filing of a Form 8-K.

12. SEC Comments

In February 2003 the SEC published a summary of the comments which it issued in connection with its review of the Form 10-K's filed by Fortune 500 companies during 2002. As described, the principal areas where the SEC issued comments include the following:

- **MD&A.** More comments were issued on the MD&A than on any other topic. The SEC issued comments "discouraging companies from providing rote calculations of percentage changes of financial statement items and boilerplate explanations of immaterial changes to these figures, encouraging them to include instead, a detailed analysis of material year-to-year changes and trends." The SEC also issued numerous comments on liquidity, cash flow and capital resources, which the SEC said were given insufficient attention.

- **Critical Accounting Policies.** Many companies did not provide any critical accounting policy disclosure in circumstances where the SEC's December 2001 guidance could be read as calling for disclosure. Also, the disclosures of many companies did not adequately respond to the guidance
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provided in December 2001. In particular, many companies failed to provide the sensitivity analysis regarding their critical accounting policies. The SEC still has outstanding a proposal to require incremental disclosures regarding critical accounting estimates.

- **Non-GAAP Financial Information.** Companies were asked either to remove this information where the SEC believed the information to be either misleading or subject to misinterpretation or to present the non-GAAP financial information less prominently with better explanation and disclosure that is more balanced. Companies that presented alternative or pro forma statements of operations were asked to remove them. SEC filings and press releases are now required to comply with the SEC’s rules governing non-GAAP financial measures.

- **Revenue Recognition.** The SEC requested clarification of how companies recognize revenue, including how their revenue recognition specifically complies with SAB 101. Companies were also asked to expand significantly their revenue recognition accounting policy disclosures. Specific disclosure issues were detailed for companies in areas of computers; capital goods, semiconductors and electronic instruments and controls; energy; and pharmaceuticals and retail.

- **Restructuring Charges.** Many companies were asked to justify or explain more fully their accounting for restructuring charges. Companies were asked to expand their disclosure of restructuring charges in their financial statements and in their MD&A. For example, companies were asked to include in their financial statements a period-by-period analysis of restructuring charges which would include the original charge, cash payments made, non-cash charges used, reversals or adjustments to the charges and non-cash writedowns, and disclosure of the adjustment or reversal for each material component of the total restructuring charge.

- **Impairment Charges.** Comments were focused on impairment charges in three distinct areas--long-lived assets, securities held for investment, and goodwill and other intangible assets.

- **Pension Plans.** Comments related to the assumptions companies use in determining the amount of pension income or expense to recognize. The majority of the SEC’s comments dealt with the long-term expected return assumption for plan assets, expanding the discussion in MD&A of the significant assumptions and estimates for pension plan accounting and the impact of pension plans on results of operations and cash flows.

- **Segment Reporting.** Some companies inappropriately aggregated multiple segments, or did not adequately address the basis for aggregating information.
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- **Securitized Financial Assets.** The SEC asked questions about how some companies described their sale of financial assets (such as accounts receivable, loans and investment securities) through securitizations. The SEC also asked for additional disclosures regarding the potential risk of loss in these assets.

- **Off-Balance Sheet Arrangements.** Companies were asked to explain more fully in their MD&A the nature and accounting for off-balance sheet arrangements and to expand their footnote disclosure to specify the accounting for these arrangements.

- **Environmental and Product Liability Disclosures.** The SEC issued comments relating to environmental and product liability disclosure to some oil and gas companies, as well as to several manufacturing companies. Current accounting literature generally provides that companies with these liabilities should disclose the nature of a loss contingency, the amount accrued, an estimate of the range of reasonably possible loss, and significant assumptions underlying the accrual, and the cost of litigation. Many companies did not provide adequate disclosure with respect to these items. The SEC also urged companies to provide in their MD&A an analysis as to why the amounts charged in each period were recorded and how the amounts were determined.

**Part III: Board of Directors**

1. **Independent Director Requirement**

   A. **New York Stock Exchange Independent Director Proposals**

   The NYSE and Nasdaq corporate governance and independent director proposals are as important if not more important than any single provision in the Sarbanes-Oxley Act. These proposals, together with new Business Roundtable and Conference Board best practices and market demands, have forced countless companies to review their corporate governance and modify or prepare to modify their procedures and structure in anticipation of the new regulations and market demand. Companies have also been reviewing their boards in order to determine if they need additional independent directors.

   The NYSE submitted its corporate governance proposal to the SEC on August 16, 2002, amended the independence of directors provisions on March 12, 2003, resubmitted its proposals in their entirety on April 4, 2003 and October 8, 2003 and amended the proposals on October 17, 2003. The SEC published the rules for comment on April 11, 2003. The NYSE proposal would modify its rules with respect to independence of directors as follows:

   - **Majority independent.** A majority of directors would have to be independent. NYSE officials estimated that more than 700 of their
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2,800 listed companies would have to add directors or otherwise change their board in order to comply with this requirement.32

- Executive sessions. Non-management directors would have to meet at regularly scheduled executive sessions without management. Non-management directors are all those directors who are not company officers, and include directors who are not independent due to material relationships, family membership or otherwise. The NYSE also stated that, if this group includes directors who are not independent, listed companies should at least once a year schedule an executive session including only independent directors.

If one director is chosen to preside at these meetings, his or her name must be disclosed in the company's annual proxy statement or, if the company does not file an annual proxy statement, in the company's Form 10-K. Alternatively, the company can disclose the procedure by which a presiding director is selected for each executive session. In order that interested parties may be able to make their concerns known to the non-management directors, a company must disclose a method for such parties to communicate directly with the presiding director or non-management directors as a group. Companies may, if they wish, utilize for this purpose the same procedures they have established to comply with the SEC requirement regarding submission of anonymous employee complaints to the audit committee.33

- Definitions of independence. In order to be deemed "independent," the board must affirmatively determine that the director has no "material relationship" with the company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company). References to "company" include any parent or subsidiary in a consolidated group with the company. Commentary to the NYSE proposals states that "[m]aterial relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others."34 The commentary further

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32 Regulators take aim at corporate boards, The News Journal (Wilmington, Delaware), August 18, 2002, at 1F.
33 The NYSE proposals would not require a lead director, which some companies use. Also, the NYSE proposals would not require separation between the chairman and the CEO, which is typical in the UK but not in the U.S.
34 A ruling by the Delaware Court of Chancery, In re Oracle Derivative Litigation, C.A. No. 18571, Strine, V.C. (Del. Ch., June 13, 2003; revised June 17, 2003), held that material factual questions existed about the independence of two members of Oracle's board's special litigation committee investigating potential insider trading by Oracle insiders. The two committee members were tenured professors at Stanford University. The
states that "when assessing the materiality of a director's relationship with the company, the board should consider the issue not merely from the standpoint of the director, but also from that of persons or organizations with which the director has an affiliation." The basis for a determination that a relationship is not material must be disclosed in the annual proxy statement or, if the company does not file an annual proxy statement, in the company's annual report on Form 10-K.

- **Categorical standards.** A board may adopt (and disclose in the proxy statement) categorical standards to assist it in making determinations of independence. The company could then make a general disclosure in the proxy statement that the independent directors meet the standards set by the board without detailing particular aspects of the immaterial relationships between individual directors (and entities with which they are affiliated) and the company. Any determination of independence for a director who does not meet these standards must be specifically explained.

- **Large shareholders.** The NYSE specifically clarified in commentary to the rules “as the concern is independence from management, the Exchange does not view ownership of even a significant amount of stock, by itself, as a bar to an independence finding.”

- **Bars to independence.** The NYSE proposals include the following provisions regarding certain persons who would not be deemed independent:
  
  - A director who is an employee, or whose immediate family member is an executive officer, of the company is not independent until three years after the end of such employment relationship. Employment as "interim chairman or CEO" does not disqualify a director from being considered independent following that employment.
  
  - A director who receives, or whose immediate family member receives, more than $100,000 per year in direct
compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service), is not independent until three years after he or she ceases to receive more than $100,000 per year in such compensation.

● Compensation received by a director for former service as an interim chairman or CEO does not need to be considered as a factor by a board in determining independence. Compensation received by an immediate family member for service as a non-executive employee of the listed company need not be considered in determining independence under this test.

○ A director who is affiliated with or employed by, or whose immediate family member is affiliated with or employed in a professional capacity by, a present or former internal or external auditor of the company is not “independent” until three years after the end of the affiliation or the employment or auditing relationship.

○ A director who is employed, or whose immediate family member is employed, as an executive officer of another company where any of the listed company’s present executives serve on that company’s compensation committee is not “independent” until three years after the end of such service or the employment relationship.

○ A director who is an executive officer or an employee, or whose immediate family member is an executive officer, of a company that makes payments to, or receives payments from, the listed company for property or services in an amount which, in any single fiscal year, exceeds the greater of $1 million, or 2% of such other company's consolidated gross revenues, is not independent until three years after falling below such threshold.

○ Charitable organizations are not considered "companies" for purposes of this provision, provided that a listed company must disclose in its annual proxy statement any charitable contributions made by the listed company to any charitable organization in which a director serves as an executive officer if, within the preceding three years, contributions in any single fiscal
year exceeded the greater of $1 million or 2% of such charity's consolidated gross revenues. Listed company boards are reminded of their obligations to consider the materiality of any such relationship in making independence determinations.

- Each of the bars to independence described above includes a three-year “lookback” provision. The look-back will be phased in by applying only a one-year look-back for the first year after adoption of these new standards. The three year look-backs will only begin to apply from and after the date which is the first anniversary of the SEC approval date of the listing rules.

- The NYSE defines “immediate family member” to include “a person’s spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, and anyone (other than domestic employees) who shares such person’s home.” In contrast, when the SEC adopted audit committee independence requirements, the SEC’s definition of family only included a person’s spouse, minor children or stepchildren or children or stepchildren sharing the director’s home. When applying the look-back provisions, listed companies need not consider individuals who are no longer immediate family members as a result of legal separation or divorce or those who have died or become incapacitated.

- **Controlled company.** A controlled company—where more than 50% of the voting power is held by an individual, group or another company—need not have a majority of independent directors or have nominating/corporate governance or compensation committees with only independent directors. However, it must have a 3-independent-director audit committee and is not exempt from the NYSE's proposed executive session requirement. If a company relies on this exemption, it would have to disclose this choice, that it is a controlled company and the basis for the determination in its annual proxy statement or, if the company does not file one, in the company's annual report on Form 10-K.

- **Timetable.** Listed companies have until the earlier of their first annual meeting after January 15, 2004, or October 31, 2004, to comply with the new corporate governance standards. If a company has a classified board and would be required (other than by virtue of an SEC audit committee requirement) to change a director who would not normally stand for election in such annual meeting, the company may continue such director in office until the second annual meeting after such date, but no later than December 31, 2005. Foreign private issuers must comply on the same
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Companies listing in conjunction with their IPO will be permitted to phase in their independent nomination and compensation committees on the same schedule as is permitted by the SEC for audit committees—e.g., one independent member at the time of listing, a majority of independent members within 90 days of listing and fully independent committees within one year. Such companies will be required to meet the majority independent board requirement within 12 months of listing. For all purposes other than the SEC audit committee requirements, a company will be considered to be listing in conjunction with an IPO if, immediately prior to listing, it does not have a class of common stock registered under the Exchange Act. The NYSE will also permit companies that are emerging from bankruptcy or have ceased to be controlled companies to phase in independent nominations and compensation committees and majority independent boards on the same schedule as companies listing in connection with an IPO. However, for purposes of the SEC audit committee requirements, a company will be considered to be listing in conjunction with an IPO only if the company was not, immediately prior to the effective date of a registration statement, required to file reports with the SEC pursuant to Sections 13(a) or 15(d) of the Exchange Act.

Companies listing upon transfer from another market have 12 months from the date of transfer in which to comply with any requirement to the extent the market on which they were listed did not have the same requirement. To the extent the other market has a substantially similar requirement but also has a transition period from the effective date of that market’s rule, which period has not yet expired, the company will have the same transition period as would have been available to it on the other market. The transition period for companies transferring from another market will not apply to the SEC audit committee requirements unless a transition period is available under the SEC rules.

The New York Stock Exchange's corporate governance proposals generally apply to all companies listing common equity securities, with several exceptions. Foreign private issuers may follow home country practice, other than the audit committee independence and responsibility requirements required by SEC rules (and the requirement that the CEO notify the NYSE when an executive officer learns of material noncompliance with applicable NYSE corporate governance rules). The proposals do not apply to companies listing only preferred or debt securities, other than the audit committee independence and responsibility requirements required by SEC rules (and the requirement that the CEO notify the NYSE when an executive officer learns of material noncompliance with applicable NYSE corporate governance rules). Limited partnerships and companies in bankruptcy proceedings need not comply with the requirements to have a majority of independent directors and to have nominating
and compensation committees composed solely of independent directors. The proposals do not apply at all to passive business organizations in the form of trusts or to derivatives and special purpose securities.

B. Nasdaq Independent Director Proposals

On October 9, 2002, Nasdaq submitted its own proposals to the SEC which would modify its rules regarding corporate governance and the independence of directors. On March 11, 2003 Nasdaq amended its proposals relating to the independence of directors and board committees, on March 17, 2003 the SEC published these Nasdaq proposals for comment and on July 15, 2003 and October 9, 2003 Nasdaq further amended its corporate governance proposal. Nasdaq's rules regarding independent directors would provide as follows:

- **Majority independence.** As with the NYSE, the majority of directors would have to be independent. The company must disclose in its annual proxy (or, if it does not file a proxy, in its Form 10-K or 20-F) those directors that the board has determined to be independent.

- **Executive sessions.** Independent directors would have to hold regularly scheduled executive sessions at which only independent directors are present. Instructions to Nasdaq's proposal state that it is contemplated that executive sessions will occur at least twice a year, and perhaps more frequently, in conjunction with regularly scheduled board meetings. Controlled companies also need to comply with the executive session requirement.

- **Independence standards.** Whereas the NYSE requires the board to determine if a director has a "material relationship" with the company which makes the director not independent, Nasdaq's current and proposed rules provide that an individual would not be deemed independent if he or she had a relationship which, in the opinion of the company's board, would "interfere with the exercise of independent judgment" in carrying out the responsibilities of a director. Nasdaq supplements this general standard with a set of six categorical rules. The following individuals would not be considered independent:

  - a director who is, or at any time during the past three years was, employed by the company or by any parent or subsidiary of the company (no change from the current rule),

35 The reference to "parent or subsidiary" is intended to cover entities the issuer controls and consolidates with the issuer's financial statements as filed with the SEC (but not if the issuer reflects such entity solely as an investment in its financial statements).
a director who accepted, or who has a family member who accepted, any payments from the company or any parent or subsidiary of the company in excess of $60,000 during the current or any of the past three fiscal years, other than compensation for board or board committee service, payments arising solely from investments in the company's securities, compensation paid to a family member who is a non-executive employee of the company or a parent or subsidiary of the company, benefits under a tax-qualified retirement plan or non-discretionary compensation, or loans permitted under Section 402 of the Sarbanes-Oxley Act (the prior rule did not previously apply to family members, and only applied to the last fiscal year),

This item is generally intended to capture situations where a payment is made directly to (or for the benefit of) the director or a family member. For example, consulting or personal service contracts with a director or political contributions to the campaign of a director would fall into this item.

a director who is a family member of an individual who is, or at any time during the past three years was, employed by the company or by any parent or subsidiary of the company as an executive officer (similar to the prior rule),

a director who is, or has a family member who is, a partner in, or controlling shareholder or an executive officer of, any organization to which the company made, or from which the company received, payments for property or services in the current or any of the past three fiscal years that exceed 5% of the recipient's consolidated gross revenues for that year, or $200,000, whichever is more, other than (i) payments arising solely from investments in the company's securities or (ii) payments under non-discretionary charitable contribution matching programs (previously only applied to for-profit businesses, and previously did not apply to family members too),

This item is generally intended to capture payments to an entity with which the director or family member is affiliated by serving as a partner, controlling shareholder or executive officer. The reference to partner is not intended to pick up limited partners. Under "exceptional circumstances," such as where a director has direct significant business holdings, it may
be more appropriate to apply the corporate measurements in this item rather than the individual measurements of the second bullet above; issuers are advised to contact Nasdaq if they wish to apply the rule in this manner.

- This item covers situations where a company makes a charitable donation to a charity where a director is an executive officer. "Nasdaq encourages companies to consider other situations where a director or their Family Member and the company each have a relationship with the same charity when assessing director independence."

- a director of the listed company who is, or has a family member who is, employed as an executive officer of another entity where at any time during the past three years any of the executive officers of the listed company serve on the compensation committee of that other entity (previously did not apply to the past three years or to family members) and

- a director who is, or has a family member who is, a current partner of the company's outside auditor, or was a partner or employee of the company's outside auditor who worked on the company's audit at any time during any of the past three years (new).

- **Family member.** For purposes of the Nasdaq rules, the term "family member" includes a person's spouse, parents, children and siblings, whether by blood, marriage or adoption, or anyone residing in such person's home. An instruction clarifies that the reference to "marriage" is intended to capture relationships that arise as a result of marriage, such as "in-law" relationships.

- **Controlled company.** As in the NYSE rules, a "controlled company" is exempt from Nasdaq's provisions regarding majority independence, nominating committees and compensation committees, but would still be required to have an all-independent audit committee and executive sessions of independent directors. A controlled company is a company of which more than 50% of the voting power is held by an individual, a group or another company. In order for a group to exist, the shareholders must have publicly filed a notice (a Schedule 13D) that they are acting as a group. A controlled company relying on this exemption must disclose in its proxy statement (or, if the issuer does not file a
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proxy, in its Form 10-K or 20-F) that it is a controlled company and the basis for that determination.

- **Large shareholders.** Instructions to Nasdaq's proposal state that "[b]ecause Nasdaq does not believe that ownership of company stock by itself would preclude a board finding of independence, it is not included in the aforementioned objective factors."

- **Non-compliance.** If an issuer fails to comply with the majority independence requirement due to one vacancy, or one director ceases to be independent due to circumstances beyond his or her reasonable control, the issuer must regain compliance by the earlier of its next annual shareholders meeting or one year from the occurrence of the event that caused the failure to comply. An issuer relying on this provision must provide notice to Nasdaq immediately upon learning of the event or circumstance that caused the non-compliance.

- **Timetable.** Issuers, other than foreign private issuers, would need to be in compliance with the new listing rules by the earlier of (1) their first annual shareholders meeting after January 15, 2004 or (2) October 31, 2004. Foreign private issuers and small business issuers would need to be in compliance with the new listing rules by July 31, 2005. In the case of an issuer with a staggered board, with the exception of the audit committee requirements, the issuer will have until its second annual meeting after January 15, 2004, but not later than December 31, 2005, to implement all new requirements, if the issuer would be required to change a director who would not normally stand for election at an earlier annual meeting.

Issuers that have listed or will be listed in conjunction with their IPO will be afforded exemptions from all board composition requirements consistent with the SEC exemptions provided for audit committees. Therefore, for each committee that the company adopts, the company must have one independent member at the time of listing, a majority of independent members within 90 days of listing and the committee must be fully independent within one year. Issuers may also choose not to adopt a compensation or nominating committee and may instead rely on a majority of the independent directors to discharge responsibilities; these issuers will be required to meet the majority independent board requirement within 24 months of listing.

Companies transferring from other markets with substantially similar requirements will be afforded the balance of any grace period afforded by the other market. Companies transferring from
other markets that do not have a substantially similar requirement will be afforded one year from the date of listing on Nasdaq.

2. Nominating/Corporate Governance Committee

A. New York Stock Exchange

The NYSE's proposals would require that listed companies have a nominating/corporate governance committee composed entirely of independent directors. The committee must have a written charter that addresses specified topics, including an annual performance evaluation of the committee. The committee should have the sole authority to retain and terminate any search firm to be used to identify director candidates. Controlled companies need not have an all-independent-director nominating/corporate governance committee.

The NYSE proposal provides that the existence of the nominating committee would not override any contractual rights of third parties to select directors. However, companies still need to carefully consider these rules when agreeing to let third parties nominate board members. In particular, agreements to allow a director to serve on all committees may not be possible because the director may not be deemed independent. In addition, market forces may penalize companies for these contractual arrangements. Even private companies need to consider these rules unless their nominating procedures cease upon the company going public.

The NYSE proposal provides that boards may allocate the responsibilities of the nominating/corporate governance committee to other committees, provided that they are composed entirely of independent directors. Any such committee would be required to have a published committee charter.

The SEC published the NYSE proposal for comment on April 11, 2003. Companies would need to comply with these requirements by the earlier of (1) their first annual meeting after January 15, 2004 and (2) October 31, 2004.

36 The proposed NYSE rules would require the nominating/corporate governance committee to have a written charter that addresses (i) the committee's purpose and responsibilities, which at a minimum must be to identify potential board members, consistent with criteria approved by the board, and to select, or to recommend that the board select, the director nominees; develop and recommend to the board a set of corporate governance principles; and oversee the evaluation of the board and management; and (ii) an annual performance evaluation of the committee. The charter should also 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.
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B. Nasdaq

Unlike the NYSE, Nasdaq would not require a nominations committee. Instead, Nasdaq's proposals provide that director nominees must either be selected, or recommended for the board's selection, either by a nominations committee consisting only of independent directors, or by a majority of the independent directors. Each issuer must certify that it has adopted a formal written charter or board resolution, as applicable, addressing the nominations process and such related matters as may be required under the federal securities laws. Controlled companies do not need to have an all-independent-director nominating committee or otherwise comply with the nominating procedures described above. Also, the nominating procedures do not apply to a company which is subject to a binding obligation that requires a director nomination structure inconsistent with these procedures and such obligation pre-dates the approval date of the Nasdaq rules.

Independent director oversight of director nominations does not apply in cases where the right to nominate a director legally belongs to a third party. For example, investors may negotiate the right to appoint directors in connection with an investment, holders of preferred stock may be permitted to appoint directors upon certain defaults, or the company may be a party to a shareholder's agreement that allocates the right to nominate some directors. However, the company still needs to comply with the committee composition requirements for the nominations, compensation and audit committees.

If the nominations committee has at least three members, one member who is not independent, and who is not a current officer or employee or a family member of such person, can be appointed to the nominations committee if the board, under "exceptional and limited circumstances," determines that such individual's membership on the committee is required by the best interests of the company and its shareholders, and the nature of the relationship and the reasons for the determination are disclosed in the next proxy statement (or, if the issuer does not file a proxy, in its Form 10-K or 20-F). This person cannot serve more than two years.

The SEC published the Nasdaq proposals for comment on March 17, 2003. Issuers, other than foreign private issuers, would be required to be in compliance with Nasdaq's new listing rules by the earlier of (1) their first annual shareholders meeting after January 15, 2004 or (2) October 31, 2004. Foreign private issuers and small business issuers would be required to be in compliance with Nasdaq's new listing rules by July 31, 2005.

3. Compensation Committee

A. New York Stock Exchange

The NYSE's proposals would require that listed companies have a
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compensation committee composed entirely of independent directors. The committee must have a written charter that addresses specified topics, including an annual performance evaluation of the committee. The committee should have the sole authority to retain and terminate a compensation consultant, if any, that is used to assist in the evaluation of director, CEO or senior executive compensation. Controlled companies need not have an all-independent-director compensation committee.

The NYSE proposal provides that boards may allocate the responsibilities of the compensation committee to other committees, provided that they are composed entirely of independent directors. Any such committee would be required to have a published committee charter.

The SEC published the NYSE proposal for comment on April 11, 2003. Companies would need to comply with these requirements by the earlier of (1) their first annual meeting after January 15, 2004 and (2) October 31, 2004.

B. Nasdaq

Unlike the NYSE, Nasdaq would not require a compensation committee. Under Nasdaq's proposals, CEO compensation must be determined, or recommended to the board for determination, either by a compensation committee of only independent directors, or by a majority of independent directors. The CEO could not be present during voting or deliberations. Compensation of all other executive officers must be determined, or recommended to the board for determination, either by a compensation committee consisting only of independent directors or by a majority of the independent directors. Controlled companies do not need to have an all-independent-director compensation committee or otherwise comply with these requirements for determining compensation.

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37 The proposed NYSE rules would require the compensation committee to have a written charter that addresses (i) the committee's purpose and responsibilities—which, at a minimum, must be to have direct responsibility to (A) review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of these goals and objectives, and either as a committee or together with the other independent directors (as directed by the board) determine and approve the CEO's compensation level based on this evaluation; and (B) make recommendations to the board with respect to non-CEO compensation, incentive-compensation plans and equity-based plans; and (C) produce a compensation committee report on executive compensation as required by the SEC to be included in the company's annual proxy statement or annual report on Form 10-K; and (ii) an annual performance evaluation of the committee. The compensation committee charter should also 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. The NYSE also clarified that this provision should not be construed as precluding discussions of CEO compensation with the board generally.
If the compensation committee has at least three members, one member who is not independent, and who is not a current officer or employee or a family member of such person, can be appointed to the compensation committee if the board, under "exceptional and limited circumstances," determines that such individual's membership on the committee is required by the best interests of the company and its shareholders, and the nature of the relationship and the reasons for the determination are disclosed in the next proxy statement (or, if the issuer does not file a proxy, in its Form 10-K or 20-F). This person cannot serve more than two years.

The SEC published the Nasdaq proposals for comment on March 17, 2003. Issuers, other than foreign private issuers, would be required to be in compliance with Nasdaq's new listing rules by the earlier of (1) their first annual shareholders meeting after January 15, 2004 or (2) October 31, 2004. Foreign private issuers and small business issuers would be required to be in compliance with Nasdaq's new listing rules by July 31, 2005.

C. IRC 162(m) and Exchange Act Rule 16b-3

Even before the NYSE and Nasdaq introduced their corporate governance proposals, many companies have maintained compensation committees consisting of independent directors in order to satisfy the requirements of Section 162(m) of the Internal Revenue Code and Rule 16b-3 under the Exchange Act.

In order to comply with the requirements of Section 162(m) of the Internal Revenue Code, most public companies maintain a committee composed solely of "outside directors" to administer its stock-based plans. Section 162(m) generally limits the deductibility of compensation paid or accrued by a public company with respect to its CEO and the next four highest paid officers to not more than $1 million per individual per year. However, to the extent that compensation is deemed to be “performance based,” it is exempt from the $1 million limitation. Stock options are deemed to be “performance-based” compensation if: (a) they are granted under a plan that is approved by shareholders and that states the maximum number of shares with respect to which options may be granted during a specified period to any individual; (b) the grant is made by a committee consisting solely of two or more “outside directors”; and (c) the options are granted with an exercise price no less than the fair market value of the underlying shares on the date of grant. If a company does not comply with these requirements, compensation recognized by optionees upon exercise of options would count towards the $1 million limitation under Section 162(m). This could result in a loss of deduction for the company.

In addition, in order to comply with Rule 16b-3 under the Securities Exchange Act, public companies typically maintain a committee composed solely of two or more “nonemployee directors” that administers its stock-based plans. Section 16 of the Exchange Act provides that any sale and any purchase of publicly-traded company stock by an insider (i.e., officer, director or ten percent
shareholder) made within a six month period must be “matched” and any profit
realized therefrom must be relinquished to the company. Rule 16b-3 provides an
exemption from Section 16 liability for transactions between an issuer and its
officers and directors which are compensatory in nature. Under Rule 16b-3, one
of the ways that the grant of a stock option (which constitutes a purchase of the
underlying securities for Section 16 purposes) can be made exempt from Section
16b is if the grant of the stock option is approved in advance by a committee of
the board of directors comprised solely of two or more “nonemployee
directors.”

4. Audit Committee Independent Director Requirement

A. The Sarbanes-Oxley Act Requirements

On April 9, 2003, the SEC adopted new rules regarding the audit
committee requirements established by the Sarbanes-Oxley Act. The SEC’s rules
prohibit the New York Stock Exchange, Nasdaq and other national securities
exchanges and associations from listing any security of an issuer unless, among
other things, each member of the issuer’s audit committee is “independent.” In
order to be deemed independent, an audit committee member must not accept,
directly or indirectly, any consulting, advisory or other compensatory fees from
the issuer or a subsidiary and may not be an “affiliated person” of the issuer or
any of its subsidiaries.

The exchanges were required to provide to the SEC proposed rules or rule
amendments that comply with the requirements by July 15, 2003. Final exchange
rules or rule amendments must be approved by the SEC no later than December 1,
2003. Issuers, other than foreign private issuers, must be in compliance with the
new listing rules by the earlier of (1) their first annual shareholders meeting after
January 15, 2004 or (2) October 31, 2004. Foreign private issuers and small
business issuers must be in compliance with the new listing rules by July 31,
2005.

1. No Compensatory Fees

Audit committee members may not, directly or indirectly, accept any
consulting, advisory or other compensatory fees from the issuer or any of its
subsidiaries. There is no "de minimis" exception to this restriction. In addition,
audit committee members are prohibited from accepting payments as an officer or
employee of an issuer, as well as other compensatory payments. Directors and
committee member fees, however, are not prohibited. Further, if the director is
also a shareholder, payments made to all shareholders of the class generally, such

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38 If one or more members of the compensation committee is not an outside director or
nonemployee director, the compensation committee can still qualify for purposes of
Section 162(m) and Exchange Act Rule 16b-3 if the nonindependent director recuses
himself or herself from the determination of matters with respect to which such director is
not independent.
as dividends, are permitted. Finally, unless a self regulatory agency’s, or SRO’s, listing rules provide otherwise, the SEC's rules permit audit committee members to receive fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the issuer (provided that such compensation is not contingent in any way on continued service).

The indirect acceptance of compensatory payments includes payments to spouses, minor children or stepchildren or children or stepchildren sharing a home with the member. The SEC's rules only cover a limited group of family members and do not extend to the broad categories of family members that may be reached by the proposed rules of self regulatory organizations such as the NYSE and Nasdaq. For example, the NYSE's definition of "immediate family member" in its proposed rules would include a person's parents, spouse, children, siblings, mothers and fathers-in-law, sons and daughters-in-law brothers and sisters-in-law and anyone (other than domestic employees) who shares such person's home.

Indirect payments also include payments accepted by an entity (1) in which an audit committee member is a partner, member (except limited partners, non-managing members and those occupying similar positions, who in each case have no active role in providing services to the entity), officer such as a managing director occupying a comparable position or executive officer or in which the audit committee member otherwise occupies a similar position and (2) which provides accounting, consulting, legal, investment banking or financial advisory services to the issuer or any subsidiary. The SEC noted that the list of covered persons does not extend to every employee of an associated entity, but is intended to include those persons, such as partners or members in professional organizations, regardless of control, whose compensation could be directly affected by the prohibited fees, even if they are not the primary service provider. Although the final rules deleted the term "principal" from the list of covered persons, the SEC noted in the adopting release that "we believe the reference to 'those occupying similar positions' covers entities such as professional corporations that use the 'principal' designation for positions similar to a partner in a partnership."

The adopting release states that the payment restrictions only relate to entities providing "accounting, consulting, legal, investment banking or financial advisory services" and would not cause a director to lack independence on the basis of other commercial business relationships between an issuer and an entity with which a director had a relationship. For example, the prohibition on payments to entities does not cover non-advisory financial services such as lending, check clearing, maintaining customer accounts, stock brokerage services or custodial and cash management services. The SEC noted, however, that it expects that the SROs' own listing standards will impose restrictions on additional services and activities.

The SEC rules only apply the prohibition to current relationships between the issuer and the audit committee member (and related persons). They do not
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extend to a "look-back" period before a director's appointment to the audit committee, although the NYSE and Nasdaq include look-back provisions in their pending independence proposals.

2. Affiliated Persons

A member of the audit committee of an issuer that is not an investment company may not be an "affiliated person" of the issuer or any subsidiary of the issuer, apart from his or her capacity as a member of the board and any board committee. An "affiliate" of, or a person "affiliated" with, a specified person, is defined, consistent with other SEC rules, as "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified." The rules define "control" as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." This definition is also consistent with other current SEC rules. The determination as to whether a person is an "affiliate" must be made based on a consideration of all relevant facts and circumstances.

Any person who is neither an executive officer nor a shareholder beneficially owning 10% or more of any class of voting equity securities of the issuer is deemed not to control the issuer. Outside of this safe harbor, affiliate status depends on whether the person controls, is controlled by, or is under common control with, the issuer, based on a facts and circumstances analysis. The rules include an instruction stating that the existence of the safe harbor does not create a presumption in any way that a person who owns more than 10% controls or is otherwise an affiliate of a specified person.

The SEC's final rules provide that an affiliate's executive officers, inside directors, general partners and managing members will be deemed to be affiliates. The SEC's original proposal would have deemed "a director, executive officer, partner, member, principal or designee of an affiliate" to be an affiliate. The SEC's adopting release explains that "the reference to executive officers, general partners and managing members of an affiliate includes the positions we intend to cover. This will help clarify that passive, non-control positions, such as limited partners, and those that do not have policy making functions, are not covered. The formulation for being deemed to be an affiliate is narrower than the formulation of covered positions for the indirect acceptance aspect of the 'no compensation' prong due to their different purposes. We believe a wider formulation is necessary for the 'no compensation' prong to capture those whose compensation is more directly linked to fees from the prohibited services but who otherwise do not hold executive positions. Finally, we have removed the term 'designee.' However, consistent with our historical interpretations of the term ...

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39 Although the safe harbor provides some clarification with respect to the term "control", it does not address the question of whether a person "is controlled by or is under common control with" the issuer.
'affiliate,' an affiliate could not evade the prohibition in the rule simply by designating a third party representative or agent that it directs to act in its place."

3. Exemptions from Audit Committee Independence Rule

The final rules contain certain exemptions from the audit committee independence requirements:

First, the final rules exempt all but one member of the audit committee from the independence requirements at the effective time of an issuer's initial registration statement under Section 12 of the Securities Exchange Act of 1934 or the issuer's initial registration statement under the Securities Act of 1933, if the issuer immediately prior to the effective date was not required to file reports pursuant to Sections 13 or 15(d) of the Exchange Act. A majority of the members must be independent, however, within 90 days from the effective date of the registration statement, and all audit committee members must satisfy the independence requirements within one year of the effective date of the registration statement. The proposed rule would only have allowed one member of the committee to be exempt for 90 days.

Second, a committee member who sits on the board of directors of both an issuer and any of its affiliates is exempt from the "affiliated person" requirement if the audit committee member, except for being a director on each such board of directors, otherwise meets the independence requirements for each such entity, including the receipt of only ordinary-course compensation for serving as a member of the board of directors, audit committee or any other board committee of each such entity. This exception as proposed would have only covered a director who sat on the board of both a company and its consolidated majority-owned subsidiary. The exception was broadened to apply to a director sitting on the boards of a company and its affiliates in order to cover 50% joint ventures, sister companies and unconsolidated entities.

The SEC stated that it did not intend to consider case-by-case exemptions, waivers or no-action letter requests with respect to the audit committee independence requirements. The SEC emphasized, however, that it has exemptive authority to respond to, and will remain sensitive to, evolving standards of corporate governance, including changes in U.S. or foreign law, in order to address any new conflicts that cannot presently be anticipated.

4. Foreign Private Issuers

The SEC adopted a number of exemptions specifically for foreign private issuers. The SEC's adopting release states that, other than as set forth in the SEC's rules described below, an exchange may not exempt foreign issuers from the audit committee requirements or grant waivers.
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Non-executive employees

Employees of a foreign private issuer who are not executive officers are exempt from both the "affiliated person" and the "no compensatory payment" requirements, and may sit on the audit committee of a foreign private issuer, provided that the employee is elected or named to the board of directors or audit committee of the foreign private issuer pursuant to the issuer's governing law or documents, an employee collective bargaining agreement or similar agreement or other home country legal or listing requirements. This exemption is particularly relevant for companies in countries such as Germany, where non-management employees, who would not be viewed as "independent" under the requirements, are required to serve on the supervisory board or audit committee.

Affiliates

Any audit committee member of a foreign private issuer can be an affiliate of the foreign private issuer or a representative of such affiliate, if (1) the "no compensation" prong of the independence requirements is satisfied, (2) the member has only observer status on, and is not a voting member or the chair of, the audit committee, and (3) neither the member nor the affiliate is an executive officer of the foreign private issuer. As proposed, this exemption would have only been applicable to one member of the committee.

Governmental representative

Any audit committee member of a foreign private issuer can be a representative or designee of a foreign government or foreign governmental entity that is an affiliate of a foreign private issuer, if the "no compensation" prong of the independence requirement is satisfied and the member in question is not an executive officer of the foreign private issuer.40 As proposed, this exemption would have only been applied to one member of the committee.

Boards of Auditors

The listing of securities of a foreign private issuer is also exempt from all of the audit committee requirements if all of the following requirements relating to the existence of a board of auditors are met:

- the foreign private issuer has a board of auditors (or similar body), or has statutory auditors, established and selected pursuant to home country legal or listing provisions expressly requiring or permitting such a board or similar body;
- the board of auditors or statutory auditor is required under home

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40 The SEC acknowledged that foreign governments hold interests in foreign private issuers in a variety of ways, including directly, through branches or agencies, through institutions organized under public law and otherwise. The SEC clarified that the exemption applies regardless of the manner in which the foreign government owns its interest.
country legal or listing requirements to be either (A) separate from the board of directors or (B) composed of one or more members of the board of directors and one or more members that are not also members of the board of directors;

- the board of auditors is not elected by management of the issuer and no executive officer of the issuer is a member of the board of auditors;

- home country legal or listing provisions set forth or provide for standards for the independence of the board of auditors from the issuer or the management of the issuer;

- the board of auditors, in accordance with any applicable home country legal or listing requirements or the issuer's governing documents, is responsible, to the extent permitted by law, for the appointment, retention and oversight of the work of any registered public accounting firm engaged (including, to the extent permitted by law, the resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the issuer; and

- the audit committee requirements relating to complaint procedures, retention of advisors and funding apply to the board of auditors, to the extent permitted by law.

**Foreign Governments**

Issuers that are foreign governments (as defined in Rule 3b-4(a) of the Exchange Act) are exempt from the audit committee rules.

**Dual Holding Companies**

The rules contain special exemptions for "dual holding companies." This refers to a corporate structure in which two foreign private issuers are organized in different national jurisdictions, collectively own and supervise the management of one or more businesses that are conducted as a single economic enterprise, and do not conduct any business other than collectively owning and supervising such businesses and "reasonably incidental" activities.

Where a foreign private issuer is one of two dual holding companies, those companies may designate one audit committee for both companies so long as each member of the audit committee is a member of the board of directors of at least one of the dual holding companies. For purposes of satisfying the "affiliated person" prong of the independence requirements, dual holding companies will not be deemed to be affiliates of each other by virtue of their dual holding company arrangements, including where directors of one dual holding company are also
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directors of the other dual holding company, or where directors of one or both dual holding companies are also directors of the business jointly controlled, directly or indirectly, by the dual holding companies (and in each case receive only ordinary-course compensation for serving as a member of the board of directors, audit committee or any other board committee of the dual holding companies or any entity that is jointly controlled, directly or indirectly, by the dual holding companies).

Two-Tier Boards

The SEC clarified that, in the case of foreign private issuers with a two-tier board of directors, with one tier designated as the management board and the other tier designated as the supervisory or non-management board, the term "board of directors" means the supervisory or non-management board. Accordingly, the supervisory or non-management board could either form a separate audit committee or, if the entire supervisory or non-management board was independent within the provisions of the rules, the entire board could be designated as the audit committee.

No Conflicts Clarifications

The SEC added instructions to the rules to address possible conflicts between its audit committee rules governing auditor supervision, complaint procedures, advisors and committee funding and other applicable legal requirements (such as those arising under foreign laws). Specifically, the SEC instructions provide that:

- The audit committee requirements do not conflict with, and do not affect the application of, any requirement or ability under an issuer's governing law or documents or other home country legal or listing provisions that requires or permits shareholders to ultimately vote on, approve or ratify such requirements. However, if such responsibilities are vested with shareholders, and the issuer provides a recommendation or nomination regarding such responsibilities to its shareholders, the audit committee of the issuer, or body performing similar functions, must be responsible for making the recommendation or nomination.

- The audit committee requirements, including the requirement that the audit committee provide recommendations to shareholders where such responsibilities are vested with shareholders, do not conflict with any legal or listing requirement in an issuer's home jurisdiction that prohibits the full board of directors from delegating such responsibilities to the audit committee or limits the degree of such delegation. However, the SEC noted that, in such an instance, it believed that the audit committee or body performing similar functions must be granted such responsibilities, which can include advisory powers, with respect to such matters to
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the extent permitted by law, including submitting nominations or recommendations to the full board of directors.

- The requirements do not conflict with any legal or listing requirement in an issuer's home jurisdiction vesting such responsibilities with a government entity or tribunal. The audit committee should be granted such responsibilities, which can include advisory powers, with respect to such matters to the extent permitted by law.

B. New York Stock Exchange

The NYSE's proposals would require that listed companies have an audit committee that satisfies the SEC requirements.

In addition to the SEC requirements, the NYSE proposals include additional audit committee requirements. The audit committee must be comprised of at least three directors who are independent under both under the NYSE definition as well as under the SEC’s audit committee independence rules. Each member must be financially literate, as such qualification is interpreted by the company's board in its business judgment, or become so within a reasonable amount of time. At least one member must have accounting or related financial management expertise, as the company's board interprets such qualification. A board may presume that a person who meets the SEC's qualifications for audit committee financial expert has accounting or related financial management expertise.

If a member of the audit committee serves on more than 3 audit committees of public companies, and the listed company does not limit the number of audit committees on which its audit committee members serve, the board would have to determine that this does not impair the member’s effectiveness and disclose this in the proxy statement or, if the company does not file an annual meeting proxy statement, in the company's Form 10-K.

The audit committee rules are effective on the earlier of (1) the first annual meeting after January 15, 2004 and (2) October 31, 2004. Foreign private issuers only need to comply with the SEC audit committee rules (not the NYSE's additional audit committee rules) and their compliance deadline is July 31, 2005.

C. Nasdaq

Nasdaq's corporate governance proposals, as proposed on March 11, 2003 and amended on July 15, 2003 and October 9, 2003, would require audit committee members to meet the following independence standards:

- There must be at least three audit committee members, and all of them must be independent as defined by Nasdaq generally.
They must be independent under the criteria specified in SEC rules for audit committee members (e.g., they cannot receive any compensatory fee from the company and cannot be an "affiliated person" of the company). Commentary to the Nasdaq proposals states that it is recommended that an issuer disclose in its annual proxy (or, if the issuer does not file a proxy, in its Form 10-K or 20-F) if any director is deemed independent but falls outside the SEC's 10% ownership safe harbor.

Audit committee members can not have participated in the preparation of the financial statements of the company or any current subsidiary of the company at any time during the past three years.

All audit committee members must be able to read and understand fundamental financial statements, including a company's balance sheet, income statement and cash flow statement, at the time of their appointment rather than "within a reasonable period of time thereafter" as previously permitted.

Each issuer must certify that it has, and will continue to have, at least one member of the audit committee who has past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a CEO, CFO or other senior officer with financial oversight responsibilities. A director who qualifies as an "audit committee financial expert" under SEC rules is presumed to qualify as a financially sophisticated audit committee member for Nasdaq purposes.

One director who is not independent under the main director tests, who meets the audit committee member independence criteria set forth in the SEC's rules, and who is not a current officer or employee or a family member of such person, may be appointed to the audit committee if the board, under “exceptional and limited circumstances,” determines this to be in the best interests of the company and its shareholders and discloses this in the next proxy statement. However, this director cannot serve on the audit committee for more than two years and cannot be its chair.

Nasdaq originally proposed that an audit committee member could not own or control 20% or more of the issuer's voting securities (or such lower measurement as may be established by the SEC). Nasdaq later withdrew this provision.

An issuer is required to provide Nasdaq with prompt notification after an executive officer of the listed issuer becomes aware of any material noncompliance by the listed issuer with the qualitative listing requirements contained in Rule 4350 (which include, among other things,
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the majority independence, nominations committee, compensation committee and audit committee composition and charter requirements).

- If an issuer fails to comply with the SEC or Nasdaq audit committee member independence requirements described above because an audit committee member ceases to be independent for reasons outside of his reasonable control, the audit committee member may remain on the audit committee until the earlier of the company's next annual shareholders meeting or one year from the occurrence of the event that caused the failure to comply with the independence requirement. An issuer relying on this provision must provide notice to Nasdaq immediately upon learning of the event or circumstance that caused the non-compliance.

- If an issuer fails to comply with the audit committee composition requirement due to one vacancy on the committee, and the cure period in the previous bullet is not being relied upon for another member, the issuer will have until the earlier of the next annual shareholders meeting or one year from the occurrence of the event that caused the failure to comply with the requirement. An issuer relying on this provision must provide notice to Nasdaq immediately upon learning of the event or circumstance that caused the non-compliance.

Issuers, other than foreign private issuers, must be in compliance with Nasdaq's new listing rules by the earlier of (1) their first annual shareholders meeting after January 15, 2004 or (2) October 31, 2004. Foreign private issuers and small business issuers must be in compliance with Nasdaq's new listing rules (to the extent applicable) by July 31, 2005.

5. Audit Committee Responsibilities

A. The Sarbanes-Oxley Act Requirements

On April 9, 2003 the SEC adopted rules in accordance with the Sarbanes-Oxley Act which directs the NYSE, Nasdaq and other national securities exchanges and associations to prohibit the listing of any security of an issuer that does not have an audit committee (1) which is responsible for the appointment, compensation, retention and oversight of the auditor, (2) which establishes procedures for the receipt and treatment of certain complaints, (3) which has authority to engage independent counsel and other advisors, (4) which has the right to appropriate funding, and (5) which consists of only independent directors.

The exchanges were required to provide to the SEC proposed rules or rule amendments that comply with the requirements no later than July 15, 2003. Final exchange rules or rule amendments must be approved by the SEC no later than December 1, 2003. Issuers, other than foreign private issuers, must be in compliance with the new listing rules by the earlier of (1) their first annual shareholders meeting after January 15, 2004 or (2) October 31, 2004. Foreign
private issuers and small business issuers must be in compliance with the new listing rules by July 31, 2005.

1. Responsibilities Relating to Auditors

The audit committee rules require the audit committee to be directly responsible for the appointment, compensation, retention and oversight of the work of any registered public accounting firm engaged for the purpose of preparing or issuing an audit report or performing other "audit, review or attest services" for the issuer (including the resolution of disagreements between management and the auditor regarding financial reporting). These requirements reinforce the SEC's recent amendments to its auditor independence rules. The new SEC rules also reiterate that the independent auditor must report directly to the audit committee.

The SEC's adopting release clarifies that the auditor oversight responsibilities include the authority to retain (or not retain) and terminate the auditor. In addition, the audit committee must have the ultimate authority to approve all audit engagement fees and terms. In comparison, the SEC specifically declined to extend the oversight requirement to include oversight of the company's internal auditor.

2. Procedures for Handling Complaints

The rules require each audit committee to establish its own procedures for the receipt, retention and treatment of complaints received by the issuer regarding accounting, internal accounting controls or auditing matters and the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters. The SEC specifically elected not to mandate specific procedures that every audit committee must establish. Given the variety of issuers in the U.S. capital markets, the SEC concluded that audit committees should be provided with flexibility to develop and utilize procedures appropriate for their circumstances.

3. Authority to Engage Advisors

The rules require an issuer's audit committee to have the authority to engage independent counsel and other advisors, as it determines necessary to carry out its duties. The SEC stated that this requirement would neither preclude

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41 The adopting release clarifies that, for purposes of these rules, "audit, review or attest services" include the same services covered in the "Audit Fee" category in an issuer's annual disclosure of fees paid to its auditors. This category includes services that normally would be provided by the accountant in connection with statutory or regulatory filings or engagements. In addition to services necessary to perform an audit or review in accordance with GAAS, the category may include services that generally only the independent accountant reasonably can provide, such as comfort letters, statutory audits, attest services, consents and assistance with and review of SEC filings.
The committee's access to, or ability to receive advice from, the company's internal counsel or regular outside counsel, nor require an audit committee to retain independent counsel.

4. Funding

The rules require each issuer to provide for appropriate funding, as determined by the audit committee, in its capacity as a board committee, for the payment of compensation to any auditor engaged for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the listed issuer and to any other advisors employed by the audit committee. In addition, the rules provide that an issuer must provide appropriate funding for ordinary administrative expenses of the audit committee that are necessary or appropriate in carrying out its duties. The SEC specifically declined to impose any limits on the amount of funding that the committee could request.

5. Covered Issuers

The rules only apply to companies which have listed securities. The rules apply not only to companies with listed equity securities, but also to any company that has any listed security, including debt securities, derivative securities and other types of listed securities. The SEC specifically declined to exempt companies with only listed debt securities or listed preferred securities from the scope of the rules. The audit committee rules do not apply, however, to a company that has no listed securities, even if the company was otherwise subject to periodic reporting pursuant to Section 13(a) or 15(d) of the Exchange Act, such as an issuer with only unlisted debt securities.

The rules only apply to securities listed on a "national securities exchange" or "national securities association." There are nine registered national securities exchanges, including the NYSE and AMEX, and only one registered national securities association, the NASD. The OTC Bulletin Board, the Pink Sheets and the Yellow Sheets will not be affected by the requirements and issuers whose securities are quoted on these interdealer quotation systems therefore will not be affected, unless their securities also are listed or quoted on an exchange or Nasdaq.

6. General Exemptions

The SEC adopted limited exemptions from the audit committee requirements, including (among others) the following:

First, the SEC included an exemption from the audit committee requirements for companies with additional listings of securities on one or more different exchanges whenever the company is already subject to the audit committee requirements because it previously listed any class of its securities on an exchange subject to the requirements.
Second, the SEC included an exemption from the audit committee requirements for listings of securities by a direct or indirect subsidiary that is consolidated or at least 50% beneficially-owned by a parent company, if the parent company is subject to the audit committee requirements as a result of the listing of a class of the parent’s own common equity securities. However, if the subsidiary were to list its own equity securities (other than non-convertible, non-participating preferred securities), the subsidiary would be required to meet the audit committee requirements.42

In addition, the SEC permits an issuer with listed securities either to designate a separate audit committee or have the entire board of directors perform the functions of an audit committee. If the entire board constitutes the audit committee, the new SRO rules, including the audit committee independence requirements, will apply to the issuer's board as a whole. In the case of a listed issuer that is a limited partnership or limited liability company, where such entity does not have a board of directors or equivalent body, the term "board of directors" means the board of directors of the managing general partner, managing member or equivalent body.

B. NYSE Audit Committee Responsibility Proposals

The NYSE requires that listed companies comply with the SEC audit committee responsibility rules.

However, the NYSE also goes beyond the SEC requirements and increases the responsibilities of the audit committee. Specifically, the NYSE's proposals would provide that:

- The audit committee must have a written charter that includes specified items, including an annual performance evaluation of the committee.43

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42 The "multiple listing" exemptions described in this and the preceding paragraph are available to U.S. subsidiaries if the parent is a foreign private issuer, even if the foreign parent is relying on one of the special exemptions for foreign private issuers (such as the board of auditors exemption). However, the special exemptions available to the foreign parent are not available to its U.S. subsidiary.

43 The audit committee charter must address (i) the committee's purpose which, at minimum, must be to (A) assist board oversight of (1) the integrity of the company's financial statements, (2) the company's compliance with legal and regulatory requirements, (3) the independent auditor's qualifications and independence, and (4) the performance of the company's internal audit function and independent auditors; and (B) prepare the audit committee report as required by the SEC to be included in the company's annual proxy statement; (ii) an annual performance evaluation of the audit committee; and (iii) the duties and responsibilities of the audit committee which, at minimum, must include those required by the SEC (e.g., appointment of auditors, procedures for receipt of complaints, obtaining advice from outside counsel and receiving appropriate funding).
The audit committee must receive at least annually a report by the auditor describing the auditor's internal quality-control procedures and any material quality-control issues raised in the past five years.

The audit committee must (1) discuss the company's annual and quarterly financial statements with management and the auditor, including the MD&A, (2) discuss the company's earnings press releases, as well as financial information and earnings guidance provided to analysts and ratings agencies (this may be done generally, and the audit committee need not discuss in advance each earnings release or each instance in which a company may provide earnings guidance), (3) discuss policies with respect to risk assessment and risk management, (4) meet separately, periodically, with management, with internal auditors and with independent accountants, (5) review with the auditor any audit problems or difficulties and management's response (among the items the audit committee may want to review are any accounting adjustments that were noted or proposed by the auditor but were passed, any communications between the audit team and the audit firm's national office respecting auditing or accounting issues, and any management or internal control letter issued by the audit firm to the company), (6) set clear hiring policies for employees or former employees of the auditors, and (7) report regularly to the board of directors.

The audit committee should review (1) major issues regarding accounting principles and financial statement presentations, including any significant changes in the company's selection or application of accounting principles, and major issues as to the adequacy of the company's internal controls and any special audit steps adopted in light of material control deficiencies, (2) analyses prepared by management and/or the independent auditor setting forth significant financial reporting issues and judgments made in connection with preparation of the financial statements, including analyses of the effects of alternative GAAP methods of the financial statements, (3) the effect of regulatory and accounting initiatives, as well as off-balance sheet structures, on the financial statements, and (4) the type and presentation of information to be included in earnings press releases, as well as any financial information and earnings guidance provided to analysts and ratings agencies.

Each listed company must have an "internal audit function." The internal auditors must provide management and the audit committee with ongoing assessments of the company's risk management processes and system of internal control. The
function can be outsourced to a firm who is not the company's external auditor.

Companies would need to comply with these requirements by the earlier of their first annual meeting after January 15, 2004, and October 31, 2004. Foreign private issuers only need to comply with the SEC audit committee rules (not the NYSE's additional audit committee rules) and their compliance deadline is July 31, 2005.

C. Nasdaq Audit Committee Responsibility Proposals

Nasdaq's corporate governance proposals would revise and augment its requirements for audit committees of Nasdaq companies. Specifically, Nasdaq's proposals would provide as follows:

- The audit committee charter must specify:

  o the committee's purpose of overseeing the accounting and financial reporting processes of the issuer and the audits of the financial statements of the issuer; and

  o the specific audit committee responsibilities and authority necessary to comply with the rules adopted by the SEC concerning responsibilities relating to registered public accounting firms (e.g., authority to appoint and oversee the outside auditors, complaints relating to accounting, internal accounting controls or auditing matters, authority to engage advisors and funding as determined by the audit committee).

- Issuers, other than foreign private issuers, must be in compliance with Nasdaq's new listing rules by the earlier of (1) their first annual shareholders meeting after January 15, 2004 or (2) October 31, 2004. Foreign private issuers and small business issuers must be in compliance with Nasdaq's new listing rules by July 31, 2005.

D. Nasdaq Provision Regarding Approval of Related Party Transactions

Nasdaq proposed on June 11, 2002 (as amended on December 30, 2002, October 2, 2003 and October 3, 2003) a new requirement that all related party transactions be "approved" by the audit committee or another independent body of the board of directors. Currently Nasdaq only requires that such transactions be "reviewed" by the audit committee. As proposed, a "related party transaction" would include any transaction required to be disclosed by Item 404 of Regulation S-K. The SEC published this proposed rule for comment on July 8, 2003.
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Nasdaq proposed that this rule change become effective on January 15, 2004.

E. New York Proposed Legislation

In early 2003 New York Attorney General Eliot Spitzer proposed a bill amending New York’s Not-For-Profit Corporation Law to protect the public against financial fraud and misconduct by not-for-profit corporations incorporated in or conducting activities in New York. Among other things, the proposed legislation included the following provisions related to audit committees:

- The board of any not-for-profit corporation (1) whose financial statements are audited by a public accounting firm, (2) that has at least $3 million in assets, or (3) that receives or accrues at least $1 million in gross revenue and support during any fiscal year, would be required to designate an audit committee, if the certificate of incorporation and bylaws so permit. The committee would consist of three or more board members.

- The audit committee, or the entire board (if the certificate of incorporation or bylaws prohibit designation of an audit committee), would be directly responsible for the appointment, compensation and oversight of the work of any registered public accounting firm employed for the purpose of preparing or issuing audit reports or related work. This requirement mirrors a Sarbanes-Oxley Act requirement for companies listed on the New York Stock Exchange, Nasdaq and other exchanges.

- Each member of the audit committee would be on the board of directors and would not be permitted to, except in their capacity as a member of a board or committee, (1) accept any consulting, advisory or other compensation or benefits from the corporation, except in their capacity as a member of the board or a committee, or (2) have participated in any other interested party transactions within the meaning of the NPCL within the previous year. This is similar to the requirement in the Sarbanes-Oxley Act that audit committee members cannot accept any compensatory fee from the corporation and must not be an affiliated person of the corporation.

- Each registered accounting firm employed by the corporation would be required to report directly to the audit committee.

- The audit committee, or the entire board (if the certificate of incorporation or bylaws prohibit designation of an audit committee), would be required to establish procedures for handling complaints regarding accounting, internal accounting controls or auditing matters and for the confidential, anonymous submission of concerns by employees of the corporation regarding questionable accounting, auditing or other financial matters.
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This also mirrors the Sarbanes-Oxley requirement for companies listed on the NYSE, Nasdaq or another exchange.

These provisions would impact the composition of audit committees of not-for-profit corporations established by for profit public companies where traditionally the board of the not-for-profit corporation is composed exclusively of employees and officers of the for profit corporation.

6. Financial Experts on the Audit Committee

Pursuant to the Sarbanes-Oxley Act, the SEC adopted new rules regarding the audit committee financial expert. The rules require reporting issuers, including foreign private issuers, to disclose in their annual reports on Form 10-K, 20-F or 40-F, whether their audit committee has at least one member who is an audit committee financial expert, and, if not, provide reasons why. The rules go beyond the requirements of the Sarbanes-Oxley Act by requiring issuers to disclose the name(s) of the audit committee financial expert and affirm that the expert(s) is independent of management, as determined by the issuer’s board of directors, or provide reasons why they are not. The new rule requires disclosure only in the annual report, not in Securities Act or Exchange Act registration statements, although the disclosure may be included in a proxy or information statement and incorporated by reference into the annual report. This requirement becomes effective for annual reports for fiscal years ending on or after July 15, 2003 (December 15, 2003 for small business issuers).

The proposed definition of the term “financial expert” proved to be controversial and was criticized for being overly restrictive, prompting the Wall Street Journal to query whether even famed investor Warren Buffett could qualify.44 Accordingly, the SEC significantly broadened the types of persons that would qualify. Under the adopted rule, an “audit committee financial expert” must have all of the following attributes:

1. an understanding of generally accepted accounting principles and financial statements;
2. an ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;
3. experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the issuer’s financial statements, or experience actively supervising one or more persons engaged in such activities;

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4. an understanding of internal controls and procedures for financial reporting; and

5. an understanding of audit committee functions.

A person can acquire these five attributes through any one or more of the following means:

1. education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions;

2. experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;

3. experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or

4. other relevant experience.

An individual will have to possess all of the five attributes listed in the above definition to qualify as an audit committee financial expert. However, the required attributes included in the final rules have been relaxed in several important respects that should make it easier for directors to qualify as audit committee financial experts. For example, the SEC eliminated the requirement that an expert have direct experience “preparing or auditing” financial statements and broadened this attribute to cover experience “preparing, auditing, analyzing or evaluating” financial statements or experience “actively supervising” one or more persons engaged in these activities.

Similarly, whereas the original proposal required that an expert must have experience applying “generally accepted accounting principles in connection with the accounting for estimates, accruals and reserves that are generally comparable to the estimates, accruals and reserves, if any, used in the registrant’s financial statements,” the final rule only requires an ability to assess the general application of GAAP in connection with the accounting for estimates, accruals and reserves. Additionally, the required attributes in the final rules include an “understanding of” internal controls and procedures, rather than “experience with” such controls and procedures as was included in the proposed rules. The SEC also clarified that the financial expert need not have experience in the same industry or with a reporting company.

The SEC’s adopting release clarified that “actively supervising” means that a person participated in, and contributed to, the process of addressing, albeit at a supervisory level, the same general types of issues regarding preparation,
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auditing, analysis or evaluation of financial statements as those addressed by the person or persons being supervised. For example, a chief executive officer who works closely with financial officers on a day-to-day basis would be included, while a chief executive officer who concentrates on the operations side of the business, but who the financial officers report to, would not be.

The fact that a person previously served on an audit committee or had experience as an auditor, chief financial officer, controller or chief accounting officer would not, by itself, justify the board in deeming the person to be an expert. Similarly, a person could be sufficiently knowledgeable in financial and accounting matters even if that person never held one of the specifically identified positions. The board would have to consider if the person’s qualifications, in the aggregate, satisfied the expert definition. The SEC’s proposing release noted categorically, however, that any accountant suspended or barred from practice before the SEC by Rule 102(e) generally would not be eligible to serve as a financial expert. In the adopting release, the SEC further noted that a board should consider any disciplinary actions to which a potential expert is, or has been, subject in determining whether that person would be a suitable audit committee financial expert.

In the case of foreign private issuers, the audit committee financial expert’s understanding must be of the generally accepted accounting principles used by the foreign private issuer in preparing its primary financial statements filed with the SEC. Although an understanding or reconciliation to U.S. generally accepted accounting principles would be helpful, the SEC stated that the proper focus of audit committee financial expertise is on the principles used to prepare the primary financial statements.

On April 9, 2003, the SEC adopted supplemental rules which provide that a foreign private issuer that is a listed issuer must disclose whether its audit committee financial expert is independent, as that term is defined by the applicable exchange's listing standards. A foreign private issuer that is not a listed issuer must choose one of the exchange definitions of audit committee member independence and disclose whether its audit committee financial expert, if it has one, is independent under that definition. The SEC also stated that the audit committee financial expert's expertise should be related to the body of generally accepted accounting principles used in the issuer's primary financial statements filed with the SEC. The new rules also clarify that, for foreign private issuers, the term "audit committee" means the board of auditors or similar body or statutory auditor, if the issuer has a board of auditors meeting the criteria described above. Foreign private issuers must comply with the audit committee financial expert disclosure requirements related to independence beginning July 31, 2005.

The SEC's rule regarding the audit committee financial expert is more stringent than existing NYSE and Nasdaq requirements. The NYSE and Nasdaq existing rules require at least one member of an issuer's audit committee to have a
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certain level of financial sophistication, but this threshold is relatively low and can be met by any individual who has "accounting or related financial management expertise" in the case of the NYSE or "past employment experience in finance or accounting" in the case of Nasdaq.45

In an attempt to assuage concerns of audit committee members of increased potential liability as a result of the increased role and responsibilities of audit committee members, the SEC's new rules provide a safe harbor under which an audit committee financial expert will not be deemed an “expert” for any purpose, including for purposes of Section 11 of the Securities Act of 1933, and that the designation of a person as an audit committee financial expert does not impose any duties, obligations or liability on the person that are greater than those imposed on such a person as a member of the audit committee in the absence of such designation, nor does it affect the duties, obligations or liability of any other member of the audit committee or board of directors. Moreover, any information in a registration statement reviewed by the audit committee financial expert is not "expertised" and is not subject to a higher level of due diligence.

7. Proposed NYSE Corporate Governance Guidelines

As part of the NYSE's corporate governance proposals published for comment by the SEC on April 11, 2003, the NYSE included a proposal which would require all listed companies to adopt and disclose corporate governance guidelines. Each listed company's website would be required to include these corporate governance guidelines and the charters of its most important committees (including at least the audit and, if applicable, the compensation and nominating committees). Each company's annual report on Form 10-K filed with the SEC would be required to state that the foregoing information is available on its website and is available in print to any shareholder that requests it. The corporate governance guidelines must address director qualification standards, director responsibilities, director access to management and (as necessary and appropriate) independent advisors, director compensation, director orientation and continuing education, management succession, and an annual performance

45 Nasdaq requires issuers to have at least one member on the audit committee who has past employment experience in finance or accounting, requisite professional certification in accounting or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities. On October 9, 2002, Nasdaq proposed to modify Nasdaq’s "financial expert" requirement to require issuers to consider whether a person has, through education and experience as a public accountant or auditor or a principal financial officer, comptroller or principal accounting officer of an issuer or from a position involving similar functions, sufficient financial expertise in the accounting and auditing areas specified in the Sarbanes-Oxley Act or SEC rules. However, the Nasdaq rules published by the SEC on March 17, 2003 withdrew this proposed revision and retained Nasdaq's existing requirement, except that audit committee members must be financially literate at the time of appointment (rather than "within a reasonable period of time" as in the current rules).
evaluation of the board. Companies would need to comply with these requirements by the earlier of (1) their first annual meeting after January 15, 2004 and (2) October 31, 2004.

8. Implementing the Corporate Governance Proposals

The Sarbanes-Oxley Act, together with the NYSE and Nasdaq proposals, have required most companies to step back and analyze their entire corporate governance structure. Particularly nettling has been deciphering which provisions are effective, which are proposed, which are likely to be adopted and in what form, what the timelines and deadlines are for all of them and how all of the proposals interconnect.

It is reportedly becoming harder for companies to locate qualified directors due to the increased potential liability of directors, more stringent definitions of independence, enhanced responsibilities of board members, especially audit committee members, greater time commitment demanded from directors, and the narrow qualifications required of the audit committee “financial expert.” This is exacerbated by suggestions or demands that directors serve on fewer boards so that they are not spread too thin. In addition, there is some evidence that directors are working harder now. Informal surveys by the National Association of Corporate Directors suggest that board members expect to spend between 175 and 200 hours per year on board business, compared to 100 to 125 hours in the recent past. Perhaps most in demand are former audit partners and retired CFO’s, who can serve as the audit committee financial expert.

Some companies are increasing director training. Cinergy Corp., for example, set up for directors a series of training sessions on accounting and finance topics, including wholesale energy trading. Cinergy also set up an Internet-based system that gives directors access to financial information and interactive tools to communicate with external auditors, management and counsel. Nasdaq’s corporate governance proposals would specifically require enhanced director continuing education for all of its companies.

Some companies are revising their corporate governance practices well in advance of final rules. For example, in November 2002 General Electric Co. announced a series of changes in its corporate governance practices. Among other things, GE named a presiding director to lead executive session meetings of non-management directors, established a board two-thirds of whom were

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46 Reforms Turn Search for Directors Into a Long, Tedium Task, The Wall Street Journal, August 29, 2002, at B1 (one CEO says a director search that used to take three to eight months now may take 12 to 18 months); Rule Proposals Stress Independent Directors; Scrutiny May Dissuade New Recruitment, The Commercial Appeal, August 25, 2002, at G4 (official at the National Association of Corporate Directors says CEO’s are less likely to serve on boards).

independent, replaced stock options with deferred stock units as compensation for directors in the future, and required all directors to visit two GE businesses a year without senior management. GE established a new standard for independence whereby a director would be considered independent if sales to and purchases from GE total less than 1% of the revenue of the companies where the director serves as an executive. The same provision applies to loans to and from GE, and to charitable donations from GE to an organization where a GE director serves as an officer or director. GE also limited its directors to serving on no more than four additional public company boards (two in the case of CEO's).48

The independence proposals have also required private equity sponsors to review the boards of their portfolio companies, to consider whether their board representatives can be deemed independent under the proposed rules and to determine if they want their employees to remain on audit committees or boards of directors at all.49 Private equity sponsors benefit from the “controlled company” exception at both NYSE and Nasdaq to the extent they control over 50% of a portfolio company’s voting power, although even in this case the audit committee must consist only of independent directors. Private equity sponsors also benefit from the provisions in the NYSE and Nasdaq proposed rules stating that ownership of a large block of stock does not by itself preclude a board from determining that a shareholder is independent. On the other hand, the Sarbanes-Oxley Act and SEC rules provide that audit committee members cannot be an “affiliated person” of the issuer or receive any consulting, advisory or other compensatory fee from the issuer other than director fees. Even if the directors can satisfy the technical independence requirements, they may not be willing to serve on boards (or audit committees) due to the perception of enhanced liability and increased responsibilities.

The NYSE’s proposals would require all listed companies to have an internal audit function, although not necessarily an internal audit department. Internal auditing has received additional attention of late, perhaps because Worldcom’s internal auditor is credited with unearthing $3 billion of erroneously booked earnings. One issue companies should consider is whether the internal auditors should report directly to the audit committee or, instead, to the CFO or CEO. According to the Institute of Internal Auditors, most companies have the internal auditor report to the audit committee for policy-making and to a senior executive such as the CFO for more routine matters. What is unclear is the role internal auditors should now play. Historically internal auditors focused on information systems and operations, but more recently they have been asked to review financial statements as well. At J.C. Penney, for example, the 80-member internal audit team is spending more time working with the external auditors. Some companies also have the internal auditors prepare the audit committee

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Companies are also outsourcing all or part of the internal audit function to other accounting firms who are not their regular auditors.

9. The Business Roundtable’s Principles of Corporate Governance

The NYSE and Nasdaq corporate governance proposals echo to a large extent the Principles of Corporate Governance issued by The Business Roundtable in May 2002. These principles recommended best practices with respect to the board of directors, board committees and the roles of directors and management. Among other things, the principles recommend that a “substantial majority” of the directors should be independent of management and that corporations should have audit, corporate governance (or nominating) and compensation committees consisting solely of independent directors. They also recommend that the board conduct periodic self-evaluations to determine whether it and its committees are following procedures necessary to function effectively.

The principles particularly highlight the critical role of the audit committee. They recommend that the audit committee should, among other things, (1) oversee the company’s risk assessment and management practices, (2) recommend the firm to be engaged as the outside auditor and conduct an annual due diligence review of the qualifications and work product of the chosen auditor, (3) consider the independence of the outside auditor and develop policies regarding the provision of nonaudit services by the auditor, (4) review and discuss with management and the outside auditor the company’s critical accounting policies and the quality of accounting judgments made by management, (5) review periodically with internal and external auditors the company’s internal controls, (6) review the company’s compliance procedures, (7) review the annual financial statements with management and the outside auditor, (8) oversee the company’s internal audit function, and (9) consider adopting a policy governing the hiring of former auditor personnel.

10. The Conference Board’s Principles of Corporate Governance

On January 9, 2003, the Commission on Public Trust and Private Enterprise of The Conference Board issued its findings and recommendations regarding corporate governance. The Commission issued a set of principles.

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50 The insiders: do internal auditors have a bigger role to play in ensuring the integrity of financial reports?, CFO, The Magazine for Senior Financial Executives, September 1, 2002, No. 9, Vol. 18, pg. 99.

51 The Business Roundtable is an association of CEO’s from leading U.S. corporations with more than 10 million U.S. employees and $3.7 trillion in revenues combined.

52 The Conference Board is a U.S. not-for-profit public interest organization which conducts research, convenes conferences, makes forecasts, assesses trends, publishes information and brings executives together. Members of the Conference Board include major U.S. and global corporations. The 12 members of the Commission on Public Trust and Private Enterprise at the time the Commission issued its principals included Peter Peterson (Blackstone Group Chairman), Paul Volcker (former Federal Reserve Chairman), Warren Rudman (former U.S. Senator), Arthur Levitt (former SEC.
with specific best practice suggestions. The suggestions include the following:

- **CEO and Chairman.** Three alternative board structures should be considered: (1) the Chairman and the CEO are different people, with the Chairman being an independent director; (2) the Chairman and CEO are different people, but the Chairman is not an independent director, the Chairman is not a member of management, and there is a Lead Independent Director; or (3) the same person is Chairman and CEO but there is a Presiding Director also. The independent Chairman, the Lead Independent Director or the Presiding Director should have ultimate approval of information that goes to the board, board meeting agendas and board meeting schedules. Boards that do not use one of the three approaches should explain why not. The separation of the CEO and Chairman and use of a lead director is not required by the Sarbanes-Oxley Act or the NYSE/Nasdaq proposals.

- **Executive sessions.** Non-management directors should have regular, frequent meetings without the CEO or other directors who are members of management. This is similar to the NYSE executive session proposal.

- **Substantial majority independence.** A "substantial majority" of the board should be composed of independent directors (compared to the NYSE/Nasdaq "majority" proposal).

- **Nominating/governance committee.** The nominating/governance committee should recommend to the full board an appropriate board organization, qualifications for board membership, an appropriate slate of qualified board nominees, requirements for director orientation and training, corporate governance principles, and candidates for CEO succession (similar to the NYSE proposal).

- **Board self-evaluation.** The board must evaluate itself, its committees, each individual director and the CEO at least annually.

- **Independent investigation.** If an independent investigation is reasonably likely to implicate management, the board rather than management should retain special counsel for the investigation. The counsel should report to the board or a board committee and should not be the company's regular outside counsel.

Chairman), Andrew Grove (Intel Chairman), John Bogle (Vanguard Founder), John Biggs (Chairman of TIAA-CREF), Peter Gilbert (Chief Investment Officer of Pennsylvania State Employees Retirement System), John Snow (former Chairman of CSX), Ralph Larsen (former Chairman of Johnson & Johnson), Charles Bowsher (former U.S. Comptroller General) and Lynn Sharp Paine (Harvard Business School Professor). Conference Board and Commission statements are not binding on any company but may influence regulators and corporate executives.
Shareholder involvement. Boards should develop procedures to receive and consider shareholders' nominations for the board as well as shareholder proposals. Boards should give serious consideration to adopting advisory shareholder proposals that receive a significant number of the votes cast, giving weight to the number of shares held and the length of time the shares have been held.

Long term share ownership. Company executives charged with communicating with shareholders should formulate and communicate to investors a strategy designed to attract investors known to pursue long-term holding investment strategies. Companies should encourage short-term traders to become long-term owners. Portfolio manager compensation arrangements should encourage a long-term rather than a short-term focus. Policy makers should formulate differential tax strategies to encourage investors to trade with a long-term investment horizon.

Audit committee compliance. Boards should devote sufficient resources and time to implementing the Sarbanes-Oxley Act and NYSE listing standards regarding audit committees. Boards should ensure that all audit committee members are independent and must disclose if there is no financial expert. Audit committees should conduct an annual assessment of the performance of the committee and its members.

Audit committee outside advisors. Audit committees should consider retaining outside advisors who have no relationship with management, the outside auditors or the internal auditor.

Audit committee continuing education. Audit committee members should participate in an initial orientation program as well as educational programs thereafter.

Internal audit function. All companies should have an internal audit function, either in-house or performed by an outside auditor. The internal auditors should prepare for the audit committee a multi-year audit plan of at least three years centered on the company's risks. The internal auditor should have direct reporting responsibility to the audit committee and should attend all audit committee meetings.

11. The Business Roundtable Corporate Governance Survey (July 2003)

In July 2003 the Business Roundtable issued the results of a survey of the corporate governance principles adhered to by its 150 members. The survey found the following:
Board Independence. 80% of Roundtable companies found that their boards of directors are at least 75% independent and 90% report that at least 2/3 of their boards are independent.

Director Education. 90% of Roundtable companies encourage, require or have in place director education for new (54%) or all (36%) directors, compared to 76% in 2002.

Director Evaluation. Over 70% of Roundtable companies performed director evaluations in 2003, compared with 44% in 2002.

Executive Session. The outside directors of 97% of Roundtable members are meeting in executive session at least once each year, and 55% expect to do so at least five times this year.

Increased Information. 77% of Roundtable companies increased the amount of information sent to their board of directors, and 88% increased the amount sent to members of the audit, compensation or nominating committees.

Increased Involvement. 91% reported increased involvement by the board of directors.

Shareholder Communications. 66% of Roundtable companies (1) reported that their nominating/governance committees have a process in place by which to communicate and respond to shareholder nominations of board candidates and (2) discussed with their nominating committee a process to communicate and respond to shareholder proposals and inquiries.

Costs of Compliance. Roundtable members who were able to estimate cost reported dedicating financial resources between $1 million to over $10 million to ensuring the implementation of the Sarbanes-Oxley Act and proposed NYSE listing standards.

12. D&O Insurance

Directors and officers need to spend additional time making sure that their companies have adequate D&O insurance policies with reputable insurance companies. The details of the insurance policies can be very significant for directors and officers. Because insurance forms and policies are constantly evolving, companies should periodically review with their insurance broker and/or counsel whether there are new standard terms which should be included in the insurance policies. Among the key provisions which should be considered in D&O policies include the following:
**Shared Limits.** D&O insurance policies often cover both the directors and officers as well as the company itself. This could hurt directors to the extent a policy has claim and aggregate limits that are reached. One option is to set up different sublimits for the company and the directors as a whole or the directors separately. Also, the policy could be amended to provide that directors' coverage is paid before others (e.g., the company).

**Insured vs. Insured Exclusion.** D&O insurance policies often disallow coverage when one insured party (e.g., the company) brings an action against another insured party (e.g., the directors). In bankruptcy, the insurance company may argue that a claim brought by the trustee in bankruptcy against the directors is not covered by the policy because the trustee stands in the shoes of the company. Directors and officers may want to make sure that their D&O policies do not allow the trustee in bankruptcy to be deemed the company for this purpose or otherwise limit this exclusion.

**Misrepresentation in the Application.** In some cases, insurance companies may refuse to pay a claim for all insured parties where a misrepresentation was committed by the person who signed the insurance application. The policy should make it clear that the misrepresentation by the signing officer does not impact otherwise innocent directors and officers.

**Fraud.** D&O policies usually have a provision that prohibits coverage for claims arising out of fraud. However, it is crucial that it be made clear that the fraud of one officer or director is not imputed to anyone else.

**Final Adjudication.** D&O policies typically include provisions which exclude coverage for claims which arise from the director's wrongful act done for personal benefit or through his or her intentional conduct. Final judicial determination of personal benefit, fraud and intentional conduct should be required before exclusions on those grounds may be asserted by the insurer for purposes of excluding coverage. In recent years, most insurers have removed the "final adjudication" limitation on the applicability of these exclusions from standard policies.

**General Counsel's Knowledge.** General counsel's knowledge acquired as legal counsel should not be imputed to the company or other insureds.

**Preferred Counsel.** Directors and officers should make sure that the insurer does not restrict choice of defense counsel to a panel list mandated by the insurer. If the desired counsel is not on the
list, directors and officers should make sure their desired counsel is listed when replacing or renewing coverage.

- **Extended Reporting Period Options for Claims First Made After Policy Expiration.** These options maintain the ability of the insured parties to seek insurance protection where there is a change to a new carrier which excludes coverage for acts prior to the inception of the new policy. Some insurers are limiting these options and pricing those offered at historic highs. Options for one, two and three years are desirable to cover claims arising from acts prior to the policy's expiration even if made thereafter. In transactional matters, a six-year period may be desired and the insurer should be asked to commit to offer it.

Directors may also require that the company obtain non-rescindable "Side A" excess executive liability insurance. This insurance policy would cover the independent directors when the underlying policy is rescinded, has its limits exhausted, or excludes the claim due to a restatement exclusion. This policy is not cancelable (except for non-payment of premiums), defines "securities claim" to include claims brought by a bankruptcy trustee, and cannot be excluded due to a financial reporting restatement or insider wrongdoing.

13. **Nasdaq Program Regarding Written Interpretations of Listing Rules**


As part of the pilot program, issuers listed on The Nasdaq SmallCap Market or The Nasdaq National Market must pay $2,000 in order to obtain written interpretations of Nasdaq listing rules (the 4000 through 4500 series). A response will be provided by Nasdaq generally within four weeks from the date that Nasdaq receives all information necessary to respond to the request. Issuers who pay $10,000 will be able to obtain a written response by a specific date that is less than four weeks but at least one week after the date Nasdaq receives all information necessary to respond to the request. Nasdaq will not assess these fees for requests submitted by issuers in connection with their initial listing on Nasdaq, because reviews of those matters are considered to be part of the processing of an issuer's application and a separate application fee is already charged in those situations. The board of directors of Nasdaq or its designee may defer or waive all or any part of the fee. Before institution of the pilot program, Nasdaq provided written interpretations of its rules at no cost to issuers.

On August 11, 2003, Nasdaq also proposed increasing its fee in connection with listing additional shares from "the greater of $2,000 or $.01 per additional share, up to a maximum of $22,500 per quarter and an annual
maximum of $45,000 per issuer" to "the greater of $2,500 or $.01 per additional shares, up to a maximum of $45,000 per issuer." Nasdaq also proposed imposing a fee of $2,500 whenever an issuer makes a change such as a change to its name, the par value or title of its security or its ticker symbol. The SEC published this proposal for comment on August 26, 2003.

14. Nasdaq Proposal Regarding Applicability of Rules During Appeals

On February 25, 2003 and October 9, 2003, Nasdaq issued a proposed rule clarifying the applicability of its corporate governance rules during the listing appeals process. In many cases during a Nasdaq listing appeal the issuer is no longer actually listed on Nasdaq and thus not technically subject to the Nasdaq corporate governance rules. However, Nasdaq proposed an amendment to its appeals rules which would provide that the NASD Board of Governors or the Listing and Hearing Review Council, as part of their review, may also consider any action by an issuer during the review process that would have constituted a violation of Nasdaq's corporate governance requirements had the issuer's securities been listed on Nasdaq at the time. The SEC has not yet published this proposal for comment.


In August 2003 the MCI Corporate Monitor, Richard C. Breeden, issued a report entitled "Restoring Trust" at the request of Judge Jed Rakoff which included a series of proposals regarding MCI's corporate governance. These recommendations were developed pursuant to the terms of the Permanent Injunction issued by Judge Rakoff in connection with the enforcement proceeding brought against WorldCom, Inc. by the SEC. The Permanent Injunction required the development of recommendations intended to prevent any reoccurrence of governance abuses at Worldcom. MCI was required to implement all of these recommendations unless it obtained leave of the court not to implement a specific recommendation.

The 78 recommendations discuss the board of directors, board leadership and the chairman, board compensation, executive compensation, the audit committee, the governance committee, the compensation committee, the risk management committee, general corporate issues, and legal and ethics programs. Key themes include the following:

- **Governance Constitution.** Most of the governance standards are required to be included in the articles of incorporation, which can only be changed with prior shareholder consent. For example, the charter should require a board of between eight and 12 members, and the charter should include specific independence standards that directors must satisfy.
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- **Electronic Town Hall.** The board is required to establish an electronic town hall where shareholders may communicate with the board and propose resolutions for consideration irrespective of whether the proposed resolution would be allowed under SEC proxy regulations. Resolutions that receive a minimum vote (such as 20%) through this process must be included in the proxy the following year.

- **New Director Each Year.** Beginning in 2005 at least one new director must be elected each year, who shall not have previously served as an employee or director of the company for at least five years. As a result, one director will not be renominated each year to permit the election of a new director.

- **Shareholder Director Nominations.** The governance committee must solicit directly nominations from the company's 10 largest shareholders (or such larger number as may be necessary to represent least 15% of the outstanding shares). This shareholder committee should then meet with the governance committee and review its suggested nominee. If the shareholder committee does not support the proposed nominee of the governance committee, the two committees should endeavor to agree on a compromise candidate. If no agreement is reached, the shareholder committee should be entitled to designate one nominee for each vacancy in that year, and this nominee must be included on the ballot as part of the management proxy.

- **Independent Board.** Other than the CEO, 100% of the members of the board must be fully independent. No compensation, consulting agreements or payments of any kind to directors will be permitted other than board retainers. A director should not have any significant prior personal or financial ties with the CEO. The company’s CEO will not be allowed to sit on other corporate boards, and independent directors will be limited to sitting on a maximum of three boards, including that of the company. The CEO of another company serving on the company’s board may not serve on more than two public company boards in total (including the board of his own company and of MCI).

- **Stringent Director Qualifications.** At least 75% of the directors should have a minimum number of years of experience serving on the board of a publicly traded company with a minimum threshold of market capitalization, revenue or assets (generally three years of service on boards of companies with at least $500 million in market capitalization or revenues).
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- **Director Change in Status.** When a director has a significant change in status, he or she should tender a resignation to the board, which should then determine whether such changed circumstances make accepting the resignation desirable.

- **Board Meetings.** The board must meet at least eight times per year, at least two of which must be at company facilities other than corporate headquarters. In addition, board members must visit company facilities at least once each year independently of board meetings. The board must meet for some portion of each meeting without the presence of the CEO or any other employee of the company. The board must meet at least annually with the CFO and General Counsel of the company independently of the CEO. The board should hold one annual board strategic retreat consisting of at least two days of meetings.

- **Director Compensation.** The annual board retainer should be substantial (at least $150,000). Directors must invest at least 25% of the cash retainer in company common stock, which cannot be sold until at least six months after they leave the board. Directors may not receive equity grants or any other equity compensation.

- **Advance Disclosure by Directors of Stock Transactions.** All stock sales or other equity transactions by directors or senior officers should be disclosed to the market in advance through a press release by the company at least two days before any such transaction. Directors and employees may not engage in derivative transactions.

- **Non-Executive Chairman of the Board.** The company must create the position of non-executive chairman of the board. The chairman must have served (1) on the board of at least three public companies, at least one of which had a market capitalization exceeding $5 billion, (2) as the chairman or CEO of at least one business or governmental organization, or (3) as present of a major university. The chairman will coordinate the board's work, establish the board's agenda for the year and for each meeting, chair meetings, coordinate with committee chairs, coordinate director visits to company facilities and organize CEO and board performance reviews. The company's bylaws should provide for annual election of the non-executive chairman and a maximum tenure of six years.

- **Independent Board Committees.** The company must have audit, governance, compensation and a risk management committee. All members of the committees must be independent.
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- **Audit Committee.** The committee should meet at least six times each year (eight times is preferred). The chairmanship of the audit committee should rotate every three years. The audit committee retainer should be at least $50,000 ($75,000 for the chairman). The audit committee should meet at least twice a year with the general counsel to review policies against related party transactions. The committee should review the CFO’s performance annually. The committee should retain an independent law firm in advance so that advice can be taken quickly when needed. External auditors should not perform consulting work for the company, other than tax work approved by the audit committee.

- **Director Term Limits.** Directors will be limited to a maximum term of ten years. Also, no director may serve beyond age 75.

- **Mandatory Auditor Rotation.** The independent auditors are limited to a maximum term of ten years. The audit committee should solicit audit proposals from competing firms every five years.

- **Maximum Compensation Limits.** The board must establish a maximum compensation level for any individual in any year without shareholder approval. The report recommends a maximum of $15 million, though the board can set a lower number. No executive can be granted more than this amount in any year, including cash or equity, without a shareholder vote.

- **Employment Agreements.** Evergreen contracts are prohibited (contracts that automatically extend themselves). The maximum severance that can be paid absent a shareholder vote should be $5 million ($10 million in the case of the CEO). Retention grants are banned. Employment agreements cannot have a duration of more than three years.

- **Aircraft.** Personal use of corporate aircraft and other corporate assets is prohibited. At least once year the audit committee should review the usage of corporate aircraft, including a review of flight logs and compliance with usage policy.

- **Ban on Stock Options.** Stock options are banned for five years. After five years stock options are permitted only if shareholders approve their use in advance. Any stock options granted must be expensed in the company’s financial statements. Equity programs will be exclusively composed of restricted stock awards, all of which must be expensed. The restricted stock must have a vesting period of at least four years.
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- **Cash Flow Statement.** The company is required to work to develop enhanced reports of cash flow.

- **Target Dividend Policy.** The company must publish a target dividend policy. The initial target will be for dividends equal to not less than 25% of net income annually.

- **Change of Control Devices.** Dead hand poison pills and a staggered board are barred. Chewable shareholder rights plans are permitted for a limited period.

### Part IV: Auditors and Auditing

1. **Non-Audit Services**

Pursuant to the Sarbanes-Oxley Act, the SEC adopted rules which limit and clarify the scope of non-audit services that independent accountants can provide to their audit clients. The rules only apply to non-audit services provided by independent accountants to their audit clients. The adopting release states that the rules do not limit the scope of non-audit services provided by an accounting firm to a non-audit client.53

The rules prohibit an auditor from providing the following non-audit services for audit clients, subject to various exceptions and qualifications: (1) bookkeeping or other services related to the accounting records or financial statements of the audit client, (2) financial information systems design and implementation, (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports, (4) actuarial services, (5) internal audit outsourcing services, (6) management functions, (7) human resources, (8) broker-dealer, investment adviser, or investment banking services, (9) legal services, and (10) expert services unrelated to the audit. While most of these categories of services (other than expert services) were prohibited under the prior independence rules, a number of exceptions to these prohibitions have been eliminated.

The SEC’s rules with respect to services provided by auditors are largely predicated on three basic principles, violations of which would impair the auditor’s independence: (1) an auditor cannot audit his or her own work, (2) an auditor cannot function in the role of management, and (3) an auditor cannot serve in an advocacy role for his or her client.

One issue that engendered considerable discussion during the rulemaking process was the extent to which the SEC would continue to allow accounting

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53 On August 13, 2003 the SEC's Office of the Chief Accountant issued frequently asked questions on the application of the January 2003 rules on auditor independence. The questions deal with partner rotation, nonaudit services, audit committee pre-approval, audit committee communications, fee disclosures, cooling off periods, and broker-dealers and investment advisers.
firms to provide tax services to their audit clients. In this regard, the Sarbanes-Oxley Act specifically identified “tax services” as permissible for accounting firms to provide SEC audit clients, subject to audit committee pre-approval, but the SEC’s proposing release contained some language that appeared to suggest that tax services would impair independence if they either fell within one or more of the categories of restricted non-audit services under the Sarbanes-Oxley Act or raised concerns under the three “basic principles” of auditor independence identified in the release.

In response to the concerns raised by the proposing release, the SEC’s adopting release states definitively that “an accounting firm can provide tax services to its audit clients without impairing the firm’s independence.” Accordingly, the SEC emphasized that “accountants may continue to provide tax services such as tax compliance, tax planning, and tax advice to audit clients, subject to the normal audit committee pre-approval requirements.” The SEC noted, however, that merely labeling a service as a “tax service” will not necessarily eliminate its potential to impair independence. In particular, the SEC notes that accountants would impair their independence by representing an audit client before a tax court, district court, or federal court of claims. In addition, the SEC warns that audit committees should “scrutinize carefully the retention of an accountant in a transaction initially recommended by the accountant, the sole business purpose of which may be tax avoidance and the tax treatment of which may be not supported in the Internal Revenue Code and related regulations.”

With respect to legal services, the SEC's new rules prohibit an accountant from “providing any service to an audit client that, under circumstances in which the service is provided, could be provided only by someone licensed, admitted, or otherwise qualified to practice law in the jurisdiction in which the service is provided.” Under the prior rules the prohibition on legal services only applied where the service provider was required to be permitted to practice before the courts in a U.S. jurisdiction. Thus, the amendment has the broad effect of extending the prohibition to regulated foreign legal services. The SEC noted that, in some jurisdictions, only lawyers can perform tax work, and that, as a general matter, the SEC rules are not intended to prohibit foreign accounting firms from providing services that an accounting firm in the United States may provide. The SEC also said it was “making clear that foreign accounting firms can provide tax services, as appropriate, despite their local definitions and local licensing requirements.” The SEC encouraged foreign accounting firms and regulators to consult with the SEC staff to address these issues.

With respect to "contribution-in-kind reports," the SEC noted in the auditor independence adopting release that laws and regulations in certain foreign countries require auditors in connection with designated transactions of their audit clients to provide "contribution-in-kind reports" that express an opinion on the fairness of the transaction, the value of a security, or the adequacy of the consideration to shareholders. The SEC stated that it has previously afforded relief from proscriptions against appraisal and valuation services where, among other things, the auditor and issuer demonstrated to the SEC’s satisfaction that the
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The auditor was not providing an opinion on the fairness of a given transaction. The SEC stated that it will continue to take this ad hoc approach and consider requests for exemptive relief from foreign auditors. The SEC also stated that it would continue to work with foreign regulatory agencies on the issue.

The SEC noted in its auditor independence adopting release that accountants sometimes are asked to prepare statutory financial statements for foreign companies that are not filed with the SEC. Consistent with the SEC’s previous rules, the SEC said that an accountant’s independence would be impaired where the accountant prepared the statutory financial statements if those statements formed the basis of the financial statements that are filed with the SEC.

The revised scope of service rules do not apply to engagements that are contracted for before May 6, 2003 so long as they are completed within one year of May 6, 2003. For example, the SEC stated that an engagement to provide non-audit services entered into in December 2002 is not subject to these rules but must be completed by May 6, 2004.

2. Audit Committee Administration of the Engagement

Pursuant to the Sarbanes-Oxley Act, the SEC adopted rules governing the audit committee administration of the auditor engagement. The rules provide that an auditor will not be deemed independent in respect of an engagement to render a service unless:

- the engagement is specifically pre-approved by the issuer’s audit committee or one or more of its members who are independent directors and are designated to perform this role; or

- (1) the engagement is entered into pursuant to pre-approval policies and procedures established by the audit committee of the issuer, which policies and procedures are detailed as to the particular service, (2) the audit committee is informed on a timely basis of each engagement, and (3) such policies and procedures do not include delegation of the audit committee’s responsibilities to management.

Under the rules as adopted, the audit committee must pre-approve all services (and, as discussed above, many types of services may not be approved). The audit committee may establish policies and procedures for pre-approval provided they are detailed as to the particular service and designed to safeguard the independence of the auditor. The Sarbanes-Oxley Act allows the audit committee to pre-approve a service at any time in advance of the activity, and the SEC’s adopting release states that “we expect audit committees will establish policies for the maximum period in advance of the activity the approval may be granted.”

These rules apply to all audit (including review and attest) services and non-audit services that are contracted for on or after May 6, 2003. Accordingly,
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audit committee approval is not required for audit or non-audit services prior to May 6, 2003.

3. Audit Partner Rotation

Pursuant to the Sarbanes-Oxley Act, the SEC adopted new rules with respect to audit partner rotation. Current auditing standards generally require the lead partner to rotate off an account after seven years and to remain off the account for only two years thereafter. In contrast, the SEC’s new rules provide that the lead and concurring partners must rotate after five years and, upon rotation, are subject to a five-year “time-out” period. In addition, other “audit partners” must rotate after no more than seven years on an engagement and are subject to a two-year “time-out” period. As proposed, all audit engagement team partners would have been subject to the five-year rotation and “time-out” provisions. In response to comments, the SEC modified the proposed standard by (i) limiting the rotational obligations to a new defined category of “audit partners” and (ii) differentiating between the lead and concurring partners and other “audit partners.”

“Audit partners” are partners on the audit engagement team who have responsibility for decision-making on significant auditing, accounting, and reporting matters that affect the financial statements or who maintain regular contact with management and the audit committee, other than a partner who consults regarding technical or industry-specific issues, transactions or events. “Audit partners” include (1) the lead partner, (2) the concurring or review partner, (3) other audit engagement team partners who provide more than ten hours of audit, review or attest services in connection with the annual or interim consolidated financial statements of the issuer; and (4) other audit engagement team partners who serve as the lead partner in connection with any audit or review related to the annual or interim financial statements of a subsidiary of the issuer whose assets or revenues constitute 20% or more of the issuer’s consolidated assets or revenues.

Partners assigned to “national office” duties (which can include technical accounting and auditing functions — whether at a local or national level — as well as centralized quality control functions) and other “specialty” partners who may be consulted on specific accounting issues related to a client are not considered “audit partners” for purposes of these requirements, even though they may periodically consult on client matters.

In adopting its audit partner rotation rules, the SEC noted that the partner rotation requirements were of particular concern to the international community. Commentators noted that the proposed requirements could have a particularly adverse impact in foreign countries, especially in emerging countries, where there may be a more limited pool of accountants and experts conversant in U.S. GAAP and U.S. GAAS. Other commentators indicated that the proposed rotation requirements would cause firms to rotate hundreds of partners in scores of countries. These commentators argued that the resulting widespread rotation would affect audit quality adversely, and would be hard, if not impossible, to
implement effectively. The SEC did not provide any special relief for foreign accounting firms in this area, although the general changes made to the proposed rules and the addition of the new category of "audit partners" address to some extent foreign concerns.

The SEC's proposing release had solicited comment as to whether it should require issuers to engage "forensic auditors" periodically to evaluate the work of the financial statement auditors, but this concept was not discussed in the final rules or adopting release.

The adopting release states that an accountant's independence will not be deemed impaired (1) until the first day of the issuer's fiscal year beginning after May 6, 2003, by a lead partner and other audit partner (other than the concurring partner) serving for periods in excess of those permitted by the partner rotation rules and (2) until the first day of the issuer's fiscal year beginning after May 6, 2004, by a concurring partner serving for periods in excess of those permitted by the partner rotation rules.  

4. Auditor "Cooling Off" Periods

The SEC was required by the Sarbanes-Oxley Act to adopt a rule prohibiting a registered public accounting firm from performing any audit services for an issuer if a CEO, controller, CFO or CAO of the issuer was employed by that auditing firm and participated in any capacity in the audit during the 1-year period before the date of initiation of the audit.

Pursuant to the Sarbanes-Oxley Act, the SEC adopted new rules governing the employment at audit clients of former employees of accounting firms. The rules provide that an accounting firm will not be independent in respect of a fiscal year if a member of the audit engagement team takes on a “financial reporting oversight role” with the issuer without observing a defined “cooling off” period (as described below) before taking up that employment with the issuer.

The new restriction only applies where the former employee of the auditor works at the issuer in a “financial reporting oversight role.” The term “financial reporting oversight role” means “a role in which a person is in a position to or does exercise influence over the contents of the financial statements or anyone who prepares them, such as when the person is a member of the board of directors.

Accordingly, for calculating periods of service related to the partner rotation requirements, (1) the rotation requirements applicable to the lead partner are effective for the first fiscal year beginning after May 6, 2003 (time served in the capacity of lead partner prior to May 6, 2003 is included), (2) the rotation requirements for the concurring partner are effective as of the end of the fiscal year beginning after May 6, 2004 (time served prior to May 6, 2003 will be counted in determining when rotation is required), and (3) for other “audit partners,” the rules are effective as of the beginning of the first fiscal year beginning after May 6, 2003 (in determining the time served, service prior to May 6, 2003 will not be taken into consideration and that first fiscal year will constitute the first year of service for these partners).
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or similar management or governing body, chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, or any equivalent position.” The SEC rejected comments to narrow the list of positions at the issuer covered by the new restriction to those specifically identified in the relevant provision of the Sarbanes-Oxley Act.

The “cooling off” requirement applies to all members of the audit engagement team except:

- persons, other than the lead partner and concurring partner, who provided ten or fewer hours of audit, review or attest services during the relevant fiscal period;

- individuals employed by the issuer as a result of a business combination between an issuer that is an audit client and the employing entity, provided that the employment was not in contemplation of the business combination and that the audit committee of the successor issuer is aware of the prior employment relationship; and

- individuals that are employed by the issuer due to an emergency or other unusual situation, provided that the audit committee determines that the relationship is in the interest of investors (such as in certain foreign jurisdictions where it may be extremely difficult or costly to comply with these requirements). The SEC’s adopting release states that the SEC expects this exception will be used “very rarely.”

Under the rules, the term “audit engagement team” refers to all partners, principals, shareholders and professional employees participating in an audit, review, or attestation engagement of an audit client. Included within the audit engagement team would be “audit partners” (as separately defined in the rules) and all other persons who consult with other members of the engagement team during the audit, review, or attestation engagement regarding technical or industry-specific issues, transactions, or events.

The proposed restriction extended to employment relationships with an “audit client,” but the restriction as adopted applies only to employment relationships entered into between members of the audit engagement team and an “issuer.” The SEC noted that extending the requirement to the “audit client” might be difficult to monitor because of the potentially broad scope of that term under the SEC’s current independence rules – particularly in situations where a member of the audit engagement team is employed by an affiliate of the issuer.

In response to comments, the rules clarify the time period of the prohibition. The rules provides that an issuer cannot hire a person who was a member of the audit engagement team “during the one-year period preceding the date that audit procedures commenced for the fiscal period that included the date of initial employment of the audit engagement team member by the issuer.” For this purpose, audit procedures are deemed to have commenced for the current
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audit engagement period the day after the prior year’s periodic annual report (e.g., Form 10-K, 20-F or 40-F) is filed with the SEC. The audit engagement period for the current year is deemed to conclude the day the current year’s periodic annual report (for example, Form 10-K, 20-F or 40-F) is filed with the SEC.55

The SEC's adopting release for its auditor independence rules noted that the international community had requested that the SEC modify its approach to conflicts of interest resulting from employment relationships. Moreover, the SEC noted that it had become aware that in certain jurisdictions the labor law or jurisprudence would prohibit foreign accounting firms from imposing restrictions on the future employment opportunities of their personnel. Although the SEC did not provide any special relief for foreign auditors or foreign issuers, the SEC’s revisions to its initial proposals concerning the “cooling off” rules will help foreign auditors. In particular, the prohibition only applies to persons who undertake a financial reporting oversight role at the “issuer” but not at affiliates or subsidiaries – including foreign subsidiaries. There is also the new exception (described above) for individuals employed by an issuer “due to an emergency or other unusual situation” if the audit committee pre-approves the arrangement.

The SEC's adopting release provides that an accountant's independence will not be deemed to be impaired by a former employee of the accounting firm becoming employed by the issuer if the employment by the issuer commences prior to May 6, 2003.

55 The SEC provided the following example to illustrate the application of this rule. Assume that Issuer A’s Forms 10-K are filed on March 15, 2003, April 5, 2004, March 10, 2005, and March 30, 2006. Issuer A is a calendar-year reporting entity. The audit engagement periods would be deemed to commence and end:

<table>
<thead>
<tr>
<th>Annual Period</th>
<th>Engagement Period Commences</th>
<th>Engagements Period Ends</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>March 16, 2003</td>
<td>April 5, 2004</td>
</tr>
<tr>
<td>2004</td>
<td>April 6, 2004</td>
<td>March 10, 2005</td>
</tr>
</tbody>
</table>

If audit engagement person B provided audit, review or attest services for Issuer A at any time during the 2003 engagement period (March 16, 2003 - April 5, 2004), and he or she begins employment with Issuer A in a financial reporting oversight role prior to March 11, 2005, the accounting firm would be deemed to be not independent with respect to Issuer A. For example, if person B last performed audit, review or attest services for Issuer A on March 24, 2003 and he or she began employment with Issuer A in a financial reporting oversight role prior to March 11, 2005, the accounting firm would be deemed to be not independent with respect to Issuer A. Likewise, if person B provided audit, review or attest services for Issuer A at any time during the 2004 engagement period (April 6, 2004 - March 10, 2005) and he or she began employment with Issuer A in a financial reporting oversight role prior to March 31, 2006, the accounting firm would be deemed to be not independent with respect to Issuer A.
5. Restrictions on Partner Compensation

The SEC adopted new restrictions on audit partner compensation which were not specifically required by the Sarbanes-Oxley Act. The rules provide that an accountant is not independent if, at any point during the audit and professional engagement period, any “audit partner” earns or receives compensation based on the audit partner’s procuring engagements with that audit client to provide any services, other than audit, review, or attest services. The restriction applies during the “audit and professional engagement period,” which begins when the auditor signs an initial engagement letter or begins audit, review or attest procedures, and ends when the client or auditor notifies the SEC that the client is no longer the auditor’s client. The restriction does not apply to specialty partners such as tax and valuation specialists (who are not considered “audit partners” for purposes of the restrictions, even if they are consulted during the audit engagement).

An accountant's independence will not be deemed to be impaired by compensation earned or received during the accounting firm's fiscal year that includes May 6, 2003.

6. Auditor Reports to the Audit Committee

Pursuant to the Sarbanes-Oxley Act, the SEC adopted new rules governing reports which an auditor must provide to audit committees of audit clients. Specifically, each accountant that performs for an audit client that is an issuer any audit required under the securities laws must report to the audit committee, prior to the filing of such audit report with the SEC:

- all critical accounting policies and practices to be used;
- all alternative treatments within GAAP “for policies and practices related to material items” that have been discussed with management of the issuer, including the ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the registered public accounting firm; and

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56 Any accounting firm with ten or fewer partners and five or fewer audit clients that are “issuers” is exempt from this rule.

57 The SEC did not require that these discussions follow a specific form or manner, but stated that accountants and issuers should read and refer to the December 2001 cautionary guidance to determine the types of matters that should be communicated to the audit committee. The SEC said that it expects, at a minimum, that the discussion of critical accounting estimates and the selection of initial accounting policies will include the reasons why estimates or policies meeting the criteria in the SEC’s December 2001 cautionary guidance are or are not considered critical and how current and anticipated future events impact those determinations. In addition, the SEC stated that it anticipated that the communications regarding critical accounting policies would include an assessment of management’s disclosures along with any significant proposed modifications by the accountants that were not included.

58 The SEC’s adopting release states that the rules are intended to cover recognition, measurement, and disclosure considerations related to general accounting policies and the
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- other material written communications between the registered public accounting firm and the management of the issuer, such as any management letter or schedule of unadjusted differences.\textsuperscript{59}

The SEC has not required that the communication be in writing. However, the SEC noted that it would expect that such communications would be documented by the accountant and the audit committee.

This provision is effective May 6, 2003.

7. Disclosure of Audit Fees

The SEC adopted new rules which modify its disclosure requirements regarding the fees paid by an issuer to its auditor. The current rules require separate disclosure in the proxy statement of audit fees, financial information systems design fees, and all other fees, in each case for the most recent fiscal year. The new rules require that an issuer disclose the following information about its "principal accountant" in its Form 10-K and proxy statement (or Form 20-F or Form 40-F used by foreign private issuers and certain Canadian issuers, respectively):

- the aggregate “Audit Fees” billed for each of the last two fiscal years for the audit and quarterly reviews or services that are normally provided by

\textsuperscript{59} The SEC's adopting release states that examples of communications that the SEC expects will be considered material to an issuer include (1) management representation letters, (2) reports on observations and recommendations on internal controls, (3) schedules of unadjusted audit differences, and a listing of adjustments and reclassifications not recorded, if any, (4) engagement letters and (5) letters confirming the accountant's independence.
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the accountant in connection with statutory and regulatory filings or engagements;60

• the aggregate “Audit-Related Fees” billed in each of the last two years that are reasonably related to the audit or review (together with a description of the nature of the services comprising the fees disclosed in this category);61

• the aggregate “Tax Fees” billed in each of the last two years for tax compliance, tax advice and tax planning (together with a description of the nature of the services comprising the fees disclosed in this category);62

• the aggregate amount of “All Other Fees” billed in each of the last two fiscal years (together with a description of the nature of the services comprising the fees disclosed in this category);

• the audit committee’s pre-approval policies and procedures;

• the percentage of Audit-Related Fees, Tax Fees and All Other Fees that were approved by the audit committee using a de minimis exception; and

• if more than 50%, the percentage of hours expended on the principal accountant’s engagement to audit the annual financial statements that were attributable to work performed by non-full time, non-permanent employees.

The SEC stated that it expects registrants to provide clear, concise and understandable descriptions of the audit committee pre-approval policies and

60 The "Audit Services" category includes fees for services necessary to perform an audit or review in accordance with GAAS, as well as fees for services that normally would be provided by the accountant in connection with statutory and regulatory filings or engagements. This includes services that generally only the independent accountant reasonably can provide, such as comfort letters, statutory audits, attest services, consents and assistance with and review of documents filed with the SEC.

61 “Audit-Related Fees” are fees for assurance and related services (e.g., due diligence services) that traditionally are performed by the independent accountant. More specifically, these services would include, among others: employee benefit plan audits, due diligence related to mergers and acquisitions, accounting consultations and audits in connection with acquisitions, internal control reviews, attest services that are not required by statute or regulation and consultation concerning financial accounting and reporting standards.

62 The “Tax Fees” category captures fees for all services performed by professional staff in the independent accountant’s tax division except those services related to the audit. Typically, such fees would relate to tax compliance, tax planning and tax advice services. Tax compliance generally involves preparation of original and amended tax returns, claims for refund and tax payment-planning services. Tax planning and tax advice encompass a diverse range of services, including assistance with tax audits and appeals, tax advice related to mergers and acquisitions or employee benefit plans and requests for rulings or technical advice from taxing authorities.
procedures. Alternatively, registrants could include a copy of those policies and procedures with the information delivered to investors and filed with the SEC.

These disclosure provisions are effective for periodic annual filings for the first fiscal year ending after December 15, 2003. The SEC’s adopting release also encourages issuers who have not previously issued their periodic annual filings to adopt these disclosure provisions earlier. The disclosure can be included in the proxy statement and incorporated by reference into the Form 10-K.

8. Retention of Corporate Audit Records

Pursuant to the Sarbanes-Oxley Act, the SEC adopted new rules which require auditors to retain records relevant to audits and reviews for seven years after the auditor concludes the audit or review of an issuer's financial statements.63 The records must be retained whether they support the auditor's final conclusions or contain information or data relating to a significant matter that is inconsistent with the auditor's final conclusions. Prior to adoption of these new rules, generally accepted auditing standards (GAAS) required documents related to audits to be retained but did not necessarily require the retention of information inconsistent with the audit and did not impose a specific time period during which records had to be retained. The new rules are applicable to both domestic and foreign accountants which audit or review financial statements of an "issuer." Violation of these rules is specifically punishable by a fine or up to 10 years imprisonment. Compliance is required for audits and reviews completed on or after October 31, 2003.

The new rules provide that an accountant for an issuer must retain "records relevant to the audit or review, including workpapers and other documents that form the basis of the audit or review, and memoranda, correspondence, communications, other documents, and records (including electronic records), which (1) are created, sent or received in connection with the audit or review, and (2) contain conclusions, opinions, analyses, or financial data related to the audit or review." One of the principal changes made in the final rule was the inclusion of the phrase "records relevant to the audit or review," which was added in response to comments.

As proposed, the rule would have required auditors to retain materials whether they "support or cast doubt on the final conclusions" reached by the auditor. In response to comment, this language was changed. The final rule requires materials to be retained "whether they support the auditor's final

63 As proposed, the retention time period would have been five years after the end of the fiscal period in which the accountant concluded the audit or review. However, the Sarbanes-Oxley Act separately requires the Public Company Accounting Oversight Board to require auditors to retain for seven years audit workpapers and other materials that support the auditor's conclusions in any audit report. The SEC concluded that a seven-year retention period would reduce inconsistencies between the rules and lessen any potential confusion related to the calculation of retention periods.
conclusions regarding the audit or review, or contain information or data, relating to a significant matter, that is inconsistent with the auditor's final conclusions regarding that matter or the audit or review. Significance of a matter shall be determined based on an objective analysis of the facts and circumstances. Such documents and records include, but are not limited to, those documenting a consultation on or resolution of differences in professional judgment."

9. **Improper Influence on Audits**

The SEC adopted new rules on May 20, 2003 in accordance with the Sarbanes-Oxley Act which prohibit officers and directors, and persons acting under their direction, from directly or indirectly taking any action to coerce, manipulate, mislead, or fraudulently influence any independent public or certified public accountant engaged in the performance of an audit or review of an issuer's financial statements that are required to be filed with the SEC "if that person knew or should have known that such action, if successful, could result in rendering" the issuer's financial statements materially misleading. The rule applies to foreign private issuers as well as domestic issuers.

The SEC's adopting release indicates that the phrase "any other person acting under the direction thereof" is intended to encompass a broader category of behavior than "supervision." Someone can be "acting under the direction" of an officer or director even if they are not under the supervision of that officer or director. Such persons might include not only the issuer's employees but also customers, vendors or creditors who, under the direction of an officer or director, provide false or misleading confirmations or other false information to auditors, or who enter into side agreements that enable the issuer to mislead the auditor. Others covered could include partners or employees of the accountant firm and attorneys, securities professionals or other advisors who, for example, pressure an auditor to limit the scope of the audit, to issue an unqualified report on the financial statements, or to not object to an inappropriate accounting treatment.

These new rules became effective on June 27, 2003.

10. **Public Company Accounting Oversight Board**

A. **Members**

The Sarbanes-Oxley Act directed the SEC to appoint the initial five

\[64\] For purposes of the rule, actions that if successful could result in rendering the issuer's financial statements materially misleading include actions taken at any time with respect to the professional engagement period to coerce, manipulate, mislead, or fraudulently influence an auditor (i) to issue or reissue a report on an issuer's financial statements that is not warranted in the circumstances (due to material violations of GAAP, GAAS or other professional or regulatory standards), (ii) not to perform audit, review or other procedures required by GAAS or other professional standards, (iii) not to withdraw an issued report, or (iv) not to communicate matters to an issuer's audit committee.
members of the Public Company Accounting Oversight Board by October 28, 2002. On October 25, 2002, the SEC named Judge William H. Webster as chairman, and Kayla J. Gillan, Daniel L. Goelzer, Willis D. Gradison Jr., and Charles D. Niemeier as the other founding members, of the Board. On November 12, 2002, Judge Webster resigned as chairman of the Board. On January 8, 2003, the SEC designated Charles Niemeier to be the Acting Chairman of the Board. On April 15, 2003, the SEC selected William J. McDonough as the next Chairman.

**B. SEC Determination**

The Sarbanes-Oxley required the Board to take a variety of actions by April 26, 2003, including the hiring of staff, proposal of rules, and adoption of initial and transitional auditing and other professional standards, so that the SEC could determine that the Board was so organized and had the capacity to fulfill its responsibilities under the Sarbanes-Oxley Act and enforce compliance with the Act by registered public accounting firms. The SEC issued an order declaring that it had made such a determination on April 25, 2003.

Under the Sarbanes-Oxley Act, beginning 180 days after the date of the SEC’s determination, it will be unlawful for any person that is not a registered public accounting firm to prepare or issue any audit report with respect to any reporting issuers. The Sarbanes-Oxley Act authorizes the SEC, however, to modify this requirement with respect to foreign public accounting firms. As discussed in the following section, U.S. public accounting firms must register by October 22, 2003, and foreign public accounting firms must register by April 19, 2004.

**C. Registration System for Accounting Firms**


Under the rules, all public accounting firms (foreign or domestic) are required to register with the Board in order to prepare or issue audit reports on U.S. public companies or play a substantial role in the preparation or issuance of such reports.65 In general, individual accountants that are associated with public accounting firms are not required to register (although individual accountants that

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65 The term "play a substantial role" means (1) perform material services that a public accounting firm uses or relies on in issuing all or part of its audit report with respect to any issuer (e.g., services for which the engagement hours or fees constitutes 20% or more of the total engagement hours or fees provided by the principal accountant in connection with the issuance of all or part of its audit report), or (2) perform the majority of audit procedures with respect to a subsidiary or component of any issuer the assets or revenues of which constitute 20% or more of the consolidated assets or revenues of such issuer necessary for the principal accountant to issue an audit report.
prepare or issue audit reports for an issuer as a sole proprietor would need to register). In addition, the rules do not contain an exception for non-U.S. public accounting firms.

Firms that seek to register must file Form 1, a web-based form that must be completed and submitted to the Board electronically via the internet. Applications for registration will become public documents, but applicants can request confidential treatment of specified portions of their application. In addition, applicants may withhold information from the application when submission of the information would cause the applicant to violate non-U.S. laws, so long as the application includes as exhibits a copy of the relevant portion of the conflicting law, a legal opinion that submitting the information would violate the non-U.S. law, and an explanation of the applicant's efforts to seek consents or waivers to eliminate the conflict and a representation that the applicant was unable to obtain such consents or waivers. Applicants will have to pay a registration fee.

Unless the applicant consents otherwise, the Board is required to take action within 45 days of receipt of the application. The Board may either (1) approve the application, (2) ask for more information about the application or (3) provide the applicant with written notice of a hearing specifying the proposed grounds for disapproval, pursuant to the Board's procedural rules governing disciplinary proceedings, to determine whether to approve or disapprove the application. The Board must approve an application if it determines that registration is consistent with the Board's responsibilities to protect the interests of investors and to further the public interest in the preparation of informative, accurate and independent audit reports for public companies. If the Board requests additional information, a new 45-day review period will begin when the requested information is received. If the applicant deems the hearing notice as a notice of disapproval, it can immediately appeal the disapproval to the SEC. An applicant may withdraw its application for registration by written notice to the Board at any time before the approval or disapproval of the application.

The Form 1 requires accounting firms to include the following information:

- The applicant must include its name, contact information, website address, primary contact with the Board, form of organization and jurisdiction of organization, offices, associated entities engaged in the practice of public accounting, and professional licenses or certifications.

- The applicant must disclose the names of all issuers for which the auditor has prepared or issued audit reports during the previous calendar year or the current calendar year, or for which the applicant expects to prepare or issue audit reports during the current calendar year, and the annual fees received by the applicant.
from these issuers for audit services, other accounting services, and non-audit services.

- The applicant must provide, as an exhibit, a narrative, summary description of its quality control policies for its accounting and auditing practices, including procedures to monitor compliance with independence requirements. Absent unusual circumstances, the Board does not contemplate granting confidential treatment requests for this information.

- Applicants must disclose whether the applicant or any of its associated persons is currently a defendant (or was a defendant in a proceeding that resulted in an adverse finding against the applicant during the previous five years) in (1) any criminal proceeding, (2) any pending civil proceeding initiated by a governmental entity arising out of conduct in connection with an audit report or a comparable report prepared for a client that is not an issuer, or (3) any pending administrative or disciplinary proceeding arising out of the applicant's conduct in connection with an audit report or a comparable report prepared for a client that is not an issuer. Applicants also must disclose pending civil proceedings against the applicant initiated by a private (non-governmental) entity that involve conduct in connection with an audit report or a comparable report prepared for a client that is not an issuer.

- Applicants should identify instances in which its issuer audit clients disclosed disagreements with the applicant in SEC filings. For each such instance in the preceding or current calendar year, the applicant must disclose the name of the issuer and the name and date of the filing, and must submit as exhibits copies of the identified filings. The applicant only needs to identify instances which the issuer already disclosed in an SEC filing.

- The application requires information about the accountants associated with the firm who participate in or contribute to the preparation of audit reports. Domestic applicants must list all accountants who are "persons associated with the applicant" and provided at least 10 hours of audit service for any issuer in the last calendar year. Foreign public accounting firms must list all accountants who are a proprietor, partner, principal, shareholder, officer or manager of the applicant and who provided at least 10 hours of audit services for any issuer during the last calendar year.

- Applicants must furnish as an exhibit consents related to the applicant's and its associated persons' cooperation and compliance with any request for testimony or the production of documents made by the Board. For non-U.S. applicants, the term "associated
persons” covers only those accountants who are partners or managers and who provided at least 10 hours of audit services for any issuer during the last calendar year.

- An authorized partner or officer of the applicant must sign the application and certify the applications completeness and accuracy.

U.S.-based firms must be registered by October 22, 2003. Foreign firms that wish to prepare or issue audit reports on U.S. public companies, or play a substantial role in the preparation of such reports, will need to be registered by April 19, 2004.

The Board elected not to provide an exemption for non-U.S. accounting firms. However, the rules include accommodations for such firms. These include (1) reducing the scope of the information required by the registration form, (2) allowing firms to withhold certain information on the form if they can demonstrate that providing the information would conflict with non-U.S. law (by providing an English copy of the non-U.S. law, a legal opinion that submitting the information would violate the law, and an explanation of the applicant’s efforts to seek consents or waivers to eliminate the conflict), and (3) allowing non-U.S. firms an additional six months to register with the Board.

On July 17, 2003, the Board announced the registration fee schedule for accounting firms that file registration applications. For firms with no issuer clients, the fee is $250; 1-49 issuer clients, $500; 50-100 issuer clients, $3,000; 101-1000 issuer clients, $29,000; and 1001 or more issuer clients, $390,000.

On July 18, 2003, the Board issued "Frequently Asked Questions Regarding Registration With the Board."

D. Accounting Support Fees


The fee is payable by (1) publicly-traded companies with average, monthly U.S. equity market capitalizations during the prior year, based on all classes of common stock, of greater than $25 million, whose share price on a monthly or more frequent basis is publicly available and (2) registered investment companies (or business development companies) with average, monthly U.S.

66 The issuance of a consent to include an audit report for a prior period by a public accounting firm, that does not currently have and does not expect to have an engagement with any issuer to prepare or issue an audit report with respect to any issuer, will not by itself require a public accounting firm to register.
equity market capitalizations (or net asset values) of greater than $250 million and whose share price (or net asset value) on a monthly or more frequent basis is publicly available. The equity market capitalization includes only the aggregate market value of securities traded in the United States, whether those securities are issued by entities based in the United States or elsewhere, and excludes the market value of securities traded outside the United States. Investment companies will pay a reduced assessment relative to other publicly traded companies, reflecting the Board's determination that audits of investment companies tend to be less complex.

Issuers do not need to pay a fee if (1) their average, monthly U.S. equity market capitalization during the prior year was less than $25 million, (2) the issuer only has public debt outstanding, (3) the issuer's share price (or net asset value) on a monthly, or more frequent, basis is not publicly available, (4) the company has filed for bankruptcy and files modified reports, (5) the company is not required to file audited financial statements with the SEC, (6) the issuer is permitted by SEC rules or action not to file audited financial statements or (7) the issuer is an employee stock purchase, savings or similar plan, interests in which constitute securities registered under the Securities Act of 1933.

The Board must compute the fee once each year (anticipated to be during the first 30 days of each year) and allocate the fee among issuers based on their average, monthly equity market capitalization in the prior year. The fee is equal to the Board's budget for that year, as approved by the SEC, less the amount of registration and annual fees received during the prior year from public accounting firms. The Board's approved budget for 2003 is $68 million. According to the proposing release, based on data as of December 31, 2002, for every $10 million of accounting support fee, the largest issuer would pay $260,000, the 1,500th largest issuer would pay $500, and the 3,000th largest issuer would pay $100.

The Board will send a notice to each issuer to which a share of the fee has been allocated. Payment will be due on the 30th day after transmittal, after which interest will accrue at a rate of 6% per year. Issuers that disagree with their fee allocation may petition the Board for a correction. Failure to pay the fee will be a violation of Section 13 of the Exchange Act and could result in SEC administrative, civil or criminal sanctions.

In addition, auditors will not be permitted to issue an unqualified audit opinion or issue a consent with respect to an issuer if that issuer has outstanding any past-due share of the accounting support fee and the issuer has not filed a petition for a correction to its share of the accounting support fee. Auditors may confirm an issuer's payment of the accounting support fee by obtaining a management representation of payment. However, the auditor of an issuer's financial statements may sign an unqualified audit opinion with respect to the issuer's financial statements, or issue a consent to the use of previously issued auditor opinions, even if the issuer has outstanding a past-due share of the accounting support fee and has not filed a petition for correction of that fee, if the
issuer needs the auditor opinion or consent in order to submit a report to, or make a filing with, the SEC. Under this exception, the issuer would need to submit to the Board a notice of the signing of the audit opinion or issuance of the consent not later than one business day after the related filing is made with the SEC. The exception would not continue longer than 15 business days after the earlier of the submission of the notice to the Board or the filing of the report or registration statement with the SEC, and may not be invoked for more than one such 15-business day period with respect to any share of the accounting support fee.

On August 1, 2003 the SEC approved the Board's 2003 budget and the annual accounting support fees for 2003 which were assessed by the Board. On August 4, 2003, the Board announced that it had begun to notify publicly traded companies and investment companies what accounting support fees they would be required to pay. About 5,200 publicly traded companies and about 3,300 investment companies will receive invoices from the Board. About 96% of the fees are to be paid by operating companies and the remainder by investment companies. About 62% of issuers will pay $1,000 or less.

E. Ethics Code

On April 18, 2003 the Board proposed and on June 30, 2003 the Board adopted an ethics code applicable to board members, staff and designated contractors and consultants. In some cases spouses, spousal equivalents and dependents are either subject to the code or impact the obligation of the Board member or staff under the code. Members of a Board advisory group are required to comply with certain provisions of the ethics code. The code only applies to designated contractors and consultants if (1) there is a contract for services (which would be required to contain specific provisions incorporating those portions of the code applicable to the contractor) and (2) the Board determines that the code should be applied to the contractor, in whole or in part. The code requires Board members and professional staff to disclose their personal investments, and those of their spouses, spousal equivalents and dependents, in the securities of issuers. On September 22, 2003 the SEC published the code for comment.

F. Interim Standards

On April 18, 2003 the Board adopted interim auditing, attestation, quality control, ethics and independence standards, based primarily on existing standards developed by the AICPA and its Auditing Standards Board. On April 25, 2003 the SEC approved these standards. While the Board's authority generally extends to registered public accounting firms, the Board noted its intent that the standards apply during the period prior to the time that public accounting firms that are subject to the registration requirements register with the Board. The standards will remain in effect while the Board conducts a review of standards applicable to registered public accounting firms and decides whether to permanently adopt, repeal or modify each standard.
The Board and the SEC adopted the following interim standards:

- **Interim Auditing Standards.** The Board designated GAAS, as proposed and promulgated by the AICPA and the Auditing Standards Board, as they existed on April 16, 2003.

- **Interim Attestation Standards:** The Board designated the Statements on Standards for Attestation Engagements and related Interpretations and Statements of Position adopted by the AICPA's Auditing Standards Board, as they existed on April 16, 2003.

- **Interim Quality Control Standards:** The Board designated the Accounting Standards Board's Statements on Quality Control Standards, as they existed on April 16, 2003. The Board also designated certain of the AICPA's SEC Practice Section membership requirements as additional interim quality control standards (applicable only to firms that are members of the AICPA SEC Practice Section).

- **Interim Ethics Standards.** The Board designated the provisions of the AICPA's Code of Professional Conduct on integrity and objectivity, as they existed on April 16, 2003.

- **Interim Independence Standards.** The Board designated the provisions of the AICPA's Code of Professional Conduct regarding independence and existing standards and interpretations of the Independence Standards Board, as they existed on April 16, 2003. The Board noted that these interim standards do not supplant the SEC's independence rules and that, to the extent that the SEC's rules are more (or less) restrictive than the Board's interim standards, registered public accounting firms must comply with the more restrictive requirements.

**G. Establishment of Auditing and Other Professional Standards**

The Sarbanes-Oxley Act authorizes and directs the Board to establish auditing, quality control, ethics and independence standards to be used by registered public accounting firms. On April 18, 2003, the Board issued a statement regarding the general process it intended to follow in order to establish auditing and other professional standards. Standards may be developed by the Board itself, through the recommendation of the Board advisory group or a Board-appointed task force, or from a third party petitioning the Board. The Board stated that it would appoint a standing advisory group to assist it in formulating new standards and in reviewing existing standards.

On April 18, 2003, the Board also announced three standard-setting projects: (1) a review of the interim professional standards on a standard-by-
standard basis (to determine if they should be made permanent, repealed or modified), (2) the adoption of auditing standards specifically required by the Sarbanes-Oxley Act, and (3) a review of the standard for an auditor's attestation relating to internal controls pursuant to Section 404(b) of the Sarbanes-Oxley Act (on October 7, 2003, the Board proposed a new standard to govern the auditor's internal controls attestation).

H. Bylaws

The Board adopted its bylaws on January 9, 2003, and adopted an amendment to the bylaws to specify the powers of the Chair on April 25, 2003. These bylaws were submitted to the SEC for approval on March 3, 2003 and April 30, 2003. The SEC issued the bylaws for comment on June 13, 2003 and approved them on July 23, 2003.

The bylaws establish a principal office in Washington, D.C. and establish the composition of a Governing Board and the powers and duties of the Governing Board and officers. The bylaws require the Governing Board to hold at least one public meeting each month, on the first Tuesday of the month, or at such other time as the Chair determines. The bylaws require the Board to adopt a written Open Meeting Policy defining the circumstances under which meetings of the Board will be open to the public.

I. Rule Requiring Adherence to Board Standards

The Board proposed on April 18, 2003 and adopted on June 30, 2003 a new rule (Rule 3100) confirming that all registered public accounting firms and their associated persons must adhere to all applicable "auditing and related professional practice standards," which include auditing (and related attestation), quality control, ethical and independence standards, and any other professional standards, that are established or adopted by the Board, in connection with the preparation or issuance of any audit report for an issuer. On September 22, 2003 the SEC published this rule for comment.

On October 7, 2003 the Board proposed a new rule (Rule 3101) regarding the terminology it will use in its auditing and related professional practice standards to describe the obligations those standards impose on firms and associated persons. The proposal includes three categories of obligations (which, once approved, would apply to the Board's interim standards):

- **Unconditional Obligations.** The words "must," "shall," and "is required" indicate unconditional obligations. These will be used sparingly in the new standards.

- **Presumptively Mandatory Obligations.** The word "should" indicates obligations that are presumptively mandatory. The auditor must comply unless the auditor can demonstrate, by
"verifiable, objective and documented evidence," that alternative actions he or she followed were sufficient to achieve the objectives of the standard. The "should" standard articulated in the proposal is stronger than current interpretations of "should," which allows an auditor to justify the failure to perform a should directive by presenting persuasive evidence which could be formulated after completion of the audit.

- **Subsidiary Obligations.** The words "may," "might," "could" or other terms describe actions that auditors have a professional obligation to consider. Whether the auditor takes the action will depend on an exercise of professional judgment.

**J. Rule Regarding Advisory Groups**

The Sarbanes-Oxley Act provides that the Board shall convene such expert advisory groups as may be appropriate to make recommendations concerning the content of auditing, quality control, ethics, independence and other standards.

On June 30, 2003 the Board adopted a rule (Rule 3700) which addresses the formation, composition and other basic matters concerning advisory groups to be used for standard setting. The rule provides that the advisory groups formed by the Board will contain individuals with expertise in accounting, auditing, corporate finance, corporate governance, investing in public companies and other areas that the Board deems to be relevant. Members of advisory groups will be selected by the Board, in its sole discretion, based upon nominations, including self-nominations, received from any person or organization. Membership in an advisory group is personal to the member and may not be delegated to others. Members of an advisory group must comply with certain specified portions of the Board's ethics code. The rule also provides that the Board may, in its discretion, establish ad hoc task forces, whose members may include advisory group members. On September 22, 2003 the SEC published this rule for comment.

On June 30, 2003, the Board also announced the establishment of a standing advisory group (SAG) to assist it in performing its standard-setting responsibilities. The SAG will assist the Board in reviewing existing standards, evaluating proposed standards recommended by staff or task forces or others, and recommending to the Board new or amended standards. The SAG will not be involved in technical drafting. The Board estimated that the SAG would have initially approximately 25 members. Members would have a variety of backgrounds, including auditors, preparers of financial statements, investors, academics, state accounting regulators, and others. The board will solicit nominations for SAG membership; interested parties will have 45 days from the date of the Board's notice to submit nominations. Membership will be for a two-year term, but approximately 50% of the initial members will be appointed for a three-year term to assure continuity, and members will not be limited in the
number of terms that they may serve. Members will not be paid, must attend at least 75% of all meetings and must spend at least 50-100 hours per year on SAG matters. The first Chair of the SAG will be the Board's Chief Auditor and Director of Professional Standards, who will be a non-voting member of the SAG. The SAG will hold public annual and semi-annual meetings. The Board retains the exclusive authority to adopt, modify or reject any SAG recommendation, in its sole discretion. The Board also stated that it may establish one or more ad hoc task forces to assist its staff with the drafting of technical language, among other things.

K. Rule on Withdrawal From Registration

The Board proposed on July 28, 2003 and approved on September 29, 2003 a rule to govern the process of a registered public accounting firm’s withdrawal from registration. A registered firm may seek to withdraw at any time by filing Form 1-WD. Withdrawal becomes effective on the 61st calendar day after the request is filed, unless the Board orders that withdrawal be delayed, or unless a Board disciplinary proceeding is pending against the firm or any of its associated persons. The Board may order that withdrawal be delayed while the Board carries out a relevant inspection, investigation or disciplinary proceeding. The Board may delay a requested withdrawal for up to 18 months, unless a disciplinary proceeding has been commenced and is pending at the end of the specified period. If such a proceeding is pending, then the period of delay of the withdrawal would automatically extend until completion of all such proceedings and reviews, including on and after any remand to the Board.

Form 1-WD requires (1) basic identifying information, (2) a description of any known ongoing regulatory or law enforcement investigations or proceedings involving the firm or any of its associated persons, (3) a certification that the firm is not participating in any audit and will not do so while the Form 1-WD is pending and (4) at the firm's option, a description of the reasons for seeking leave to withdraw. The content of a filed Form 1-WD will be nonpublic but the fact that a firm seeks to withdraw will be made public. Also, in commentary to the rule the Board stated that it plan to adopt a practice of eliminating online access to a firm's registration application and annual reports three years after withdrawal.

Beginning on the fifth business day after the Form 1-WD is filed, (1) any annual fee assessed after that date with respect to the firm will be zero, (2) the annual reporting requirement may be satisfied by submitting a report stating a Form 1-WD is pending, and (3) the Board may forego any regular inspection of the firm that would otherwise commence. In addition, while the request to withdraw is pending, the firm may not engage in preparing or issuing, or playing a substantial role in preparing or furnishing, an audit report for a public company, other than issuing a consent to the use of an audit report for a prior period. Also, a firm that has filed a Form 1-WD may not hold itself out as registered with the Board without specifying that its registration status is “registered—withdrawal request pending.” If a firm files a Form 1-WD that misleads the Board as to a
material point, and the Board later discovers the misstatement or omission, the Board could void the withdrawal of the firm's registration for three years after the firm's registration is deemed withdrawn.

L. Rule on Inspections of Accounting Firms

The Board proposed on July 28, 2003 and adopted on October 7, 2003 rules on inspections of registered public accounting firms. The Board will conduct both "regular inspections," to be conducted on a regularly scheduled basis, and special inspections, to be conducted at the request of the Board or the SEC. Regular inspections will include (1) inspecting and reviewing selected audit and review engagements of the firm performed at various offices and by various auditors of the firm, (2) evaluating the sufficiency of the quality control system of the firm and the manner of documentation and communication of that system, and (3) such other tests of the audit, supervisory and quality control procedures of the firm as the Board determines.

The frequency of regular inspections will depend on the number of public companies in the U.S. (domestic or foreign) for which the firm issues or plays a substantial role in the preparation or furnishing of audit reports. During each calendar year, beginning no later than the calendar year following the calendar year during which its registration with the Board has been approved, a firm that during the prior calendar year issued audit reports for more than 100 public companies in the U.S. will be subject to an annual regular inspection. At least once in every three calendar years, beginning with the three-year period following the calendar year in which its registration with the Board has been approved, a firm that during any of the three prior calendar years issued audit reports for at least one, but no more than 100, public companies in the U.S., or that played a substantial role in the preparation or furnishing of audit reports for at least one public company in the U.S., will be subject to regular inspection once every three years. With respect to a firm that is seeking to withdraw its registration, the Board has the discretion to forego any regular inspection that would otherwise commenced during the period beginning on the fifth day following the filing of its Form 1-WD and continuing until the firm's registration is deemed withdrawn.

If the Board determines that an inspection of a firm reveals a possible violation of the Sarbanes-Oxley Act, the Board's rules, the SEC's rules, the firm's own quality control policies or any professional standard, the Board will, if it determines appropriate, (1) report the possible violation to the SEC and each appropriate state regulatory authority and (2) commence an investigation or disciplinary proceeding. Every registered public accounting firm and associated person must cooperate with the Board in the performance of any Board inspection.

At the conclusion of an inspection, the Director of the Division of Registration and Inspections will make a draft inspection report available for review by the firm that is the subject of the report. The firm may, within 30 days
after the report is made available to it, or such longer period as the Board may order, submit to the Board a written response to the draft report. After receiving and reviewing any response letter, the Board may take such action with respect to the draft inspection report as it considers appropriate, including adopting the draft report as the final report, revising the draft report, or continuing or supplementing the inspection before issuing a final report. Promptly following the Board's issuance of a final inspection report, the Board will (1) make the final report available for review by the firm, and (2) transit to the SEC and to each appropriate state regulatory authority the final report, any additional letter or comments by the Board or the Board's inspectors and any response submitted by the firm to a draft report.

If any final inspection report includes criticisms of, or describes potential defects in, a firm's quality control systems, the firm may submit evidence or otherwise demonstrate to the Director of the Division of Registration and Inspections that it has improved such systems and remedied such defects no later than 12 months after the issuance of the final inspection report. The Board must notify the firm of its final determination concerning whether the firm has addressed the criticisms or defects to the Board's satisfaction. The Board will notify the SEC and each appropriate state regulatory authority if the Board determines that a firm has satisfactorily addressed quality control defects and criticisms within the required 12-month period. The Board may at any time publish such summaries, compilations or other general reports concerning the results of its findings as the Board deems appropriate. Such reports may include discussion of criticisms of, or potential defects in, quality control systems of any firm that was subject to an inspection, provided that no such report shall identify the firm to which the criticisms relate unless that information has previously been made public in accordance with the procedures described in the prior paragraph.

M. Rules on Investigations and Adjudications

The Board proposed on July 28, 2003 and adopted on September 29, 2003 rules on investigations and hearings in disciplinary proceedings and hearings on registration applications.

Under the rules, the Board and its staff may conduct investigations concerning any acts or practices, or omissions to act, by registered public accounting firms and persons associated with such firms, or both, that may violate
any provision of the Sarbanes-Oxley Act, the rules of the Board, the provisions of
the securities laws relating to the preparation and issuance of audit reports and the
obligations and liabilities of accountants with respect thereto, including the rules
of the SEC issued under the Sarbanes-Oxley Act, or professional standards. The
Board's rules require registered public accounting firms and their associated
persons to cooperate with Board investigations, including producing documents
and providing testimony. The rules also permit the Board to seek information
from other persons, including clients of registered firms.

When violations are detected, the Board will provide an opportunity for a
hearing, and in appropriate cases, impose sanctions designed to deter a possible
recurrence and to enhance the quality and reliability of future audits. The
sanctions may include revoking a firm's registration or barring a person from
participating in audits of public companies. Sanctions may also include monetary
penalties and requirements for remedial measures, such as training, new quality
control procedures, and the appointment of an independent monitor.

The Board may also hold hearings on registration applications. If the
Board if unable to determine that a public accounting firm has met the standard
for approval of an application, the Board may provide the firm with a notice of a
hearing, which the firm may elect to treat as a written notice of disapproval for
purposes of making an appeal to the SEC. If such a firm chooses to request a
hearing, the Board would, in appropriate circumstances, afford the firm a hearing.

N. Proposed Auditing Standard for Internal Control Audits

On October 7, 2003 the Board proposed a new auditing standard for "An
Audit of Internal Control Over Financial Reporting Performed in Conjunction
With an Audit of Financial Statements." SEC rules require the management of a
public company to assess the effectiveness of the company's internal control over
financial reporting as of the end of the company's fiscal year and to include in the
annual report management's conclusion about whether the company's internal
control is effective. The annual report must also include an attestation by an
outside auditor of management's conclusions. This proposed standard would
govern the attestation by auditors of management's internal controls report.
Accelerated filers must comply with the internal controls report requirement
beginning with fiscal years ending on or after June 15, 2004. Other companies
have until fiscal years ending on or after April 15, 2005. Several key features of
the proposed auditing standard include the following:

● The Integrated Audit. As proposed, an auditor can only issue a report on
the internal controls if it also audits the company's financial statements.
The standard views the audit of the financial statements and the internal
controls as a single integrated audit. The integrated audit would result in
two opinions, one on internal controls and one on financial statements,
which may be expressed in a combined report or in separate reports.
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- **Management's Responsibilities.** For an auditor to complete its internal controls audit, management must accept responsibility for the effectiveness of the internal controls, evaluate their effectiveness, support the evaluation with sufficient evidence including documentation, and present a written assessment about the effectiveness of the internal controls. If management has not fulfilled its responsibilities, the auditor should communicate in writing to management and the audit committee that the internal controls audit cannot be satisfactorily completed and he or she is required to disclaim an opinion.

  The auditor must obtain representations from management (1) acknowledging management's responsibility for internal controls, (2) stating that management has evaluated the effectiveness of the internal controls, (3) stating management's conclusion about the internal controls, (4) stating that management has disclosed to the auditor all material weaknesses, (5) describing any material fraud or any other immaterial fraud that involves senior management or employees who have a significant role in internal controls, (6) stating whether internal control deficiencies previously reported to the audit committee have been resolved, and (7) stating whether there were any changes in internal controls or other factors that might significantly effect internal controls. Failure to obtain written representations from management constitute a limitation on the scope of the audit sufficient to preclude an unqualified opinion. When management limits the scope of the audit, the auditor should either withdraw from the engagement or disclaim an opinion.

- **Components of the Audit.** The audit of internal controls would include (1) planning the audit, (2) evaluating the process management used to perform its assessment of internal control effectiveness, (3) obtaining an understanding of the internal control, (4) evaluating the effectiveness of both the design and operation of the internal control, and (5) forming an opinion about whether internal control over financial reporting is effective. In order to provide its opinion, the auditor must (a) evaluate and test management's assessment process, (b) evaluate and test work on internal control performed by others such as internal auditors and (c) test the effectiveness of the controls himself or herself.

- **Planning the Audit.** Factors related to planning the internal control audit include the auditor's knowledge of the company, matters affecting the company's industry, matters relating to the company's business, and the extent of recent changes in the company's operations or internal control.

- **Evaluating Management's Assessment.** The auditor must determine whether management has (1) determined which controls should be tested, including controls over relevant assertions related to all significant accounts and disclosures in the financial statements, (2) evaluate the likelihood that failure of the control could result in a misstatement and
whether other controls achieve the same control objectives, (3) determined
the locations or business units to include in the evaluation, (4) evaluated
the design effectiveness of controls, (5) evaluated the operating
effectiveness of controls based on sufficient procedures and testing, (6)
determined the deficiencies that constitute significant deficiencies or
material weaknesses, and (7) communicated findings to the auditor and
others if applicable. The auditor must evaluate not only the adequacy of
management's processes but must also become satisfied that management's
conclusion is correct and therefore fairly stated.

The auditor must also evaluate the adequacy of management's
documentation of the design of the internal controls and their assessment
of internal control effectiveness. Inadequate documentation could be a
significant deficiency or a material weakness.

- **Obtaining an Understanding of the Internal Controls.** Procedures to
  be performed include making inquiries of and observing the personnel
  who perform the controls, review documents that are used in and result
  from the application of the controls, and comparing supporting documents
  (such as sales invoices) to the accounting records.

  The standard would require auditors to perform "walkthroughs" as part of
  the internal control audit. In a walkthrough, the auditor traces all types of
  company transactions from origination, through the accounting and
  information systems and financial report preparation processes, to their
  being reported in the company's financial statements. The walkthroughs
  must be performed by the auditor himself or herself.

  The standard would also require the auditor to obtain evidence about the
  operating effectiveness of internal controls for all "relevant assertions"
  about all "significant accounts or disclosures."

- **Evaluating the Audit Committee.** The auditor must evaluate factors
  related to the audit committee's oversight of internal controls, including
  audit committee independence, audit committee understanding of its role,
  level of involvement and interaction with the independent auditor, level of
  involvement and interaction with internal audit, committee compliance
  with applicable listing standards, existence of a financial expert, and
  amount of time devoted by the audit committee to control issues.
  Ineffective audit committee oversight over internal controls is at least a
  significant deficiency and a strong indicator that a material weakness
  exists.

- **Testing and Evaluating the Design of Controls.** In order to test design
effectiveness, auditors must inquire of company personnel, observe
internal controls, conduct walkthroughs, and evaluate whether the controls
are likely to prevent or detect misstatements if they operate as designed.
Using the Work of Management and Others. The auditor must understand the results of procedures performed by management and others (internal auditors and third parties) on internal controls. The auditor must review all reports issued during the year by internal audit that address internals and evaluate any internal control deficiencies identified in those reports.

Evaluating the Results. The auditor must communicate in writing to the audit committee all significant deficiencies and material weaknesses of which the auditor is aware. The auditor also must communicate to management, in writing, all internal control deficiencies of which he is aware. A deficiency is a significant deficiency if, by itself or in combination with other deficiencies, it results in more than a remote likelihood of a misstatement of the company's annual or interim financial statements that is more than inconsequential in amount will not be prevented or detected. A significant deficiency is a material weakness if, by itself or in combination with other deficiencies, it results in more than a remote likelihood that a material misstatement in the company's annual or interim financial statements will not be prevented or detected.

The following circumstances are not only significant deficiencies but also strong indicators that a material weakness exists: (1) ineffective oversight of the company's external financial reporting and internal control by the company's audit committee (the auditor must evaluate the effectiveness of the audit committee oversight), (2) material misstatements in the financial statements not initially identified by the company's internal controls, (3) significant deficiencies that have been communicated to management and the audit committee but that remain uncorrected after some reasonable period of time, (4) restatement of previously issued financial statements to reflect the correction of a misstatement, (5) for larger, more complex entities, the internal audit function or the risk assessment function is ineffective, (6) for complex entities in highly regulated industries, an ineffective regulatory compliance function, and (7) identification of fraud of any magnitude on the part of senior management.

Forming an Opinion and Reporting. The auditor can express an unqualified opinion on internal controls if it identifies no material weaknesses in internal controls after performing all necessary procedures. If the auditor cannot perform all necessary procedures, the auditor can either qualify or disclaim an opinion. If an overall opinion cannot be expressed, the auditor must explain why. The auditor's report must disclose material weaknesses but not significant deficiencies. If there is a material weakness, the auditor's opinion must be adverse; a qualified opinion would not be permitted.
The auditor must modify the standard clean report if (1) management's assessment is inadequate (requiring a scope limitation) or management's report is inappropriate (requiring an explanatory paragraph describing the reasons for this conclusion), (2) there is a material weakness in internal controls (which requires an adverse opinion), (3) there is a restriction on the scope of the engagement (the auditor should withdraw, disclaim an opinion or express a qualified opinion), (4) the auditor decides to refer to the report of other auditors as the basis for the auditor's own report, (5) a significant subsequent event has occurred since the date being reported on, or (6) there is other information contained in management's report on internal control.

- **Fraud.** The auditor must test controls specifically intended to prevent or detect fraud that is reasonably likely to result in material misstatement of the financial statements. Such controls include, among others, the controls restraining the inappropriate use of company assets, the company's risk assessment processes, code of ethics provisions, adequacy of the internal audit activity and adequacy of the company's procedures for handling complaints and concerns about questionable accounting or auditing matters.

- **Auditor Independence.** The auditor may not accept an engagement to provide an internal control-related non-audit service to an audit client that has not been specifically pre-approved by the audit committee.

- **CEO/CFO Certifications.** If the auditor becomes aware of any matters leading to the belief that modifications to the quarterly certifications or related disclosures are necessary, then the auditor must communicate the matters to management. If management does not respond appropriately, the auditor should inform the audit committee. If the audit committee does not respond appropriately, the auditor should evaluate whether to resign from the engagement. If an auditor becomes aware that management's annual report fails to appropriately disclose a material weakness that was corrected in the fourth quarter, the auditor must modify his or her audit report on internal control.

11. **The Conference Board's Principles Regarding Audit Committees and Accounting**

On January 9, 2003, the Commission on Public Trust and Private Enterprise of The Conference Board issued its findings and recommendations regarding accounting. The Commission's principles and best practices include the following:

- Audit committees should consider rotating audit firms when there is a combination of circumstances that could call into question the audit firm's independence from management. The Commission
suggested that the existence of some or all of the following factors may particularly warrant possible rotation: (1) the audit firm has been employed by the company for a substantial period of time, such as more than ten years, (2) one or more former partners or managers of the audit firm are employed by the company and (3) significant non-audit services are provided to the company.

- Public accounting firms should limit their services to performing audits for clients and closely related services that do not put the auditor in an advocacy position, such as novel and debatable tax strategies and products.

- The leadership of the Big Four accounting firms should each examine their business model to ensure that the model is consistent with the idea that quality audits is their number one priority.

The Commission also formed a subcommittee to focus on accounting principles. One of the primary recommendations of the subcommittee was that the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) should continue to consider a “principles” rather than a “rules” based approach to audit opinions. The Sarbanes-Oxley Act did not require a principles-based approach but mandated a study on this topic.

12. IOSCO Statement on Auditor Independence

In October 2002, the Technical Committee of the International Organization of Securities Commissions (IOSCO) issued a statement regarding auditor independence and the role of the corporate governance structure (audit committee) in monitoring auditor independence. The principles endorsed in the IOSCO statement include:

- the audit committee or other governance body independent of management should oversee the process of selection and appointment of the auditor and should evaluate the audit fees charged by the auditor;

- the audit committee should meet regularly with the external auditors without management present and discuss any contentious issues that have arisen with management;

- the audit committee should satisfy itself that the auditor is independent and discuss with the auditor at least annually matters related to independence;

- the audit committee should oversee establishment of the company's policies governing the circumstances in which auditors can provide non-audit services;
the audit committee should establish policies relating to the hiring from an entity's audit firm of senior officers for the entity; and

the audit committee should report to shareholders on the actions it has taken to safeguard the independence of the auditor.

13. FASB Pronouncements

On April 25, 2003, in accordance with the requirements of the Sarbanes-Oxley Act, the SEC issued a policy statement reaffirming that it will continue to recognize pronouncements of the Financial Accounting Standards Board (FASB), the private-sector standard-setting organization formed in 1973, and its parent, the Financial Accounting Foundation (FAF), as being generally accepted for purposes of SEC filings. As a result, registrants are required to continue to comply with those standards in preparing financial statements filed with the SEC.

In its policy statement the SEC noted the following:

- The FASB and FAF should give the SEC timely notice of, and discuss with the SEC, the FAF's intention to appoint a new member of the FAF or FASB.

- The FASB should provide timely guidance to public companies, accounting firms, regulators and others on accounting issues that the SEC considers to be of immediate significance to investors. The SEC staff will refer issues to the FASB when those issues may warrant new, amendments to, or formal interpretations of accounting standards, and the SEC expects that the FASB will address such issues in a timely manner.

- The SEC expects that, when requested to do so, the FASB will make information and staff reasonably available to facilitate the SEC's understanding and implementation of a FASB standard.

- The SEC expects the FASB to consider, in adopting accounting principles, the extent to which international convergence on high quality accounting standards is necessary or appropriate, including consideration of moving towards greater reliance on principles-based accounting standards whenever it is reasonable to do so.

- The SEC expects the FASB to take reasonable steps to continue to improve the timeliness with which it completes its projects, while satisfying appropriate public notice and comment requirements.

In early 2003 New York's Attorney General proposed to amend the provisions of New York state law governing the oversight of accountants. New York law generally requires the licensing of accountants or firms performing public accountancy services in New York. The proposed reforms are patterned after public accountancy reforms enacted under the Sarbanes-Oxley Act and under legislation recently enacted by the state of California. The New York State Society of CPAs has provided specific comments on the Accounting Bill addressing the efficacy of the accounting reforms.

- The Accounting Bill proposes to alter the membership of the New York State Board of Public Accountancy (the “Board”) to comprise 16 licensed accountants and 9 public representatives (as compared with the current membership of 20 licensed accountants and 2 public representatives).
  - The public representatives would need to meet certain criteria to ensure that they are independent of the accountancy profession.
  - Investigations of any complaint against an accountant alleging professional misconduct could only be dismissed or terminated with administrative warning after consultation with, and the written concurrence of, a public representative of the Board.
  - The Board's executive secretary "may" be a current or former accountant (under existing rules it must be a certified public accountant).

- The Accounting Bill sets forth specific fraudulent and improper acts that would constitute professional misconduct and increases fines for professional misconduct.

- Under the Accounting Bill, individual accountants and accounting firms would be subject to the following requirements:
  - They would be prohibited from receiving commissions or referral fees, except in limited circumstances not involving “attest” clients or clients receiving similar services and where full disclosure is made.
  - They would be prohibited from providing “attest” services to corporations in which they or an immediate family member have a direct or material indirect financial interest.
  - They could not provide certain non-audit services to “attest” clients, except in limited circumstances. The proposed list of prohibited services is more or less the same as that provided in the
SEC’s recently amended independence regulations, although the extension of these provisions to clients that are not public companies substantially expands their scope.

- They could not provide corporate accountancy services for client executives or any client-sponsored retirement plan, if they perform similar services for the client. Under the Accounting Bill, “attest” means any audit, any review of financial statements or any attestation engagement in accordance with standards developed by an agency of the federal government or recognized accountancy organization.

- Accounting firms would be subject to the following additional requirements: (1) they would not be able to provide attest services for any corporation whose senior executives were employed by the accounting firm and participated in any capacity in the attestation of that corporation during the previous year; (2) they would be required to rotate the lead audit partners performing or reviewing attestation services for a corporation every 5 years; (3) they would be required to undergo peer review every 3 years; the department may conduct the peer review or authorize a recognized statewide or national professional accounting association to administer the peer review; and, although records and comments would be confidential, the results of the peer review would be a matter of public record; and (4) they would be required to retain audit documentation.

- Additional requirements would apply to individual accountants: (1) they would be required to report certain actions to the Board, such as judgments or license suspensions, that may affect their ability to practice public accountancy; and (2) they would be prohibited from accepting employment with clients if they provided attest services for the client within the past 12 months and their new employment would entail oversight of the former client’s financial reporting.

Part V: Ethics/Compliance

1. Code of Ethics

A. The Sarbanes-Oxley Act

Pursuant to the Sarbanes-Oxley Act, the SEC adopted new rules regarding codes of ethics. The final rules require reporting issuers, including foreign private issuers, to disclose in their annual report (on Form 10-K, 20-F or 40-F) whether they have adopted a written code of ethics that applies to the issuer’s principal executive officer, principal financial officer, principal accounting officer or controller, or people performing similar functions (the Sarbanes-Oxley Act had not included the CEO in this litany). The rules specifically indicate that an issuer
may have separate codes of ethics for different types of officers, directors and employees. Although the rules do not require an issuer to adopt a code of ethics, if the issuer has not adopted such a code of ethics, it must state the reasons why. The rules also do not require an issuer to amend its existing code, but amendments may very well be necessary in order to meet the SEC’s criteria for codes of ethics, and, if necessary amendments are not made, then the issuer would have to disclose the reasons why it did not have an SEC-defined code of ethics.

The SEC believes that ethics codes do and should vary from issuer to issuer, and that decisions as to specific provisions, compliance procedures and disciplinary measures for ethical breaches are best left to the issuer. However, in order to meet the SEC’s requisite standard, an issuer’s code of ethics must be reasonably designed to deter wrongdoing and promote:

1. honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;\(^{67}\)

2. full, fair, accurate, timely and understandable disclosure in reports and documents that an issuer files with, or submits to, the SEC and in other public communications made by the issuer;

3. compliance with applicable governmental laws, rules and regulations;

4. prompt internal reporting of code violations to “an appropriate person or persons” identified in the code (this was not in the Sarbanes-Oxley Act); and

5. accountability for adherence to the code (this was not in the Sarbanes-Oxley Act).

The final rule permits an issuer to choose among the following three alternative methods of making its ethics code publicly available:

1. filing a copy of its code as an exhibit to its annual report on Form 10-K, 20-F or 40-F;

2. posting the text of its code, or the relevant portion thereof, on its Internet website (although an issuer choosing this option must disclose its Internet address and intention to provide disclosure in this manner in its annual report); or

3. providing an undertaking in its annual report to provide a copy of its code to any person without charge upon request.

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\(^{67}\) The proposing release also would have required the ethics code to specifically address "avoiding conflicts of interest, including disclosure to an 'appropriate person or persons' identified in the code of any material transaction that reasonably could be expected to give rise to such a conflict."
Issuers (other than foreign private issuers that file their annual reports on either Form 20-F or Form 40-F) are required to disclose changes to, or waivers from, the code of ethics for their senior financial officers and principal executive officer on Form 8-K within five business days (the proposal was two business days). Alternatively, these issuers may disclose such changes or waivers on the issuer’s Internet website, if the issuer’s most recent annual report on Form 10-K provided the issuer’s Internet address and stated that the issuer intended to disclose these events on its website. The website disclosure would need to be made within five business days of the event, would have to be maintained on the website for at least 12 months, and would have to be retained by the issuer for at least five years. Foreign private issuers are only required to disclose such changes or waivers in their annual report on Form 20-F or 40-F, although the SEC strongly encourages prompt disclosure by foreign private issuers under cover of Form 6-K or on the issuer’s website. The waiver disclosure requirement only applies to waivers for senior financial officers and the chief executive officer but not to other executive officers, directors or affiliates.68

Companies must comply with the code of ethics disclosure requirements in their annual reports for fiscal years ending on or after July 15, 2003. They also must comply with the requirements regarding disclosure of amendments and waivers to their ethics codes with respect to specified officers on or after the date on which they file their first annual report in which the code of ethics disclosure is required.

B. Nasdaq Code of Conduct Proposal

On October 9, 2002, Nasdaq submitted a rule proposal to the SEC regarding codes of conduct. Nasdaq amended this proposal on January 15, 2003 and October 3, 2003. The Nasdaq proposed rule would require each issuer to adopt a code of conduct applicable to all directors, officers and employees. The code of conduct would need to be publicly available. The code of conduct would need to comply with the definition of "code of ethics" set out in the Sarbanes-Oxley Act and the SEC rules promulgated thereunder. In addition, the code must

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68 The issuer must disclose the nature of (i) any amendment to its code that applies to its principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions; and (ii) any waiver, including an implicit waiver, from a provision of its code granted by the issuer to one of these specified officers, the name of the person to whom the issuer granted the waiver and the date of the waiver. Also, in response to several comments, the final rules defined the terms “waiver” and “implicit waiver”. A “waiver” is the approval by the issuer of a material departure from a provision of its code. An “implicit waiver” is the issuer’s failure to take action within a reasonable period of time regarding a material departure from a provision of its code that has been made known to at least one of the issuer’s executive officers. The final rules also clarify that only amendments or waivers relating to the specified elements of the code of ethics and the specified officers must be disclosed. This clarification is intended to allow and encourage issuers to retain broad-based business codes that are more comprehensive than necessary to meet the new disclosure requirements.
have an enforcement mechanism. Any waivers of the code for directors or executive officers would have to be approved by the board and disclosed in a Form 8-K within five days. This proposal was published for comment by the SEC on July 2, 2003. As proposed, issuers would be required to comply with the rule six months after SEC approval.

C. NYSE Code of Business Conduct and Ethics Proposal

The NYSE corporate governance proposal, published by the SEC for comment on April 11, 2003, would require all listed companies to adopt and disclose a code of business conduct and ethics for directors, officers and employees, and promptly disclose any waivers of the code for directors or executive officers. Waivers of the code for executive officers or directors could only be made by the board or a board committee. The code must contain compliance standards to ensure prompt and consistent action against code violators. The code should address, among other things, 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 encouraging the reporting of illegal or unethical behavior. Companies may draft the "fair dealing" component in a manner that does not alter existing legal rights and obligations such as "at will" employment arrangements. The code of business conduct and ethics would need to be available on the company’s website. The annual report on Form 10-K filed with the SEC would be required to state that the code is on the website and that the information is available in print to any shareholder who requests it. Companies would need to comply with these requirements by the earlier of (1) their first annual meeting after January 15, 2004 and (2) October 31, 2004.

D. Recent Developments in Ethics

Spurred on by the Sarbanes requirements and stock exchange proposals, more companies are taking additional steps to ensure ethical behavior in their organizations. For example, United Technologies Corporation asked each of its 155 financial executives worldwide to sign and certify a statement based on the model ethics code prepared by Financial Executives International in order to assist the CEO and CFO in signing their certifications. Many companies are either reviewing their existing ethics codes or creating new ones. More companies are appointing chief ethics officers or similar compliance figures in order to focus attention on the area. Membership in the Ethics Officer Association, a group of compliance officers from major companies, is reportedly increasing. Companies that adopt an ethics code which complies with the SEC definition also need to appoint an “appropriate person” within their organization.

69 Codes of ethics: How to comply with the letter and spirit of the Sarbanes-Oxley Act, Directorship, October 2002.
to receive reports of code violations or inquiries regarding potential conflicts. In addition, under federal sentencing guidelines companies that set up programs to prevent or detect fraud can be eligible for reduced sentences.

2. Whistleblower Protections

A. The Sarbanes-Oxley Act

The Sarbanes-Oxley Act contains three principal provisions aimed at assisting and protecting corporate whistleblowers:

- SEC rules adopted on January 8, 2003 direct the national securities exchanges to prohibit the listing of any security of an issuer that does not have an audit committee with established procedures for receipt and treatment of complaints from employees and other persons regarding accounting and for confidential, anonymous submission by employees of concerns regarding accounting.

- The Sarbanes-Oxley Act created a new civil action for employees of publicly traded companies who believe they were discharged, demoted, suspended, threatened, harassed or discriminated against because they provided information or assisted in an investigation of securities fraud and related crimes.

- In addition, the Sarbanes-Oxley Act created a new felony if any person knowingly takes any action harmful to any person, including interference with the employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission of any federal offense. The punishment for this felony is a fine or imprisonment of not more than 10 years, or both.

These whistleblower provisions—as well as the code of ethics requirements under the Sarbanes-Oxley Act and the NYSE and Nasdaq listing requirement proposals—require companies to adopt procedures to protect the company against potential liability under the whistleblower provisions and to allow for the receipt by the audit committee of complaints by employees and others. Companies need to make sure that their codes of conduct encourage personnel to report matters involving fraud or unethical behavior and include prohibitions on retribution or discrimination against personnel who so report. Specified individuals in the company should be designated to receive complaints and reports.

Alternatively, some companies have established or are considering setting up a third-party hotline for the receipt of complaints. For example, National Hotline Services Inc. broadcasts on its website, www.hotlines.com, a new service entitled "New: Sarbanes-Oxley Hotline." According to the website, the hotline
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can be available 24 hours a day, all year, to receive anonymous or confidential tips from employees and others. The hotline service summarizes the tips in a report for the company.71 Other hotline services are offered by The Network (www.tnwinc.com) and a partnership of the Better Business Bureau and Planetfeedback (biz.planetfeedback.com). Another solution is the web-based hotline offered by Ethicspoint, which allows employees to anonymously report issues to Ethicspoint directly from their desktop computer.72

B. New York Proposed Legislation

In early 2003 New York's Attorney General proposed to amend New York’s Labor Law and Civil Service Law to improve protections for “whistleblower” employees. Related legislation was introduced in the New York Senate. Key provisions proposed by the Attorney General include the following:

- Private employees would be protected from retaliatory personnel action in the following circumstances:
  - The employee discloses or threatens to disclose information to a supervisor or public body about an “illegal business activity.” The definition of “illegal business activity” would be expanded and would no longer require “substantial and specific danger to public health and safety.”
  - The employee provides information or testimony to a public body conducting an investigation into any illegal business activity (similar to existing law).
  - The employee refuses to participate in any illegal business activity (similar to existing law).

- Under existing law, prior to reporting to a public body, the employee must notify a supervisor and afford the employer a reasonably opportunity to correct the activity. Under the Whistleblower Bill, the employee would only be required to make a "good faith effort" to notify the employer and prior employer notification would not be required where (1) there is imminent and serious danger to the public health or safety, (2) the employer has failed to advise employees of their rights (described below), or (3) the employee reasonably believes that reporting would result in a destruction of evidence or other concealment of the illegal business activity.

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The protection against retaliatory personnel action would apply to any employee who "in good faith reasonably believes that an illegal business activity has occurred or will occur, based on information that the employee in good faith reasonably believes to be true." This is a new standard not included in existing law.

Both public and private employers would be required to publicize employees’ rights under the whistleblower statutes.

Plaintiff employees who prevail against private or public employers would also be entitled to two new remedies: compensatory damages for economic loss, and a civil penalty if the court finds that the employer acted in bad faith (up to $10,000).

3. Attorney Up-the-Ladder Reporting Requirement

A. The Sarbanes-Oxley Act Requirement

The Sarbanes-Oxley Act required the SEC to adopt rules by January 26, 2003 setting forth minimum standards of professional conduct for attorneys appearing and practicing before the SEC in any way in the representation of issuers. In particular, the SEC was required to adopt a rule requiring attorneys to report evidence of a material violation of securities law or breach of fiduciary duty to the CEO or CLO of the company and, if the response was not appropriate, the audit committee or another committee of independent directors or the board itself. These rules are referred to as "up-the-ladder" reporting.

B. SEC Rules

The SEC adopted rules which implement this up-the-ladder reporting requirement. The rules become effective on August 5, 2003.

The SEC rules describe steps that must be taken by attorneys appearing and practicing before the Commission who become aware of evidence of a material violation of United States federal or state securities laws, a material breach of fiduciary duty arising under United States federal or state law or a similar material violation of any United States federal or state law by an officer, director, employee or agent of the issuer.

Initial Reporting by Attorneys

Attorneys covered by the rule are expected (1) to report "evidence of a material violation" either to the issuer's chief legal officer (CLO) or its equivalent, or the CLO along with the chief executive officer (or the equivalent thereof), or (2) to pursue an alternative reporting procedure by notifying the issuer's qualified legal compliance committee (QLCC), if the issuer has previously formed such a committee (the audit committee can assume the responsibility of acting as a
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If the attorney believes it would be futile to report the evidence directly to the CLO or chief executive officer for any reason, such as the officer's complicity with the violation, the attorney may bypass the CLO and CEO and immediately report the evidence to an appropriate committee of directors or the full board, as discussed below.

**Reporting Triggered by "Evidence of a Material Violation"**

"Evidence of a material violation" is "credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur." In the adopting release, the SEC states that to be "reasonably likely" a violation must be more than a mere possibility, but need not be "more likely than not." The "circumstances" are "the circumstances at the time the attorney decides whether he or she is obligated to report" and may include the attorney's professional skills, background and experience, the time constraints under which the attorney is acting, the attorney's previous experience and familiarity with the client and the availability of other lawyers with whom the attorney may consult.

**Investigation by the Chief Legal Officer**

Once a report has been made to the CLO or chief executive officer, the final rule requires the CLO to (1) initiate an inquiry into the evidence as he or she reasonably believes to be appropriate, (2) notify the reporting attorney if he or she determines that no material violation has occurred, is ongoing, or will occur, and the basis for such a determination, (3) unless the CLO (or the equivalent) reasonably believes that no material violation has occurred, is ongoing, or is about to occur, take all reasonable steps to cause the issuer to adopt an "appropriate response" and (4) advise the reporting attorney of such steps.

Alternatively, the CLO may report the suspected violation to the QLCC of the board of directors in lieu of conducting an inquiry if the issuer has duly established a QLCC prior to the report of evidence of a material violation.

**"Appropriate response" by the Chief Legal Officer**

If the reporting attorney reasonably believes that the issuer has provided a timely "appropriate response" to the report, he or she has no further obligations. An "appropriate response" is a response to an attorney reporting evidence of a material violation as a result of which the attorney reasonably believes:

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73 The SEC's release notes that the SEC intends the definition of the term "reasonably likely" to be consistent with its use in the rule governing disclosure of off-balance sheet transactions.
that no material violation has occurred, is ongoing, or is about to occur;

that the issuer has, as necessary, adopted appropriate remedial measures, including appropriate steps or sanctions to stop any material violation which is ongoing, to prevent any material violation that has yet to occur, and to remedy or otherwise appropriately address any material violation that has already occurred and to minimize the likelihood of its recurrence; or

that the issuer, with the consent of the issuer's board of directors, audit committee or committee of directors not directly or indirectly employed by the issuer, or a qualified legal compliance committee (QLCC), has retained or directed another lawyer to review the evidence of a material violation and either:

(i) has substantially implemented any remedial recommendations made by such other lawyer after a reasonable investigation and evaluation of the reported evidence; or

(ii) has been advised that such other lawyer may, consistent with his or her professional obligations, assert a "colorable defense" on behalf of the issuer (or the issuer's officer, director, employee, or agent) in any investigation or judicial or administrative proceeding relating to the report.

Subsequent Reporting to the Audit Committee or Board

If the CLO and CEO fail to respond appropriately to evidence of a material violation, the attorney is required to report the evidence further up-the-ladder to (i) the audit committee; (ii) another committee of the board of directors consisting solely of directors who are not directly or indirectly employed by the issuer; or (iii) directly to the board of directors itself if the issuer has no committee described in (ii). As discussed below, this duty does not apply if the reporting attorney has reported to a QLCC.

If an attorney is not satisfied that his or her report was appropriately and timely addressed by the CLO, CEO, board committee or the full board, the attorney shall give the reasons for his or her dissatisfaction to the CLO, CEO and any directors to whom the attorney made such report. As discussed below, this duty does not apply where the attorney has reported directly to a QLCC.

Qualified Legal Compliance Committee

If the reporting attorney chooses to report evidence of a material violation to the QLCC, a reporting attorney is relieved of his or her "up-the-ladder" reporting obligation. Once an attorney reports a suspected violation to the QLCC,
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the attorney is not required to assess the issuer's response to the report and has no further obligations.

The CLO may also report the suspected violation to the QLCC in lieu of conducting an inquiry. The CLO must inform the reporting attorney that the matter has been referred to the QLCC.

The rule defines a "qualified legal compliance committee" (QLCC) as a committee of an issuer that:

- consists of at least one member of the issuer's audit committee (or one member of an equivalent committee if no audit committee exists) and two or more members of the issuer's board of directors who are not employed, directly or indirectly, by the issuer;

- has adopted written procedures for the confidential receipt and consideration of any report of evidence of a material violation;

- has been duly established by the board of directors, with the authority and responsibility:
  - to inform the CLO and CEO, or their equivalents, of any report of evidence of a material violation;
  - to determine whether an investigation of evidence of a material violation is necessary, and if so, to (i) notify the audit committee or the full board of directors, (ii) initiate such investigation, which may be conducted by the CLO or outside attorneys, and (iii) retain such expert personnel as the committee deems necessary; and
  - at the conclusion of such investigation, (i) to recommend, by majority vote, that the issuer implement an appropriate response and (ii) to inform the CLO and CEO and the board of directors of the results of the investigation and the appropriate remedial actions to be adopted; and

- has the authority and responsibility, acting by majority vote, to take all other appropriate action, including notification to the SEC in the event that the issuer fails in any material respect to implement an appropriate response recommended by the QLCC.

The audit committee or another committee can serve as the QLCC if it satisfies the above criteria. The SEC's adopting release clarifies that the SEC does not intend service on a QLCC to increase any liability of any member of a board under state law and expressly finds that it would be inconsistent with the public interest for a court to so conclude.
Lawyers Affected by the Up-the-Ladder Reporting Rule

The rule applies to attorneys "appearing and practicing before the SEC" in the representation of an issuer. Attorneys acting in the context of an attorney-client relationship (other than non-appearing foreign attorneys) are "appearing and practicing before the SEC" if they:

- transact any business with the SEC, including communication in any form;
- represent an issuer in an SEC administrative proceeding, or in connection with any SEC investigation, inquiry, information request, or subpoena;
- provide advice regarding United States securities laws or the SEC’s rules or regulations thereunder regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to the SEC, including the provision of advice in the context of preparing any such document; or
- advise an issuer as to whether information or a statement, opinion, or other writing is required under the United States securities laws or the SEC’s rules or regulations thereunder to be filed with or submitted to the SEC, or incorporated into such a document.74

The final rule limits up-the-ladder reporting obligations to attorneys who provide "legal services to an issuer with whom the attorney has an attorney-client relationship." As a result, the rule should not be applicable to attorneys representing parties in privity of contract with an issuer, such as underwriters, and attorneys acting in a non-legal capacity, such as investment bankers who happen to also be lawyers.

74 In a speech to the American Bar Association's 2003 Conference for Corporate Counsel on June 12, 2003, Alan Beller (Director of the SEC Division of Corporation Finance) stated: "I expect your valued advisers have felled many trees and spilled barrels of ink describing the meaning and consequences of the terms 'appearing and practicing before the Commission' and 'evidence of a material violation,' among others. They should do that; you should know what the rules mean. And it is very important for the Commission in doing its job to have rules that are appropriately clear. But I would submit to you that in deciding how you want your internal legal staff and your outside lawyers to behave, you shouldn't much care what those terms mean. You should want every lawyer, whether or not and before whomsoever they are appearing and practicing, to understand and embrace the notion that they represent your company and that they will bring issues up-the-ladder and as appropriate to you. And you should want them to bring to their supervisor and to you as appropriate every legal, business, professional, or ethical concern that they have about what is going on in the company. The 'Does it smell bad?' test or the 'Does it make me uncomfortable?' test captures the best practices that I believe you want, rather than the test of whether something is evidence of a material violation."
Foreign lawyers

The SEC's final up-the-ladder rule provides that a "non-appearing foreign attorney" is not covered by the rule, thereby exempting most foreign attorneys from the rule. To qualify as a "non-appearing foreign attorney," an attorney must (1) be admitted to practice in a jurisdiction outside the United States, (2) not hold himself or herself out as practicing, and not give legal advice regarding, United States federal or state securities laws (except, as provided below, in consultation with a U.S. lawyer), and (3) either (a) conduct activities that would constitute appearing and practicing before the SEC only incidentally to, and in the ordinary course of, the practice of law in a jurisdiction outside the United States or (b) appear and practice before the SEC only in consultation with counsel, other than a non-appearing foreign attorney, admitted or licensed to practice in a state or other United States jurisdiction.

The final rules also state that non-U.S. attorneys practicing outside of the United States will not be required to comply with the requirements of the rule to the extent that such compliance is prohibited by applicable foreign law.

C. Noisy Withdrawal

Original Proposal (November 2002)

Under the SEC's original proposal on "noisy withdrawal," included in the November proposing release on attorney up-the-ladder reporting, an attorney retained by the issuer who suspected that a material violation likely to result in substantial injury to the issuer or its investors was ongoing or about to occur and had fully reported such evidence "up-the-ladder" without receiving an appropriate response would be required to:

- withdraw from representing the issuer, indicating that the withdrawal is based on professional considerations;

- give written notice to the SEC of the attorney's withdrawal within one business day, citing professional considerations; and

- promptly disaffirm any opinion, document, representation or the like filed with the SEC, or incorporated by reference in a document filed with the SEC, that the attorney has had a role in preparing and that he or she believes may be materially false or misleading.

Under the same circumstances an attorney employed by the issuer would be required to:

- notify the SEC within one business day that he or she intended to disaffirm some opinion, representation or the like in a document filed
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with the SEC, or incorporated by reference in a document filed with the SEC, that the attorney has had a role in preparing and that he or she believes may be materially false or misleading; and

- promptly disaffirm to the SEC in writing such opinion, document, affirmation or similar product. In-house attorneys, however, would not be required to resign.

If the suspected material violation took place in the past and was not ongoing, an attorney retained by the issuer would, under the November proposal, be entitled but not required to:

- withdraw forthwith from representing the issuer, indicating that the withdrawal is based on professional considerations;
- give written notice to the SEC of the attorney's withdrawal within one business day, citing professional considerations; and
- disaffirm to the SEC any opinion, document, representation or the like filed with the SEC, or incorporated by reference in a document filed with the SEC, that the attorney has had a role in preparing and that he or she believes may be materially false or misleading.

An attorney employed by the issuer would be entitled but not required to:

- notify the SEC within one business day that he or she intends to disaffirm some opinion, representation or the like in a document filed with the SEC, or incorporated by reference in a document filed with the SEC, that the attorney has had a role in preparing and that he or she believes may be materially false or misleading; and
- promptly disaffirm such opinion or writing.

None of the foregoing provisions would apply if the attorney elected to report through the QLCC mechanism.

Alternative Proposal (January 2003)

The SEC's noisy withdrawal proposal was significantly criticized for, among other things, violating the attorney-client privilege, impairing the lawyer's ability to be a zealous advocate, harming the client's willingness to trust his or her counsel, reducing the information clients provide to their attorneys, going beyond the SEC's statutory authority, and preempting state court determinations of what constitutes attorney-client privilege.

In response to the comments, the SEC deferred its consideration of the proposal, proposed an alternative "noisy withdrawal" provision on January 29,
2003, and asked for comments on both the original and alternative proposals by April 7, 2003. The alternative proposal would require withdrawal under a narrower set of circumstances (i.e., when substantial evidence exists that a material violation is ongoing or about to occur), and shift to the issuer the obligation of reporting the reporting attorney’s withdrawal to the SEC.

Under the alternative proposal, an attorney who had reported evidence of a material violation "up-the-ladder" (rather than through the QLCC mechanism) would be required either to withdraw (if retained by the issuer) or cease participating in any matter concerning a potential violation (if employed by the issuer) if the attorney (i) did not receive a timely and appropriate response in a reasonable time and (ii) had reasonably concluded that there is substantial evidence that a material violation is occurring or is about to occur that is likely to cause substantial injury to the interests of the issuer or investors.

Under the alternative proposal, (1) an attorney retained by the issuer would be required to withdraw from such representation and notify the issuer, in writing, that the withdrawal was due to professional considerations, and (2) an attorney employed by the issuer would be required to cease forthwith any participation in any matter concerning the violation and to notify the issuer in writing that the issuer had not provided a timely and appropriate response to the report of evidence of a material violation. The foregoing provisions would not apply to a report through the QLCC mechanism.

The alternative proposal does not require an attorney to withdraw from representation or cease participation in the matter if the attorney would be prohibited from doing so by order or rule of any court, administrative body or other authority with jurisdiction over the attorney. In such cases, the attorney would be required to give notice to the issuer that, in the absence of such a prohibition, he or she would have withdrawn from representation or ceased any participation in the matter.

The alternative proposal retains a provision requiring an attorney who reasonably believes he or she has been dismissed for reporting evidence of a material violation to notify the issuer’s CLO or its equivalent. The alternative proposal would also require the CLO to notify an attorney’s successor that the previous attorney had withdrawn, ceased to participate or had been discharged pursuant to the provisions of the alternative proposal.

The alternative proposal, by shifting the reporting obligation to the issuer, is intended to address the concern that the "noisy withdrawal" provisions in the November proposal is inconsistent with attorney-client privilege. The issuer would be required publicly to disclose receipt of any of the attorney notices required by the alternative proposal, on Form 8-K, 20-F or 40-F, as applicable, within two business days. If the issuer fails to do so, the proposed alternative rule allows, but does not require, an attorney employed or retained by the issuer to
inform the SEC that the attorney provided notice pursuant to the rule and that such action was based on professional considerations.

4. The Conference Board's Principles of Ethics

On January 9, 2003, the Commission on Public Trust and Private Enterprise of The Conference Board issued its findings and recommendations regarding corporate governance. One of the principles was that boards should be responsible for overseeing corporate ethics. Specific best practice recommendations include:

- Continued and repeated emphasis by the board and CEO on the importance of ethical conduct and using as criteria for senior management a candidate's ability to foster and history of fostering ethical practices ("tone at the top").

- Programs to ensure that employees understand, apply, and adhere to the company's code of ethics, and processes that encourage and make it safe for employees to raise ethical issues and report possible ethical violations.

- Designation of a board committee to oversee ethics issues, designation of an officer to oversee ethics and compliance with the code of conduct and inclusion of ethics-related criteria in employees’ annual performance reviews.

Part VI: Compensation

1. Section 16

A. 2-Business Day Deadline

The Sarbanes-Oxley Act amended Section 16 of the Securities Exchange Act of 1934 to require that, effective August 29, 2002, officers, directors and 10% beneficial owners of an issuer must file forms indicating changes in beneficial ownership of the issuer's equity securities within two business days of the related transaction. Previously Forms 4 could be filed within 10 days of the end of the month in which the transaction occurred.

On August 27, 2002 the SEC adopted rules which implemented the requirement that Forms 4 be filed not later than two business days following transactions in the equity securities of reporting companies. The SEC also changed its rules to require officers and directors to report most transactions in equity securities directly with the related issuer--such as grants, awards and other acquisitions of equity securities from the issuer, dispositions of equity securities to the issuer, and intra-plan transfers involving an issuer equity securities fund exempt from Section 16(b) short-swing profit recovery--also on Form 4 not later
than two business days following the transaction; previously most of these transactions could be reported on Form 5 within 45 days of the end of the year in which the transaction occurred. In particular, issuances, exercises and cancellations and regrants of stock options, including repricings, became reportable on Form 4 no later than the second business day following the transaction. These rules became effective on August 29, 2002.

The SEC's adopting release asked for comments on whether any changes are required in the treatment of stock options under Section 16. "One set of issues involves whether and how the six-month period of Section 16(b) should be applied and calculated in connection with stock options, exercises and the sale of the underlying stock. For example, should a six-month holding period be required as a mandatory condition to exempt grants under Rule 16b-3(d), rather than be one of the alternative permissible bases for an exemption?" Prior to August 15, 1996, Rule 16b-3 required that either the option or the underlying shares have been held for six months in order for the option grant to qualify as an exempt transaction. The SEC has not subsequently given any indication that it intends to take action on this particular topic.

B. Corporate Procedures for Accelerated Section 16 Filings

The 2-business-day filing requirement has caused many issuers to review and modify their internal Section 16 procedures. Various actions which should be considered or taken in order to facilitate the filing process include the following:

- Require directors and executive officers to pre-clear transactions in issuer securities prior to execution.
- Establish procedures whereby insiders must promptly inform the corporate secretary or general counsel of transactions in issuer securities.
- Designate more than one person at the company to be responsible for Section 16 filings.
- Prepare Section 16 forms in advance of or in connection with award grants to directors and officers.
- Obtain (and file with the SEC) powers of attorney for signing Section 16 forms.
- Periodically remind officers and directors of their Section 16 obligations (and that the obligations can apply to their family members and trusts).
- Require all officers and directors to use one broker or a limited number of brokers who know to report transactions directly to the company.
Develop procedures with brokers to ensure timely receipt by the company of information about transactions by the company's directors and officers.

Review the list of employees who are deemed "officers" for purposes of Section 16.

Obtain Edgar access codes for all officers and directors, and begin filing Section 16 forms by EDGAR in advance of the required date for such filing.

C. Electronic Filing of Section 16 Forms

The Sarbanes-Oxley Act also required the SEC to adopt rules no later than July 30, 2003 requiring that Section 16 forms be filed electronically, be made available on a publicly accessible website no later than the end of the business day following that filing, and be made available on the issuer's website (if the issuer maintains a corporate website) no later than the end of the business day following the filing.

On May 7, 2003 the SEC adopted rules which provide that all Forms 3, 4 and 5 filed under Section 16 must be filed by EDGAR. These rules apply to Section 16 forms filed on or after June 30, 2003. In addition, related correspondence and supplemental information pertaining to a document that is the subject of mandatory EDGAR filing must also be filed electronically. Forms submitted by direct transmission on or before 10:00 pm Eastern time will be deemed filed on the same business day (the SEC acknowledged that the 5:30 p.m. Eastern time deadline has been troublesome for reporting persons located in the western United States). However, Edgar filing support will not be available after 7:00 p.m. Eastern time.

Under the new rules, temporary hardship exemptions under Regulation S-T will no longer be available for late Section 16 forms. In addition, the SEC's adopting release states that "it is unlikely that a continuing hardship exemption would be granted with respect to Forms 3, 4 and 5 given the nature of the information that appears in these forms and the expected ease of electronic filing."
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Filing date adjustments (under Rule 13(b) of Regulation S-T) still will be available where an electronic filer attempts in good faith to file a document with the SEC in a timely manner but the filing is delayed due to technical difficulties beyond the filer's control. However, filing date adjustments "should be few in number" and in any event will not be available due to failure to obtain CIK and CCC codes on a timely basis.77

Also, the SEC has granted limited relief from Item 405 of Regulation S-K, which requires issuers to disclose Section 16 reporting deficiencies in their proxy or information statements for annual meetings at which directors are elected, and in their Forms 10-K. The final rules provide that no disclosure is required if a Form 4 is filed by the end of the business day following the regular due date. This relief is available only through June 2004.

In addition, under the new rules issuers that maintain a public corporate website must post on their website all Forms 3, 4 and 5 filed with respect to its equity securities by the end of the business day after filing. Issuers must comply with the website posting requirements as to reports filed on or after June 30, 2003. This rule applies to companies with public internet sites (as opposed to private intranet sites). The forms must remain posted for at least one year. An issuer could satisfy the website posting requirement by providing access directly or by hyperlinking to the Section 16 filings via a third-party service (or EDGAR). Hyperlinking is permitted only if the following conditions are met:

- the forms are made available in the appropriate time frame;
- access to the reports is free of charge to the user;
- the display format allows retrieval of all information in the forms (publishers who provide only Table I information would not qualify);
- the medium to access the forms is not so burdensome that the intended users cannot effectively access the information provided;
- the access includes any exhibits or attachments;
- the forms are accessible for at least a 12-month period;
- access to the forms is through the issuer website address the issuer normally uses for disseminating information to investors; and
- any hyperlink is directly to the Section 16 forms (or to a list of the Section 16 forms) and not just to the home page or general search page of the third party service (an intermediate screen stating the viewer is leaving the issuer's website, or a disclaimer screen, would be acceptable). The hyperlink caption must indicate clearly that the link leads to the issuer's insiders' Section 16 forms.

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77 The SEC's adopting release states that the SEC staff generally does not grant filing date adjustments over extended periods of time. The release states that if technical difficulties prevent the filing from being made on the due date, it is important to address these difficulties as quickly as possible and request the filing date adjustment promptly after the filing is made.
The SEC rules require insiders to send or deliver their forms to a person designated by the issuer to receive such forms or, in the absence of such a person, to the issuer's secretary or person performing equivalent functions. The SEC's adopting release states that, in designating such a person, the SEC expects an issuer would also designate an electronic transmission medium compatible with the issuer's own systems, so that a form sent via that medium would be received by the issuer in time to satisfy the website posting deadline. The SEC also encouraged issuers to post on their website the identify of the designated person and electronic transmission medium.

In order to file electronically, directors and officers will need to obtain filing codes from the SEC. Persons can only acquire the codes by submitting a Form ID to the SEC. An individual reporting person must have his or her own codes, cannot rely on the company's own codes and should not have separate codes for each company he or she serves as a director or officer. Companies need to make sure they know the codes of their officers and directors.\(^7\)

The SEC has established a new internet website exclusively for the on-line creation and submission of Section 16 ownership reports. The site can be accessed at https://www.onlineforms.edgarfiling.sec.gov. The new system was made available for testing in March 2003 and went live on May 5, 2003. The Division of Corporation Finance guidance on the electronic filing process can be accessed at http://www.sec.gov/divisions/corpfin/sec16faq.htm.

2. Loan Prohibition

A. Overview

The Sarbanes-Oxley Act provides that an issuer may not, directly or indirectly, "extend or maintain credit, arrange for the extension of credit, or renew an extension of credit," in the form of a "personal loan" to or for any director or executive officer of that issuer. Extensions of credit maintained on July 30, 2002 are grandfathered, as long as there is no material modification to any term of any such extension or any renewal of any such extension of credit. The provision applies to both domestic and foreign private issuers.

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\(^7\) Obtaining codes for a reporting person may result in the cancellation of codes previously issued for the reporting person. The SEC stated in the adopting release that it is exploring potential methods for the system to identify uniquely each insider and enable an insider to manage the access codes more effectively. However, for the time being, the SEC urged insiders to file Forms ID well in advance of when they expect to need codes, to keep track of their codes and to advise issuers for which they become insiders of their existing codes, and the SEC advised issuers to inquire whether an insider already has codes before submitting a Form ID filing on the insider's behalf. Also, insiders and issuers can determine if an insider currently has codes by looking at the SEC website (at http://www.edgarcompany.sec.gov/servlet/CompanyDBSearch?page=main) (enter the insider's last name in the "Company Name" field).
This provision created significant consternation among attorneys and corporate executives because of its potential breadth. Numerous questions arose as to the provision's applicability to various transactions (many of which were previously considered ordinary course) such as the cashless exercise of stock options, split dollar life insurance, advances of director and officer indemnification expenses pursuant to charter, bylaw or contractual provisions, travel advances, personal use of company credit cards, relocation payments, deferred compensation, leveraged co-investments, loans from 401(k) plans, drawdowns on committed lines of credit and forgiveness of grandfathered loans. The SEC has steadfastly refused to take any position on the questions raised by the loan prohibition.

An article in the New York Times in August 2002 indicated that the uncertainty caused by this provision had virtually halted the sale of split-dollar life insurance policies. The article quoted Senator Charles Schumer, author of the loan prohibition, as saying, "There have been abuses of these policies in the past. The general view when we passed the law was that this was the type of thing we wanted to eliminate. There was an effort by the life insurance industry to exempt these policies, but we kept them in."

Another significant question was whether the routine cashless exercise of stock options constituted a loan by the company of the option exercise price to the executive or director. Many attorneys recommended that their clients stop the practice for executive officers and directors. The New York Times quoted Senator Charles Schumer on August 30, 2002 as saying, "I believe they probably are banned. . . . [T]he bottom line is that the corporation is not an arms-length lender to its top executives. And in this case, particularly since the loan is so short term and well collateralized, there's no reason they can't find financing apart from the corporation."

On September 25, 2002, Senators Susan Collins and Carl Levin, of the Senate Permanent Subcommittee on Investigations, sent a letter to SEC Chairman Harvey Pitt urging the SEC to resist any efforts to narrow or weaken the insider loan prohibition. Their letter states that the legislative history provides "no basis" for creating exemptions for company loans used by executives to purchase company stock, exercise stock options, obtain insurance, relocate for work, or pay taxes.

B. 25 Law Firms' White Paper

On October 15, 2002, a group of 25 law firms issued a paper which provided the consensus position of these law firms on a variety of issues related to the loan prohibition. The paper emphasized that the provision only applied to "personal loans" and that definitions of similar terms used in the margin

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regulations were not necessarily applicable due to the different policy considerations underlying the margin rules. Overall, the paper concluded that many standard types of arrangements entered into in the ordinary course of business should be permissible notwithstanding the loan prohibition. For example, the paper concluded that the following transactions should be permissible:

- **Travel and similar advances**: advances of cash, in accordance with company policy, to cover reimbursable travel and similar expenses incurred while performing executive responsibilities.

- **Personal use of company credit card, required to be reimbursed**: if company policy permits only business use and limited ancillary personal use and requires settlement within a reasonable period.

- **Relocation payments subject to reimbursement**: if treated the same as travel and similar advances.

- **Indemnification advances**: under charter, bylaws or indemnification agreements or D&O policies, where repayment is required under some circumstances.

- **Loans from 401(k) plans**: where the loan is effectively an executive officer borrowing from himself or herself and the issuer is not making or arranging the loan.

- **Drawdowns on committed lines**: as long as the issuer was legally committed before July 30, 2002, without the issuer having discretion or a termination right.

- **Forgiveness of grandfathered loans**: (1) if the forgiveness or bonus/repayment is in full or (2) if partial forgiveness or bonus/repayment in part, to the extent partial prepayment is not prohibited and no other term of the loan is changed.

The paper also contained a lengthy analysis which concluded that some types of cashless option exercises should also be permissible. The paper's principal conclusions on this topic are as follows:

"i. Plan provides for payment of exercise price against delivery of stock at the time of settlement of the related sale transaction (often T+3):

- Permissible -- Issuer appoints broker and has previously agreed with broker to deliver stock at the time of settlement of the related sale transaction, and in fact can assure that it
does so (e.g., through pre-delivery of treasury shares to issuer account at broker or through use of DTC's DWAC system). (no personal loan)

- Permissible -- (A) Issuer has not previously agreed with broker, (B) broker is selected by insider with no involvement by issuer, and (C) all issuer does is perform the ministerial act of acknowledging to broker upon broker's request that issuer will deliver stock promptly, whether or not the plan terms so require. (no personal loan and no arranging)

- Permissible -- Issuer distributes to employees a list of several brokers experienced in these types of transactions. (no personal loan and no arranging)

ii. Plan provides for payment of exercise price prior to settlement of the related sale transaction:

- Permissible -- (A) Issuer has not previously agreed with broker, (B) broker is selected by insider with no involvement by issuer, and (C) broker advances the exercise price and withholding taxes to the issuer on the exercise date, but (D) all issuer does is perform the ministerial act of acknowledging to broker upon broker's request that issuer will deliver stock promptly, whether or not the plan terms so require. (no arranging)

- Permissible -- Issuer distributes to employees a list of several brokers experienced in these types of transactions. (no arranging)

- Should be permissible based on the apparent policy of Section 402 -- Issuer appoints broker and has previously agreed with broker that broker will advance the exercise price to the issuer on the exercise date, and issuer will deliver stock promptly on T+3.

iii. Plan provides for delivery of treasury shares by company prior to payment of the exercise price.

- Should be permissible based on the apparent policy of Section 402.

iv. The above conclusions are not affected by the fact that the issuer contracts with an administrative agent to administer the stock option plan and process exercises of stock options (including
"cashless exercises") and pays the agent annual administrative and per exercise fees."

The conclusions in the paper were not endorsed or reviewed in advance by the SEC, and the SEC has not indicated if it agrees with all or any portion of the paper. The signatories to the paper also recognized the existence of relatively limited direct authority for the conclusions in the paper. Companies are still reviewing all transactions impacted by the loan prohibition as there have been no official government interpretations issued with respect to the provision and none are currently expected.

C. Foreign Banks

On September 11, 2003, the SEC issued rule proposals in order to exempt qualified banks from the Sarbanes-Oxley loan prohibition. The Sarbanes-Oxley Act, as originally adopted, permitted certain insider lending by a bank or other depository institution that is insured under the Federal Deposit Insurance Act. However, foreign banks whose securities are registered with the SEC are not eligible for this bank exemption.

Some foreign banks commented to the SEC that the inability of foreign banks to qualify for the “insured depository” exemption placed them at a disadvantage compared to U.S. banks. Some foreign banks also commented that, under foreign banking regulations or as a matter of practice, directors and executive officers were prohibited from borrowing money from other banks; the combination of these prohibitions and the Sarbanes-Oxley loan prohibition would effectively foreclose a director or executive officer of an SEC-registered foreign bank from borrowing money.

As proposed, an issuer that is a foreign bank or the parent company of a foreign bank would be exempt from the prohibition of extending, maintaining, arranging for or renewing credit in the form of a personal loan to or for any of its directors or executive officers, so long as all three of the following conditions are met:

1. Either (a) the laws or regulations of the foreign bank’s home jurisdiction require the bank to insure its deposits (the SEC’s proposing release states that 34 European countries, 10 African countries, 8 Asian countries, 4 Middle Eastern countries and 16 countries in North or South America have a deposit insurance scheme), or (b) the Board of Governors of the Federal Reserve System has determined that the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis (“CCS”) by the bank supervisor in the foreign bank’s home jurisdiction.
2. The laws or regulations of the foreign bank’s home jurisdiction restrict the foreign bank from making loans to its executive officers and directors or those of its parent company, unless the foreign bank is permitted to and does extend the loan:

- on substantially the same terms as those prevailing at the time for comparable transactions by the foreign bank with other persons who are not executive officers, directors or employees of the foreign bank or its parent company; or

- pursuant to a benefit or compensation program that is widely available to the employees of the foreign bank or its parent company and does not give preference to any of the executive officers or directors of the foreign bank or its parent company over any other employees of the foreign bank or its parent company; or

- following the express approval of the loan by the bank supervisor in the foreign bank’s home jurisdiction.

3. For any loan that, when aggregated with the amount of all other outstanding loans to a particular executive officer or director, exceeds $500,000, both (i) a majority of the foreign bank’s board has approved the loan in advance and (b) the loan’s intended recipient has abstained from participating in the vote regarding the loan. For banks with a two-tier board system, with a management board and a supervisory/non-management board, majority approval of the insider loan by either board would suffice as long as the individual receiving the loan abstained from participating in the board’s voting.

Under the SEC proposal, a “foreign bank” means an institution (1) the home jurisdiction of which (the place where it is incorporated or organized) is other than the U.S., and (2) that is regulated as a bank in its home jurisdiction, and (3) that is engaged substantially in the business of banking. Engaging in the business of banking means (a) receiving deposits to a substantial extent in the regular course of business, (b) having the power to accept demand deposits and (c) extending commercial or other types of credit. This definition would exclude banks which extend credit but do not also receive deposits.

The SEC also proposed a related amendment to Form 20-F (but not Form 40-F) regarding disclosure of insider loans by foreign banks. Currently, unless a loan is a problematic loan, the foreign bank simply discloses that its insider loans were made in the ordinary course of business, were made on substantially the same terms as those prevailing with other third parties, and did not involve more than the normal risk of collectibility or present other unfavorable features. If the loan is problematic, current rules require the foreign bank to disclose the largest
amount outstanding during the period covered, the amount outstanding as of the latest practicable date, the nature of the loan and the transaction in which it was incurred, and the interest rate on the loan. As proposed, in the case of a problematic loan, a foreign bank also would be required to disclose the identity of any director, executive officer or other related party otherwise required to be disclosed who has received the problematic loan, and the nature of the relationship of the loan recipient with the foreign bank.

As proposed, the rules would be effective upon publication in the Federal Register. The amendment to Form 20-F would be effective 30 days after publication in the Federal Register.

3. **Insider Trades During Pension Fund Blackout Periods**

   **A. Prohibition on Insider Trades**

   **General Rule**

   Pursuant to the Sarbanes-Oxley Act, the SEC adopted new Regulation BTR (Blackout Trading Restriction). Regulation BTR makes it unlawful for any director or executive officer of an "issuer" of any equity security to, directly or indirectly, purchase or sell or otherwise acquire or transfer any equity security of the issuer during a "blackout period" with respect to such security, if such director or officer acquired such equity security "in connection with his or her service or employment as a director or executive officer." These rules apply to both domestic issuers and foreign private issuers and became effective on January 26, 2003.

   **Definition of "blackout period"**

   The trading prohibition only applies during a "blackout period." A blackout period is defined (with certain exceptions) for U.S. issuers as any period exceeding three consecutive business days during which transactions in equity securities of such issuer are temporarily suspended, and at least 50% of the U.S. participants under all individual account plans maintained by the issuer are impacted by the suspension.

   Under the rules, the prohibition on insider trading during blackout periods would not apply to a blackout period that affects a plan maintained outside the United States primarily for the benefit of persons located outside the United States, as such plans are not considered “individual account plans”. In addition, the rules do not apply to employee benefit plans that have been approved by a foreign taxing authority or are eligible for preferential treatment under foreign tax laws.

   Plans of foreign private issuers that do not meet the foregoing exemptions (e.g., they are maintained in the United States primarily for the benefit of persons located within the United States) would need to comply with the blackout rules if
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(i) the rights to trade in the issuer's equity securities are temporarily suspended with respect to at least 50% of the participants and beneficiaries under all individual account plans of the issuer maintained in any U.S. state or territory (the standard applicable to domestic issuers), and (ii) the number of participants and beneficiaries located in the United States subject to the temporary suspension exceeds either (a) 15% of the total number of employees of the issuer and its consolidated subsidiaries or (b) 50,000. This calculation would compare (x) the number of participants or beneficiaries located in the United States who are subject to the temporary suspension, to (y) the number of employees of the issuer worldwide. If this percentage is greater than 15%, or if the number of participants and beneficiaries in the United States who are subject to the temporary suspension is greater than 50,000, and the concurrent 50% test also is met, the trading prohibition would apply to the directors and executive officers of the foreign private issuer.

Securities Acquired in Connection with Service or Employment

The rules apply to any equity securities acquired in connection with service or employment as a director or executive officer. For this purpose, the term "acquired in connection with service or employment" generally does not include securities which an employee acquired prior to becoming a director or executive officer. However, the term does include equity securities acquired by a director or executive officer --

- as a direct or indirect inducement to service or employment as a director or executive officer;
- as a result of a business combination in respect of securities of an entity involved in the business combination that he or she had acquired in connection with service or employment as a director or executive officer of such entity;
- at a time when he or she was a director or executive officer, as "director's qualifying shares" or securities that he or she must hold to satisfy minimum ownership requirements or guidelines for directors or executive officers;
- at a time when he or she was a director or executive officer, under a compensatory plan, contract, authorization or arrangement of the issuer or a parent, subsidiary or affiliate, including an option, warrant or rights plan, a pension, retirement or deferred compensation plan or a bonus, incentive or profit-sharing plan; and
- at a time when he or she was a director or executive officer, as a result of any related party transactions or business relationships described in paragraph (a) or (b) of Item 404 of Regulation S-K.

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80 Item 404(a) requires disclosure of any transaction since the beginning of the company's last fiscal year, to which the company was or is a party, in which the amount involved exceeds $60,000 and in which a director, executive officer, director nominee, 5%
for this purpose, it is irrelevant whether any such securities were acquired in an arms-length, commercial transaction.

Equity securities acquired in connection with service or employment as a director or executive officer before a company became an "issuer" would also be subject to the statutory trading prohibition. Similarly, equity securities acquired in connection with an individual's service or employment as a director or executive officer before the effective date of the Sarbanes-Oxley Act would be considered subject to the rule.

A rebuttable presumption exists which treats any sale or other transfer of an equity security of an issuer during a blackout period as a transaction involving an equity security acquired in connection with service or employment as a director or executive officer to the extent that such director or officer has a pecuniary interest in the securities. This presumption can be rebutted by showing that such equity securities were not acquired in connection with service as an officer or director, which must be established by identifying the source of the equity securities and demonstrating that the same specific identification for all purposes related to the transaction were used (such as tax reporting and any applicable disclosure and reporting requirements).

For purposes of determining whether equity securities are subject to Section 306(a), any equity securities acquired by a director or executive officer, at a time when he or she was a director or executive officer of a foreign private issuer, generally as a result of any transactions between the foreign private issuer and its affiliates, shareholders and key management personnel, will be considered to have been acquired in connection with an individual's service or employment as a director or executive officer of such foreign private issuer. This type of acquisition is in addition to the other types enumerated above that may result in the director's or executive officer's securities becoming subject to Section 306(a).

Persons Subject to the Trading Prohibition

Only "directors" and "executive officers" of issuers are subject to the statutory trading prohibition. These terms are defined by reference to Section 16 of the Exchange Act which focuses on policy-making functions of the individual. If an issuer identifies an individual as an "executive officer" pursuant to Item 404(b) requires disclosure of certain relationships involving directors or director nominees where the director was an executive officer or 10% shareholder of a business that has made payments to or received payments from the company in excess of 5% of the company's revenues or the other entity's revenues, or where the director is or was a partner or executive officer of an investment banking firm that performed services for the company, other than as an underwriter in a syndicate, during the last fiscal year although the dollar amount need not be disclosed if the amount does not exceed 5% of the investment bank's gross revenues for its last full fiscal year.
401(b) of Regulation S-K, it will be presumed that the individual so identified is an "executive officer" of the issuer for purposes of Section 306(a) as well.

The statutory trading prohibition does not apply to an individual who ceases to be a director or executive officer of an issuer. Therefore, any person who no longer serves as a director or executive officer of the issuer would be free to trade the issuer's equity securities (regardless how or when such securities were acquired) during a blackout period, subject to any other limitations imposed under applicable law.

Regulation BTR governs "directors" and "executive officers" of foreign private issuers, but defines these terms differently and more narrowly for foreign private issuers. As defined for purposes of Section 306(a), the term "director" means any director (within the meaning of Section 3(a)(7) of the Exchange Act) who is a management employee of the issuer (thereby excluding all non-management directors from the application of the trading prohibition). The term "executive officer" is also narrowly defined to mean the principal executive officer or officers, the principal financial officer or officers and the principal accounting officer or officers of the issuer (or if there are none, the controller).

Securities Subject to the Trading Prohibition

Section 306(a) of the Sarbanes-Oxley Act only applies to "equity securities of an issuer," which term includes any equity security or derivative security relating to the issuer, whether or not issued by that issuer.

The term "equity security" includes any stock or similar security, limited partnership interest, any security future on any such security, any security convertible, with or without consideration into such a security, or carrying any warrant or right to subscribe to or purchase such a security, any such warrant or right, or any put, call, straddle, or other option or privilege of buying such a security from or selling such a security to another without being bound to do so. Thus, restricted stock grants to, and transfers or redemptions by, a director or executive officer during a blackout period would generally be prohibited under the Sarbanes-Oxley Act.

The term "derivative security" generally includes any option, warrant, convertible security, stock appreciation right, or similar right with an exercise or conversion privilege at a price related to an equity security, or similar securities with a value derived from the value of an equity security. Thus, stock option grants to, and exercises by, a director or executive officer during a blackout period would also generally be prohibited. For this purpose, a derivative security is defined by reference to the rules under Section 16 and would include an interest that may be settled only in cash, but the value of which is denominated or based on an equity security (such as phantom stock).

Notice

In any case in which a director or executive officer is made subject to the statutory trading prohibition in connection with a blackout period, the issuer must
timely notify such director or officer and the SEC of such blackout period. These notices must generally contain --

- the reasons for the blackout period;
- a description of the plan transactions to be suspended during, or affected by, the blackout period;
- the description of the equity securities subject to the blackout period;
- the actual or expected beginning date and ending date of the blackout period, or the calendar weeks during which the blackout period is expected to begin and end provided that the notice describes how directors and executive officers may obtain information during such weeks as to whether the blackout period has begun or ended; and
- the name, address and telephone number of the person designated by the issuer to respond to inquiries about the blackout period.

An issuer's failure to provide notice would not be an affirmative defense to an SEC enforcement action or a private action to recover profits for a violation of the statutory trading prohibition. Moreover, the SEC has indicated that an issuer's failure to provide notice (whether or not a director or executive subsequently violated the statutory trading prohibition) may result in an enforcement action against the issuer.

Issuers must provide notice to their directors and executive officers --

- no later than five business days after receiving the notice of the blackout from the plan administrator required by Department of Labor regulations, or
- if no such notice is received by the issuer, on a date that is at least 15 calendar days before the actual or expected beginning date of the blackout period.

In some instances, however, it may not be practicable for an issuer to provide advance notice to its directors and executive officers -- e.g., where the commencement of a blackout period is due to events that are unforeseeable or circumstances that are beyond the reasonable control of the issuer. In such a case, the SEC will excuse an issuer from the advance notice requirement -- but only if the issuer determines in writing that the circumstances preclude compliance with the notice requirement and notifies the affected directors and executive officers of the blackout as soon as reasonably practicable.

If there is a subsequent change in the actual or expected beginning or ending dates of the blackout period as provided in the notice to directors and executive officers, an issuer must provide an updated notice explaining the reasons for the change in the dates and identifying all material changes in the information contained in the prior notice. The updated notice is generally required to be provided as soon as reasonably practicable.
Remedies

Upon violation of Regulation BTR, (1) the company or a shareholder of the company can bring an action against the director to seek recovery of the director's "profit" and/or (2) the SEC can bring an enforcement action and seek civil, injunctive or even criminal penalties.

With respect to any profit recoverable (including any loss avoided) from a prohibited transaction (other than a grant, exercise, conversion or termination of a derivative security) generally in respect of any publicly-traded equity security, such profit may be measured by comparing the difference between the amount actually paid or received on the date of the transaction during the blackout period and the average market price of the equity security calculated over the first three trading days after the last day of the blackout period.

With respect to any profit recoverable (including any loss avoided) from any other transaction, such profit may be measured in a manner that is consistent with the objective of identifying the amount of any gain realized or loss avoided by a director or executive officer as a result of a transaction taking place during the blackout period as opposed to taking place outside of such period.

B. 30-Day Notice Provision

The Sarbanes-Oxley Act also amended ERISA to require plan administrators to give 30-days advance notice of blackout periods to plan participants and beneficiaries. The Secretary of Labor was required to issue interim final rules by October 13, 2002 in order to carry out this provision, and was required to issue initial guidance and a model notice no later than January 1, 2003.

On October 21, 2002, the Department of Labor's Pension and Welfare Benefits Administration issued the interim final rule and published a model notice to plan participants and beneficiaries. On January 24, 2002 the U.S. Department of Labor published final regulations which clarify Section 306(b). Section 306(b) requires that written notice be provided to affected participants and beneficiaries of individual account plans of any blackout period. For this purpose, a "blackout period" is any period of more than three business days during which the ability of participants and beneficiaries to direct or diversify assets in their accounts or to obtain loans or distributions from the plan is temporarily suspended, limited or restricted.

The DOL's final regulations provide that notice to affected participants is generally required to be provided at least 30 but not more than 60 days prior to the last day on which they can exercise their rights under the plan before the blackout period commences. The final regulations address matters relating to the form, content and timing of required notices (including the provision of a model notice) and detail a number of exceptions to the requirements (such as a suspension that occurs by reason of federal securities law or a domestic relations order or that is
regularly scheduled under an individual account plan that has been disclosed to affected participants and beneficiaries in the documents that govern the plan's operation).

The Department of Labor also established procedures relating to the assessment of civil penalties under ERISA for failures or refusals by plan administrators to provide notices of a blackout period as required under the Sarbanes-Oxley Act. Both of these sets of Department of Labor regulations took effect on January 26, 2003.

4. Forfeiture of Certain Bonuses and Profits

The Sarbanes-Oxley Act provides that, if an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the CEO and CFO of the issuer must reimburse the issuer for any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the SEC of the financial document embodying such financial reporting requirement, and any profits realized from the sale of securities of the issuer during that 12-month period. The provision on its face applies to both domestic and foreign private issuers. The SEC is permitted to exempt any person from the application of this provision.

5. Stockholder Approval

A. Equity Compensation Plans

On June 30, 2003 the SEC approved proposals by the NYSE and Nasdaq that require shareholder approval of most equity compensation plans. Many such plans previously did not require shareholder approval. In particular, broad-based equity plans no longer enjoy an exemption from shareholder approval.

The NYSE proposal was originally filed by the NYSE with the SEC on August 16, 2002. It was amended and refiled with the SEC by the NYSE on October 7, 2002, published for comment by the SEC on October 8, 2003, amended and refiled with the SEC by the NYSE on June 20, 2003 and approved by the SEC on June 30, 2003.

- The NYSE provision requires shareholder approval for all equity compensation plans and material revisions thereto.

- The term "equity compensation plan" is defined as a plan or other arrangement that provides for the delivery of equity securities (either newly issued or treasury shares) of the listed company to any employee, director or other service provider as compensation for services. Even a compensatory grant of options or other equity
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securities that is not made under a plan is, nonetheless, an "equity-compensation plan" for these purposes.

- However, the term "equity compensation plan" does not include (1) plans that are made available to shareholders generally, such as a typical dividend reinvestment plan, or (2) plans that merely allow employees, directors or other service providers to elect to buy shares on the open market or from the listed company for their current fair market value, regardless of whether (a) the shares are delivered immediately or on a deferred basis or (b) the payments for the shares are made directly or by giving up compensation that is otherwise due (for example, through payroll deductions).

- Shareholder approval is required for a "material revision." The term "material revision" includes (1) a material increase in the number of shares available under the plan (other than an increase solely to reflect a reorganization, stock split, merger, spinoff or similar transaction), (2) an expansion of the types of awards available under the plan, (3) a material expansion of the class of employees, directors or other service providers eligible to participate in the plan, (4) a material extension of the term of the plan, (5) a material change to the method of determining the strike price of options under the plan (a change in the method of determining fair market value from the closing price on the date of grant to the average of the high and low price on the date of grant is an example of a change that is not material), and (6) the deletion or limitation of any provision prohibiting repricing of options. Also, an amendment will not be considered a material revision if it curtails rather than expands the scope of the plan in question.

- Under the NYSE proposal, shareholder approval is not required for (1) employment inducement awards (a grant of options or other equity-based compensation as a material inducement to a person or

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81 If a plan contains a formula for automatic increases in the shares available or for automatic grants pursuant to a formula (a "formula plan"), each such increase or grant will be considered a revision requiring shareholder approval unless the plan has a term of not more than ten years. Examples of automatic grants pursuant to a formula are (1) annual grants to directors of restricted stock having a certain dollar value and (2) "matching contributions," whereby stock is credited to a participant's account based upon the amount of compensation the participant elects to defer. If a plan is not a formula plan and contains no limit on the number of shares available (a "discretionary plan"), then each grant under the plan will require separate shareholder approval regardless of whether the plan has a term of not more than ten years.

82 A plan that does not contain a provision that specifically permits repricing of options will be considered as prohibiting repricing. Accordingly, any actual repricing of options will be considered a material revision of the plan even if the plan itself is not revised. This consideration will not apply to a repricing through an exchange offer that commenced before June 30, 2003.
persons being hired by the listed company or any of its subsidiaries, or being rehired following a bona fide period of interruption of employment), including grants to new employees in connection with a merger or acquisition,83 (2) certain plans, grants and amendments in the context of mergers and acquisitions,84 (3) plans intended to meet the requirements of Section 401(a) of the Internal Revenue Code (such as ESOPs), (4) plans intended to meet the requirements of Section 423 of the Internal Revenue Code (stock purchase plans) and (5) "parallel excess plans" (plans that are "pension plans" under ERISA and that are designed to work in parallel with a 401(a) plan to provide benefits that exceed the limits of applicable IRS regulations). Plans not subject to shareholder approval as a result of one of these exemptions are subject to approval of the compensation committee or a majority of the independent directors. Also, companies must notify the NYSE when they use one of these exemptions.

- In general, a plan that was adopted before June 30, 2003 is not subject to shareholder approval unless and until it is materially revised. The NYSE rules also include detailed transition rules with respect to "formula plans" and "discretionary plans."

- The NYSE rules provide that broker-dealers can no longer give a proxy to vote on equity compensation plans unless the beneficial

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83 Promptly following a grant of any inducement award in reliance on this exemption, the listed company is required to disclose in a press release the material terms of the award, including the recipient and the number of shares involved.

84 Two exemptions apply in the context of corporate acquisitions and mergers. First, shareholder approval is not required to convert, replace or adjust outstanding options or other equity-compensation awards to reflect the transaction. Second, shares available under certain plans acquired in corporate acquisitions and mergers may be used for certain post-transaction grants without further shareholder approval. This exemption applies to situations where a party that is not a listed company following the transaction has shares available for grant under pre-existing plans that were previously approved by shareholders. A plan adopted in contemplation of the merger or acquisition transaction is not considered pre-existing for this exemption. Shares available under such a pre-existing plan may be used for post-transaction grants of options and other awards with respect to equity of the entity that is the listed company after the transaction, either under the pre-existing plan or another plan, without further shareholder approval, so long as (1) the number of shares available for grants is appropriately adjusted to reflect the transaction, (2) the time during which those shares are available is not extended beyond the period when they would have been available under the pre-existing plan, absent the transaction; and (3) the options and other awards are not granted to individuals who were employed, immediately before the transaction, by the post-transaction listed company or entities that were its subsidiaries immediately before the transaction. Any shares reserved for listing in connection with a transaction pursuant to these exemptions will be counted by the NYSE in determining whether the transaction involves the issuance of 20% or more of the company's outstanding common stock and thus requires shareholder approval.
owner of the shares provided voting instructions. Current NYSE rules permit a broker holding shares in its name on a client's behalf to vote those shares on routine matters in its discretion, in the absence of specific instructions from the shareholder. Therefore, in the absence of specific shareholder instructions for a shareholder proposal regarding an equity compensation plan, all broker-held shares will be "broker non-votes" on such a proposal. Item 21 of Schedule 14A requires the proxy statement to describe how broker non-votes are treated for calculation purposes with respect to each proposal.


- Nasdaq requires shareholder approval when a stock option or purchase plan is to be established or materially amended or other equity compensation arrangement made or materially amended, pursuant to which options or stock may be acquired by officers, directors, employees or consultants.

- Nasdaq's interpretative material includes a non-exclusive list of plan amendments that are considered material, including (1) any material increase in the number of shares to be issued under the plan (other than to reflect a reorganization, stock split, merger, spinoff or similar transaction); (2) any material increase in benefits to participants, including any material change to (i) permit a repricing (or decrease in exercise price) of outstanding options, (ii) reduce the price at which shares or options to purchase shares may be offered, or (iii) extend the duration of a plan; (3) any material expansion of the class of participants eligible to participate in the plan; and (4) any expansion in the types of options or awards provided under the plan.

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85 This rule is effective for any meeting of shareholders that occurs on or after September 28, 2003 (the 90th day following June 30, 2003). The NYSE also stated it intends to establish a working group to advise with respect to the need for, and design of, mechanisms to facilitate implementation of the rule that brokers may not vote on equity compensation plans without instructions from the beneficial owners.

86 Nasdaq indicated that while general authority to amend a plan would not obviate the need for shareholder approval, if a plan permits a specific action without further shareholder approval, then no such approval would generally be required. However, if a plan contains a formula for automatic increases in the shares available (sometimes called an "evergreen formula"), or for automatic grants pursuant to a dollar-based formula (such as
Nasdaq provides exceptions to the stockholder approval requirement for (1) warrants or rights issued generally to all security holders of the company, (2) stock purchase plans available on equal terms to all security holders of the company (such as a dividend reinvestment plan), (3) tax qualified, non-discriminatory employee benefit plans (e.g., plans that meet the requirements of Section 401(a) or 423 of the Internal Revenue Code) or parallel nonqualified plans,87 (4) plans that merely provide a convenient way to purchase shares on the open market or from the issuer at fair market value, (5) plans or arrangements relating to an acquisition or merger,88 or (6) inducement awards (issuances to a person not previously an employee or director of the company, or following a bonafide period of non-employment, as an inducement material to the individual's entering into employment with the company), including grants of options or stock to new employees annual grants based on a certain dollar value, or matching contributions based upon the amount of compensation the participant elects to defer), such plans cannot have a term in excess of ten years unless shareholder approval is obtained every ten years. However, plans that do not contain a formula and that do not impose a limit on the number of shares available for grant would require shareholder approval of each grant under the plan. A requirement that grants be made out of treasury shares or repurchased shares will not alleviate these additional shareholder approval requirements.

An equity compensation plan that provides non-U.S. employees with substantially the same benefits as a comparable tax qualified, non-discriminatory employee benefit plan or parallel nonqualified plan that the issuer provides to its U.S. employees, but for features necessary to comply with applicable foreign tax law, are also exempt from shareholder approval.

Plans or arrangements involving a merger or acquisition do not require shareholder approval in two situations. First, shareholder approval will not be required to convert, replace or adjust outstanding options or other equity compensation awards to reflect the transaction. Second, shares available under certain plans acquired in acquisitions and mergers may be used for certain post-transaction grants without further shareholder approval. This exception applies to situations where the party which is not a listed company following the transaction has shares available for grant under pre-existing plans that meet the requirements of the shareholder voting rule. These shares may be used for post-transaction grants of options and other equity awards by the listed company (after appropriate adjustment of the number of shares to reflect the transaction), either under the pre-existing plan or arrangement or another plan or arrangement, without further shareholder approval, provided (1) the time during which those shares are available for grants is not extended beyond the period when they would have been available under the pre-existing plan, absent the transaction, and (2) such options and other awards are not granted to individuals who were employed by the granting company or its subsidiaries at the time the merger or acquisition was consummated. Nasdaq would view a plan or arrangement adopted in contemplation of the merger or acquisition transaction as not pre-existing for purposes of this exception. Any additional shares available for issuance under a plan or arrangement acquired in connection with a merger or acquisition would be counted by Nasdaq in determining whether the transaction involved the issuance of 20% or more of the company's outstanding common stock, which would trigger a separate shareholder approval requirement.
in connection with a merger or acquisition. Inducement grants, tax qualified non-discriminatory benefit plans and parallel nonqualified plans must be approved either by the independent compensation committee or a majority of the issuer's independent directors.

- Promptly following an issuance of any employment inducement grant in reliance on the above exception, a company must disclose in a press release the material terms of the grant, including the recipients of the grant and the number of shares involved.

- Also, a company cannot use repurchased shares to fund option plans or grants without prior shareholder approval.

**B. Discounted Private Placements**

On March 14, 2003, Nasdaq submitted a proposed amendment to Nasdaq's shareholder approval requirements when officers and directors participate in a discounted private placement. As proposed, shareholder approval would be required for private placements by the company of common stock (or securities convertible into or exercisable for common stock) to officers and directors of the company for less than the market value of the stock. However, shareholder approval would not be required if the total number of shares issued to officers and directors is less than 5% of the total shares issued in the transaction and less than 1% of the total shares outstanding before the issuance.

**C. Change of Control**

On March 28, 2003, Nasdaq submitted a proposed amendment to its shareholder approval requirements with respect to changes of control. Nasdaq currently requires shareholder approval when an issuance or potential issuance of securities will result in a change of control. In addition, issuers are required to notify Nasdaq no later than 15 calendar days prior to issuing securities that may potentially result in a change of control.

However, Nasdaq's rules do not currently define "change of control." Under the existing rules, Nasdaq presumes that a change of control does not occur in a transaction involving an issuance in which an investor holds less than 20% of the common stock after the transaction. In contrast, if an investor holds more than 30% of the common stock or voting power after the transaction, Nasdaq presumes that a change of control has occurred. If the investor holds between 20 and 30%, Nasdaq will consider other factors, such as whether the investor has a right to representation on the board or to participate in management, the intent of the investor, and whether the investor is entitled to board representation. Since the determination is based on the facts and circumstances, Nasdaq receives numerous interpretative requests regarding this issue.
As proposed, the term "change of control" for purposes of the shareholder vote provision "means that an investor or a group of investors acquires, or obtains the right to acquire, 20% or more of the common stock (or securities convertible into or exercisable for common stock) or the voting power of an issuer on a post-transaction basis, unless, following the transaction, either (A) another shareholder or group of shareholders unaffiliated with the investor or group of investors has a greater interest, or (B) the issuer's management and directors as a group (other than any individuals that are affiliated with the investor or group of investors) have a larger interest than the investor or group of investors."

6. The Conference Board Report on Executive Compensation

On September 17, 2002 the Conference Board's Commission on Public Trust and Private Enterprise issued a report on executive compensation practices and reforms. The Commission's report included a specific set of recommendations regarding executive compensation practices:

- Compensation committees must take primary responsibility for a company's compensation programs, must be independent of management and should hire their own consultants. The chair of the committee should "take ownership" of the committee's activities and be available at shareholder's meetings to answer questions.

- Companies should increasingly use performance-based compensation by tying compensation to long-term goals such as cost of capital, return on equity, market share, quality goals, compliance goals, environmental goals, revenue and profit growth, cost containment or cash management.

- Compensation should have a long-term focus--key executives and directors should be encouraged to obtain and hold a significant amount of stock on a long-term basis. Substantial minimum holding periods for equity received as compensation should be specified.

- Fixed price stock options should be "expensed" on financial statements of public companies. (Andrew Grove dissented from this recommendation, and Paul Volcker dissented by opposing the use of fixed price stock options altogether.)

- Shareholders should have the right to vote on equity compensation plans and amendments to such plans, including repricings.

- Companies should require senior executives to provide advance notice of their intention directly or indirectly to dispose of stock.
A company's public filings should include a conspicuous statement highlighting both earnings per share after dilution and the proportion of future shareholder value that equity-based compensation plans would provide to executives and employees.

Companies should disclose publicly employment agreements with executive officers promptly following their execution, together with a plain English summary of the agreement.

7. New York Proposed Legislation

In early 2003 New York's Attorney General Eliot Spitzer proposed a bill amending New York’s Not-For-Profit Corporation Law to protect the public against financial fraud and misconduct by not-for-profit corporations incorporated in or conducting activities in New York. Among other things, the legislation proposed to amend New York's not-for-profit law as it applied to interested party transactions, compensation of directors and officers and indemnification of directors and officers.

A. Interested Party Transactions

Interested party transactions would be expanded to include contracts and transactions directly or indirectly entered into between a not-for-profit corporation and its directors or officers (or the directors and officers of its affiliates), or between a not-for-profit corporation and any other corporation, firm, association or other entity in which one or more of its directors or officers (or the directors and officers of its affiliates) are directors or officers or have a substantial financial interest (the proposed legislation would add the italicized words to the current law).

An interested party transaction could be voided or modified by the corporation or the New York Attorney General, unless the interested director or officer and any approving director established that the contract or transaction was “fair and reasonable” as to the corporation at the time of the transaction.

An interested party transactions would be presumed to be "fair and reasonable" if (1) the transaction is approved in advance by the board or committee entitled to vote with disclosure of the material facts of the transaction; (2) the board or committee relied upon appropriate comparability data; and (3) the board or the committee adequately documented the basis for the approval of the transaction at the time of approval.

There would be an exception in the case where an interested director or officer lacks actual knowledge and the transaction does not exceed the lesser of 1% of the corporation's gross receipts in the prior year or $100,000.
B. Compensation

Compensation of directors and officers for services in any capacity (other than or serving on the board or any committee), including for service as a director or officer of another corporation or other entity on behalf of the corporation, would be fixed by the affirmative vote of a majority of the board (or a committee of independent directors or members, as applicable), unless the certificate of incorporation or bylaws provide for a higher proportion. The compensation must be an amount that is “fair and reasonable” as determined under Section 4958 of the Internal Revenue Code (which taxes excess benefit transactions between a tax-exempt organization and a disqualified individual where the economic benefit exceeds the consideration or performance of services received by the organization).

Compensation of directors for serving on the board or any committee must be fixed by the affirmative vote of a majority of the entire board, unless the certificate of incorporation or bylaws provides for a higher proportion, and the compensation must be an amount that is “fair and reasonable” as determined under Section 4958 of the Internal Revenue Code.

Compensation approved in accordance with the above requirements would be presumed to be “fair and reasonable” to the not-for-profit corporation if (1) the compensation is approved in advance by the board or committee entitled to vote with disclosure of the material facts of the compensation (and any compensation paid by an affiliate of the corporation for services related or substantially similar to the services performed on behalf of the corporation); (2) the board or committee relied upon appropriate comparability data; and (3) the board or the committee adequately documented the basis for the approval of the compensation at the time of approval.

An affiliate is any entity that is (1) a disqualified individual pursuant to Section 4958 of the Internal Revenue Code or (2) controlled by, in control of, or under common control with the not-for-profit corporation.

C. Remedies

If the foregoing interested party transaction and compensation approval requirements have not been met, the corporation or the Attorney General would be permitted to void or modify the transaction or compensation, unless doing so would put the corporation in a worse position. The corporation or the New York Attorney General would also be permitted to seek restitution from the interested directors or officers or approving directors in amounts equivalent to certain excise tax remedies available under Section 4958 of the Internal Revenue Code of 1986, as amended, with respect to charitable organizations, including the amount of any compensation in excess of an amount that is "fair and reasonable."
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D. Indemnification

The New York Attorney General would be entitled to receive notice of any application to a court for indemnification of directors or officers of a Type B or Type C corporation. Directors and officers would be required to provide the corporation with an undertaking that they will repay any advances for indemnification if eventually found to not be entitled to indemnification.

A Type B or Type C corporation would not be permitted to indemnify its directors or officers, under other rights pursuant to Section 721 of the NYPCL, unless the corporation filed a notice with the Attorney General in the form prescribed for a period of at least 30 days without notification of any objection from the Attorney General (though the Attorney General reserves the right to object after the 30-day notice period).

Part VII: Other

1. Analyst Conflicts of Interest

A. The Sarbanes-Oxley Act

The Sarbanes-Oxley Act requires the SEC, or at the SEC's direction a national securities exchange, to adopt rules by July 30, 2003 reasonably designed to address conflicts of interest regarding research analysts research reports and public appearances. As described below, on July 29, 2003 the SEC approved NYSE and NASD rules which were designed to satisfy the requirements outlined by the Sarbanes-Oxley Act.

B. Regulation AC

The SEC proposed on August 2, 2002 and adopted on February 6, 2003 new Regulation Analyst Certification, or Regulation AC. Regulation AC will require research analysts to certify the truthfulness of the views they express in research reports and public appearances, and to disclose whether they have received any compensation related to the specific recommendations or views expressed in those reports and appearances.

Under Regulation AC, research reports distributed by brokers, dealers, and certain covered persons will be required to include (1) a statement by the research analyst certifying that the views expressed in the research report accurately reflect such research analyst's personal views about the subject securities or issuers; and (2) a statement by the research analyst certifying whether the analyst's

89 A Type B corporation is in general a not-for-profit corporation formed for any one or more of the following non-business purposes: charitable, educational, religious, scientific, literary, cultural, or for the prevention of cruelty to children or animals. A Type C corporation is in general a not-for-profit corporation formed for any lawful business purpose to achieve a lawful public or quasi-public objective.
compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report. If the analyst received related compensation, the statement will include the source, amount, and purpose of such compensation, and further disclose that such compensation may influence the recommendation in the research report.

Under Regulation AC, broker-dealers will be required to make a record related to public appearances by research analysts. Specifically, a broker or dealer who publishes, circulates, or provides a research report by a research analyst will be required to make a record within 30 days after each calendar quarter in which the research analyst made the public appearance, that will include (1) a written statement by the research analyst certifying that the views expressed in each public appearance accurately reflected such research analyst's personal views about the subject securities or issuers and (2) a written statement by the research analyst certifying that no part of such research analyst's compensation was, is, or will be directly or indirectly related to any specific recommendations or views expressed in any public appearance.

In cases where the broker or dealer does not obtain a statement by the research analyst in connection with public appearances as described above, the broker or dealer will be required to disclose in all research reports prepared by that analyst for the next 120 days that the research analyst did not provide the certifications.

Regulation AC became effective on April 14, 2003.

C. Global Analyst Research Settlement

On April 28, 2003, the SEC, NYSE, NASD, New York Attorney General and other regulators announced that ten of the nation's top investment banks had settled enforcement actions involving conflicts of interest between research and investment banking. The proposed final judgments in the SEC actions are subject to court approval.

As part of the settlement, the firms agreed to separate research and investment banking, including physical separation, completely separate reporting lines, separate legal and compliance staffs and separate budgeting processes. In addition:

- Analysts' compensation cannot be based directly or indirectly on investment banking revenues or input from investment banking personnel.
- Investment bankers cannot evaluate analysts.
- An analysts compensation will be based in significant part on the quality and accuracy of the analyst's research.
Decisions concerning compensation of analysts will be documented.

Investment bankers will have no role in determining what companies are covered by the analysts.

Research analysts will be prohibited from participating in efforts to solicit investment banking business, including pitches and roadshows.

Firms will implement policies and procedures reasonably designed to assure that their personnel do not seek to influence the contents of research reports for purposes of obtaining or retaining investment banking business.

Firms will create and enforce firewalls between research and investment banking reasonably designed to prohibit improper communications between the two.

Each firm will retain, at its own expense, an independent monitor to conduct a review to provide reasonable assurance that the firm is complying with these structural reforms. The review will be conducted 18 months after the date of the entry of the final judgment, and the monitor will submit a report of his or her findings to the SEC, NASD and NYSE within six months after the review begins.

In addition, each firm will include a disclosure on the first page of each research report stating that it "does and seeks to do business with companies covered in research reports. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report." Also, when a firm decides to terminate coverage of an issuer, it will issue a final research report discussing the reasons for the termination. In addition, each quarter, each firm will publish on its website a chart showing its analysts' performance, including each analysts' name, ratings, price targets, and earnings per share forecast for each covered company, as well as an explanation of the firm's rating system.

For a five year period, each of the firms will be required to contract with no fewer than three independent research firms and will make available the independent research to the firm's customers. Firms will notify customers of the availability of the independent research on customer account statements, on the first page of research reports, and on the firm's website. An independent consultant for each firm will have final authority to procure independent research, and will report annually to regulators concerning the research procured. Payments for independent research will total $432.5 million.

Seven of the firms will make payments totaling $80 million for investor education. The SEC, NYSE and NASD authorized that $52.5 million of these payments
funds will be put into an investor education fund to support programs designed to equip investors with the knowledge and skills necessary to make informed investment decisions. The remaining $27.5 million will be paid to state securities regulators and will be used by them for investor education purposes.

The firms have also collectively entered into a voluntary agreement restricting allocations of securities in hot IPO's to certain company executive officers and directors ("spinning").

As part of the settlement, the firms agreed to pay disgorgement and civil penalties totaling $875 million, including one firm's previous payment of $100 million in connection with that firm's prior settlement with the states. The firms may not seek to treat the civil penalties as tax deductible or eligible for reimbursement under their insurance policies. Half the funds will be paid to the states. The other half will be paid in resolution of actions brought by the SEC, NYSE and NASD and will be put into funds to benefit customers of the firms. This half will be administered by an SEC-recommended, court appointed administrator, who will formulate a plan to distribute the funds in an equitable manner to customers who purchased certain equity securities.

D. NYSE/NASD Rules

The SEC published for comment on December 31, 2002, republished on May 22, 2003 and approved on July 29, 2003, rule changes by the New York Stock Exchange and NASD relating to research analysts conflicts of interest. These rule changes build on other rule changes approved by the SEC on May 10, 2002 which enhanced the regulation of research analysts and research reports. The principal new NYSE rules include the following (the NASD rules are substantially similar):

- **Prohibition on Solicitation of Investment Banking Business.** Under the rule changes, research analysts are now prohibited from participating in efforts to solicit investment banking business. This prohibition includes, but is not limited to, participating in “pitch” meetings to solicit the investment banking business of prospective investment banking clients, or having other communications with companies for the purpose of soliciting investment banking business. The prohibition does not apply to any communication between the research analyst, company, and/or non-research personnel, the sole purpose of which is due diligence. The NYSE and NASD noted that this new prohibition is intended to support the existing prohibition under the Analyst Conflict Rules on promising favorable research as a marketing tool to prospective investment banking clients and is designed to encourage issuers to choose an investment bank based on the merits of the firm’s underwriting capabilities.

- **No Analyst Public Appearances During Quiet Periods.** The existing prohibition under the Analyst Conflict Rules on issuing research for 40
days after an IPO and 10 days after a secondary offering, in either case where the broker-dealer was a manager or co-manager of the offering, is extended to a research analyst recommending or offering an opinion on an issuer's securities in a public appearance.

- **Expansion of Quiet Period to All Underwriters and Dealers Participating in an IPO.** The prohibition under the Analyst Conflict Rules on managers and co-managers from publishing or otherwise distributing research (and the prohibition on a research analyst from recommending an issuer’s securities in a public appearance) after an IPO is extended to any other broker-dealer who has agreed to participate or who is participating as an underwriter or dealer in an IPO. However, whereas managers and co-managers have a 40 day quiet period under the Analyst Conflict Rules for IPOs, such other broker-dealers would have a quiet period of only 25 days following the IPO offering date. The term “offering date” is also now specifically defined to refer to the later of the effective date of the registration statement or the first date on which the security was bona fide offered to the public.

- **Prohibition on "Booster Shots" Before or After Lockup Expirations.** The rule changes prohibit a broker-dealer which has been a manager or co-manager of a securities offering from issuing a research report, and prohibit a research analyst from recommending or offering an opinion on an issuer’s securities in a public appearance, in each case within 15 days prior to or after the expiration, waiver or termination of a lock-up agreement (i.e., an agreement by shareholders with the underwriters not to sell shares for a specified period after an offering). This prohibition is intended to prevent the issuance of positive research just when the lockup is expected to expire in order to help large shareholders who were locked up sell their shares at a higher price.

Some commenters argued that this provision would raise difficult compliance issues for investment banks because co-managers often have no knowledge of a lead manager's waiver of a lock-up agreement. However, the NYSE and NASD indicated that this issue could be addressed by adding a provision in the underwriting agreement which would require a lead or co-managing underwriter to notify the other managers or co-managers of its intention to get such a waiver a specified number of days prior to doing so.

Under the rule changes, a broker-dealer may make exceptions for the publication or distribution of research reports (or recommendations or opinions in a public appearance) as a result of significant news or events, if the report is pre-approved in writing by legal or compliance personnel. The prohibition also does not apply to public appearances or research reports published under Rule 139 regarding issuers whose securities are “actively traded” for Regulation M purposes.
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- **Public Notice of Termination of Research Coverage.** The rule changes now require a broker-dealer to notify the public if it intends to terminate coverage of a company. In such a case, the broker-dealer must make available a final research report on the company using the means of dissemination equivalent to those it ordinarily uses to provide the customer with its research reports on the company. The report must be comparable in scope and detail to prior research reports and must include a final recommendation or rating, unless it is impracticable for the broker-dealer to produce a comparable report (e.g., if the analyst has left the broker-dealer or where the broker-dealer terminates coverage on the industry or sector). If it is impracticable to provide a final recommendation or rating, the broker-dealer must provide the rationale for the decision to terminate coverage. The NASD stated that it intends to provide general guidance as to what constitutes a “termination” of coverage for this purpose and that it will consider such scenarios on a case-by-case basis.

- **Analyst Compensation to be Approved by a Committee Without Representatives of Investment Banking.** The Analyst Conflict Rules already provide that a broker-dealer cannot compensate a research analyst for specific investment banking transactions or provide a research analyst with an incentive or bonus based on specific investment banking services. The rule changes go a step further and provide that the compensation of a research analyst primarily responsible for the preparation of the substance of a research report must be reviewed and approved at least annually by a committee that reports to the board of directors or, if there is no board, a senior executive. The committee may not include representatives from the investment banking department. The committee must consider, among other things, the analyst's individual performance (including productivity and the quality of his or her research), the correlation between the analyst's recommendations and stock price performance, and the overall ratings received from clients, sales force and peers independent of investment banking and other independent rating services. The research analyst’s contribution to investment banking may not be considered. The rule changes do not prohibit, however, the consideration of the financial results of the firm as a whole.

  The committee must also document the basis upon which each analyst's compensation was established. The broker-dealer's annual attestation must certify that the committee reviewed, approved and documented the basis for establishing the compensation for each research analyst as described above. These requirements are intended to further separate analyst compensation from investment banking influence.

- **Prohibition on Prepublication Review of Research by Non-Research Personnel.** Under the rule changes, research reports may not be subject to
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review or approval prior to publication by investment banking personnel or any other non-research personnel, other than legal or compliance department personnel. Prior to this change, prepublication review was only prohibited with respect to investment banking personnel.

- **Prohibition on Retaliation Against Research Analysts.** The rule changes provide that no broker-dealer, and no employee of a broker-dealer who is involved in investment banking activities, may, directly or indirectly, retaliate against or threaten to retaliate against any research analyst employed by the broker-dealer or its affiliates as a result of an adverse, negative or otherwise unfavorable research report written or public appearance made by the research analyst that may adversely affect the broker-dealer's present or potential investment banking relationship with the relevant company. This prohibition does not limit a broker-dealer's authority to discipline or terminate a research analyst, in accordance with its policies and procedures, for any cause other than the writing of such an unfavorable research report or the making of such public appearance.

- **Significant Increases in the Disclosures Required in Research Reports.** The rule changes increase the disclosures required in research reports. The Rules currently require, among other things, disclosure if a broker-dealer or its affiliates received investment banking compensation from a subject company in the past 12 months. Under the rule changes, a broker dealer must now also disclose the following in research reports (subject to exceptions):

  (1) If, as of the last day of the month immediately preceding the date of publication of a research report (or the end of the second most recent month if the publication date is less than 30 calendar days after the end of the most recent month), the subject company currently is a client of the broker-dealer or was a client of the broker-dealer during the 12 months prior to distributing the research report, and the type of services provided to the subject company, which may be described as investment banking services, noninvestment banking-securities related services, or non-securities services. The NYSE and NASD clarified that a subject company is a client of a broker-dealer if the broker-dealer received compensation from the subject company, or if the broker-dealer entered into an agreement with the subject company for it to provide services to the subject company.

  - The broker-dealer must also disclose in research reports if, to the extent the research analyst or an employee of the broker-dealer with the ability to influence the substance of the research report knows, the subject company currently is a client of the broker-dealer or was a client of the broker-dealer during the 12 months
prior to distributing the research report, and the types of services
provided to the subject company.

(2) If, as of the last day of the month immediately preceding the date of
publication of a research report (or the end of the second most recent
month if the publication date is less than 30 calendar days after the end
of the most recent month), the broker-dealer received any
compensation for products or services other than for investment
banking from the company in the past 12 months. The SEC indicated
that there is overlap between this disclosure regarding compensation
and the client disclosure described above, and that the NYSE and
NASD have declined to link or merge these two restrictions in drafting
their respective rules.

● The broker-dealer must also disclose in research reports if, to the
extent the research analyst or an employee of the broker-dealer
with the ability to influence the substance of the research report
knows, the broker-dealer received compensation for products or
services other than investment banking from the subject company
in the past 12 months.

(3) If, to the extent the research analyst or broker-dealer has “reason to
know,” an affiliate of the broker-dealer received any compensation for
products or services other than investment banking from the company
in the past 12 months. This requirement is deemed satisfied if
disclosure is made within 30 days after completion of the most recent
calendar quarter, provided that the broker dealer takes steps reasonably
designed to identify such compensation during the calendar quarter.
There is also a presumption that there is no “reason to know” if the
broker-dealer maintains and enforces policies and procedures
reasonably designed to prevent research analysts from receiving
information from the affiliate about such compensation. However, if
there is actual knowledge of such compensation, then there is no
longer such a presumption and disclosure is necessary. Thus, there are
two mechanisms in which compliance with this disclosure obligation
can be satisfied: either disclosure within 30 days of the end of the
quarter or reliance on the presumption as set out above.

(4) If the research analyst received any compensation from the company
in the past 12 months.

(5) The nature of any financial interest, including whether it consists of
any option, right, warrant, futures contract, long or short position, of a
research analyst or household member of the research analyst in a
subject company.
The disclosure in (1) above is not required if it would reveal material non-public information about specific potential future investment banking services for the company.

- **Increase in the Disclosures Required in Public Appearances.** The rule changes increase the disclosures required to be made by research analysts in public appearances. Under the rule changes, a research analyst must disclose in public appearances: (1) if, to the extent the research analyst knows or has reason to know, the subject company currently is a client of the broker-dealer or was a client of the broker-dealer during the 12 months prior to the date of the public appearance, and the types of services provided to the company, which may be described as investment banking services, non-investment banking-securities related services and non-securities services (previously disclosure was only required if the company was an investment banking client of the broker-dealer), (2) if, to the extent the research analyst knows or has reason to know, its broker-dealer or any of the broker-dealer’s affiliates received any compensation from the broker-dealer in the past 12 months, (3) if the research analyst received any compensation from the company in the past 12 months and (4) the nature of any financial interest, including whether it consists of any option, right, warrant, futures contract, long or short position, of the research analyst or household member of the research analyst in the subject company. The disclosures in (1) and (2) above are not required if they would reveal material non-public information about specific potential future investment banking services for the company.

- **Qualification Exam and Continuing Education for Research Analysts.** The rule changes require research analysts to be registered with, qualified by and approved by the NYSE and NASD. These requirements apply only to research analysts who are primarily responsible for the preparation of the substance of a research report or whose name appears on the research report. In addition, research analysts must participate in a continuing education program that includes training in applicable rules and regulations, ethics and professional responsibility.

- **Definition of "Public Appearance" Expanded to Include Print Media.** The rule changes amend the term "public appearance" to include print media appearances, such as print media interviews or the writing of a print media article. This requires research analysts to make the same disclosures with respect to print media that they are required to make in other public appearances.

The NYSE adopted a new interpretation with respect to the new definition of "public appearance." Under the NYSE interpretation, when a research analyst makes a recommendation in a print or broadcast media interview, newspaper article or other type of public medium, all required disclosures must be provided to the media outlet for inclusion in the published
interview, article, broadcast or other medium. In addition, a record of such interview, article or broadcast must be made within 48 hours. Such record must include, at minimum, the name of the analyst, the name of the publication, the date of the interview or article, the name of the interviewer, the name of the securities recommended and the specific disclosures provided. Such record must be made regardless of whether the media outlet published or broadcasted the required disclosures.

- **Small Firm Exception.** The existing rules had included a temporary exception for small broker-dealers from the rules which restricted the ability of investment banking personnel to supervise research analysts. This temporary exception applied to broker-dealers that over the prior three years, on average per year, participated in 10 or fewer investment banking services transactions (both debt and equity underwritings, but not municipal securities underwritings) as manager or co-manager and generated $5 million or less in gross investment banking revenues from those transactions. The rule changes make this exception permanent. A broker-dealers that qualifies for this exemption must maintain records for three years of any communications that, but for this exception, would have been subject to the review and monitoring elements of such restrictions.

- **Effective Dates.** The NYSE’s effective dates for the above changes to the Analyst Conflict Rules are as follows (the NASD’s effective dates are substantially similar):
  
  o All rule provisions except as noted below—60 days after SEC approval (e.g., the rules became effective on September 27, 2003)
  
  o Anti-retaliation and small firm exemption provisions—immediately.
  
  o Compensation committee review—90 days after SEC approval (e.g., this rule becomes effective on October 27, 2003).
  
  o Compensation disclosure provisions—180 days after the date of SEC approval (January 25, 2004), extendible for 90 days upon written request to the NYSE.
  
  o Exception to compensation disclosure provisions for disclosure of material information about a specific future transaction—180 days (but immediately for disclosure in research reports if the broker-dealer or its affiliates received investment banking services compensation in the past 12 months or expect to seek investment banking compensation from the company in the next 3 months).
  
  o Continuing education requirement for research analysts—180 days after SEC approval (firm element).
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- Qualification, examination and registration requirement for research analysts—365 days after completion of qualification examination (180 days after approval to develop and implement examination).

2. IPO Process

A. NASD IPO Allocation Process Rulemaking

In August 2002 the NASD proposed a new conduct rule, and an amendment to a current conduct rule, which would substantively regulate the process whereby broker-dealers allocate shares in an IPO. The NASD's proposed rules would regulate IPO's in the following ways:

- The rule would prohibit NASD members from offering or threatening to withhold IPO shares as consideration or inducement for the receipt of compensation which is excessive relative to the services provided by the member to the recipient of the shares.

- The rule would bar tie-in arrangements whereby a broker-dealer conditions receipt of IPO shares on the recipient's agreement to purchase additional shares in the aftermarket.

- The rule would prohibit an NASD member from "spinning" or allocating IPO shares to an executive officer or director of a company, either on condition that the person direct the company's future investment banking business to the member, or as consideration for investment banking services previously directed by the company to the member.

- The rule would prohibit an NASD member from directly or indirectly recouping or attempting to recoup any portion of a commission or credit paid to an associated person of a member as a penalty for selling IPO shares to a customer that flips the shares, unless the managing underwriter also assesses a penalty bid on the syndicate member with which the individual is associated.

The NASD has also proposed requiring the managing underwriter of any public offering subject to NASD review to file a statement with the NASD regarding whether any executive officer or director of the issuer which has conducted the public offering has purchased IPO shares of any issuer from the managing underwriter during either the 180 day period immediately preceding the filing date of the company's public offering or during the 180 day period immediately following the effective date of the public offering.
The NASD's comment period on the proposed rules expired on September 9, 2002. The rules have not yet been forwarded to the SEC for approval.

B. NYSE/NASD IPO Advisory Committee Report

In May 2003 a committee convened by the New York Stock Exchange and the National Association of Securities Dealers at the request of the SEC prepared a report and recommendations on the IPO underwriting process, particularly price setting and allocation practices. The committee's report included the following recommendations:

- **IPO Pricing Committee.** Require each issuer to establish an IPO pricing committee of its board of directors--including at least one director who is independent of management--to oversee the pricing process.

- **Show All Indications of Interest to Pricing Committee.** Require underwriters to provide to the issuer's pricing committee all indications of interest before the issuer determines the IPO price.

- **Laddering.** Redress and prevent prohibited IPO laddering (e.g., inducing investors to give orders to purchase shares in the aftermarket at particular prices in exchange for receiving IPO allocations).

- **Unpriced Orders on First Day After IPO.** Prohibit, for the first trading day following the IPO, the placing of unpriced orders to purchase an issuer's shares (e.g., orders to purchase "at any price"). These orders may result in purchases by individual investors at prices that reflect neither their true investment decisions nor their reasonable expectations.

- **Penalty Bids.** Prohibit the inequitable imposition of "flipping penalties." Managing underwriters sometimes impose penalty bids on syndicate members. This allows the manager to reclaim a selling concession from a syndicate member if the member's customers sell the IPO shares originally allocated to them shortly after the IPO ("flipping"). Penalty bids are intended to promote a stable aftermarket. However, there have been instances where the manager did not impose a penalty bid but syndicate members have imposed penalties on individual brokers in connection with flipping by small retail customers, while not penalizing flipping by others. The report recommends that the SEC and SRO's require that in the absence of a penalty bid, a syndicate member may not impose penalties on a retail broker or investor.
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- **Returned Shares.** Establish clear parameters for underwriters' sales of returned shares after secondary market trading has commenced. IPO shares are sometimes returned to the underwriter due to factors such as mistaken allocations, incomplete information or other problems. If the IPO shares are trading at a premium, this could give the underwriter an opportunity to allocate returned shares to favored customers. The report recommends that SRO's require that IPO shares that are returned to the underwriter for any reason (1) should first be allotted to reducing any existing syndicate short position and (2) should then be sold on the open market with any profits returning to the issuer.

- **Increases in Price or Number of Shares at Pricing.** Raise the SEC's threshold requirement for amendment to the prospectus from 20% to 40% in cases of increases to the offering price or number of shares offered. Because issuers must amend the registration statement if the price or number of shares increases at pricing by more than 20%, this discourages any such increases in amounts above 20%. Instead, the SEC should allow increases of up to 40%, and any amended or supplemental filing should be immediately effective without the need for SEC staff review.

- **Alternatives to Bookbuilding.** Eliminate regulatory impediments to the development of alternatives to bookbuilding, such as Dutch auctions. In a Dutch auction, pricing and allocation are not determined by the issuer and underwriter. Instead, investors express their interest level and price threshold, and the offering price is set at the highest level at which all of the shares to be offered can be sold.

- **Spinning.** Prohibit the allocation of IPO shares (1) to executive officers and directors (and their immediate families) of companies that have an investment banking relationship with the underwriter, or (2) as a quid pro quo for investment banking business.

- **Receipt of IPO Shares by Directors and Officers.** Provide that a listed company's code of business conduct and ethics should include a policy regarding receipt of IPO shares by the company's directors and executive officers.

- **Quid Pro Quo Allocations.** Strengthen the existing prohibitions on unlawful quid pro quo allocations. SEC rules already prohibit an underwriter's allocation of IPO shares based on the recipient's agreement to kick back to the underwriter, either through excess commissions or otherwise, a portion of the flipping profits.
Friends and Family Programs. Impose substantive limits on issuers' "friends and family" programs. The program should be capped at 5% of the offering, and lockup letters signed by directors and officers should include shares purchased in this program.

Electronic Roadshow. Require issuers to make a version of their IPO roadshow available electronically to unrestricted audiences. The report states that the reliance on oral roadshow presentations, coupled with selective attendance at roadshows (mostly big institutions), creates a disparity of information that may disadvantage retail investors. The report states that there is a strong perception that critical information is communicated to institutional investors at roadshows but is not included in the prospectus for the benefit of other investors.

Final IPO Allocation. Require that the underwriter disclose the final IPO allocations to the issuer.

Describe Lockups in the Prospectus. Require that the prospectus include a clear description of lock-up agreements and of whether the underwriter expects to grant exceptions relating to hedging or other transactions.

Derivatives. Reiterate existing requirements that all collars and other custom derivatives relating to initial insider holdings be promptly filed electronically with the SEC on Form 4.

Require 8-K Disclosure of Waivers to Lockups. Require that underwriters notify issuers prior to granting any exemption to a lock-up, require issuers to file a Form 8-K at least one business day prior to the time the insider commence the transaction, and require that prior to the transaction the lead underwriter announce the exemption by broad communication to the investment community through a major news service.

Require Disclosure of Directed Share Programs. Require more complete prospectus disclosure about the nature and size of the issuer's "friends and family" program.

Promote High Standards of Conduct. Impose additional requirements to promote the highest standards of conduct for underwriters, including (1) enhanced periodic internal review by the underwriter of its IPO supervisory procedures, and (2) a heightened focus on the IPO process in SRO examinations for investment banking personnel.
3. **Voting of Proxies by Mutual Funds and Investment Advisers**

The SEC proposed on September 20, 2002 and adopted on January 31, 2003 new rules relating to the voting of proxies by mutual funds and investment advisers. The rules require mutual funds to publicly disclose their proxy voting records on an annual basis on new Form N-PX. This form must be filed with the SEC no later than August 31st of each year and will cover the most recent twelve month period which ends on June 30th of the related year. The SEC adopted these requirements notwithstanding the objections of many commenters, including fund industry participants, who strongly opposed any requirement for a fund to provide disclosure of its actual proxy votes cast. The SEC did not accept their arguments but asked the SEC staff to monitor the effects of the disclosure and report back to the SEC on the operation of the rules, and whether there were any unintended consequences, no later than December 31, 2005.

The new rules also require registered investment advisers who possess voting authority with respect to client securities to disclose to clients how they can obtain information about the adviser's voting record with respect to the client’s securities. The rules also require both mutual funds and investment advisers to disclose the policies and procedures they utilize with respect to voting portfolio securities. The SEC did not specify the policies and procedures which it expected to be adopted, other than policies regarding potential conflicts of interest. The SEC also imposed a new record keeping requirement on investment advisers in connection with the proxy voting procedure.

The new mutual fund rules became effective on April 14, 2003. In addition, the SEC has adopted the following compliance dates:

- Registered management investment companies must file their first report on Form N-PX by August 31, 2004, for the twelve-month period ending June 30, 2004.

- Initial registration statements on Forms N-1A, N-2 and N-3, all post-effective amendments that are annual updates, and every annual report on Form N-CSR, in each case filed on or after July 1, 2003, must include the new disclosure regarding the fund's proxy voting policies and procedures.

- Initial registration statements on Forms N-1A, N-2 and N-3, and all post-effective amendments that are annual updates, in each case filed on or after August 31, 2004, and every shareholder report transmitted to shareholders on or after August 31, 2004, must include disclosure about the availability of the fund's proxy voting record.
The new adviser rules became effective on March 10, 2003 and compliance was required by August 6, 2003. By this date, advisers must have (1) adopted and implemented the proxy voting policies and procedures, (2) provided clients with a description of the policies, and (3) provided clients with disclosure of how clients can obtain information from the adviser on how it voted their securities. Advisers can choose any means to make this disclosure, as long as it is not buried in a longer document. An adviser could send the disclosure with a periodic account statement, deliver it in a separate mailing, or include it in its brochure or Part II of Form ADV.

4. Compliance Programs for Mutual Funds and Investment Advisers

On February 5, 2003, the SEC proposed new rules relating to internal compliance policies and procedures for registered investment companies (together with business development companies, "funds") and registered investment advisers ("advisers"). Under these rules, which echo the Sarbanes-Oxley Act emphasis on internal controls and senior officer certification, funds and advisers would be required to:

- adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws;
- review these policies and procedures annually for their adequacy and the effectiveness of their implementation;
- appoint a chief compliance officer to be responsible for administering the policies and procedures and, in the case of funds, providing an annual report to the board discussing material changes in the policies and procedures and material compliance issues; and
- maintain records related to those policies and procedures.

The SEC also solicited comment on other possible roles for the private sector in overseeing compliance by funds and advisers, including

- periodic compliance reviews of funds and advisers by a third party (such as a compliance consultant) that would produce a report of its findings which would be available to the SEC staff,
- requiring the fund's auditor to examine the fund compliance controls and/or identify material weaknesses in the internal controls,
- the formation of one or more self-regulatory organizations (SRO's) that would regulate funds and advisers by establishing business practice rules and ethical standards, conducting routine examinations, requiring minimum education or experience standards, and bringing actions to discipline members for violating its rules and the federal securities laws, and
- a requirement that advisers obtain fidelity bonds from insurance companies in order to compensate investors who are victims of fraud or embezzlement by their adviser, which would result in greater
oversight of advisers by the insurance companies that issue the bonds.

The comment period for the proposed rules expired on April 18, 2003.

5. **Rule 10b-18 Modifications**

On December 10, 2002, the SEC proposed amendments to Rule 10b-18, the non-exclusive safe harbor from liability for market manipulation which companies often use in conducting common stock repurchase programs.

- Currently, in order to qualify for the Rule 10b-18 safe harbor, the maximum amount of common stock that can be purchased in a given day is limited to 25% of the security’s average daily trading volume (ADTV), not including block purchases. This would be amended to the greater of 25% of the ADTV or 500 shares. Importantly, block purchases would count towards an issuer’s daily 25% volume limitation but similarly would be included in the ADTV calculation.

- Companies would be permitted to purchase up to 100% (rather than just 25%) of the ADTV in the trading session after a market-wide trading suspension.

- Currently, in order to qualify for the Rule 10b-18 safe harbor, a company cannot repurchase its common stock during the last half hour of trading. As proposed, companies with an ADTV of $1 million or more and a public float of $150 million or more would not be allowed to bid for or purchase their securities in the 10 minutes before the scheduled close of the principal market for the security, in the 10 minutes before the scheduled close of the market where the purchase is made, or after the termination of the period in which last sale prices are reported on the consolidated system.

- Currently the highest price a company may bid or pay for its common stock varies depending on whether the security is a reported, exchange-traded, Nasdaq or other security. As proposed, the same price condition would be used regardless of where the common stock is traded, and the maximum price could not exceed the highest independent bid or the last independent transaction price, whichever is higher, regardless of where the securities are traded.

Comments on the SEC’s proposal were due by February 18, 2003.
6. Impact on Foreign Private Issuers

A. The Sarbanes-Oxley Act

The Sarbanes-Oxley Act does not expressly provide exemptions for foreign companies. As a result, the Sarbanes-Oxley Act on its face applies to foreign private issuers who have securities registered pursuant to Section 12 of the Securities Exchange Act or which are required to file reports in accordance with Section 15(d) of the Securities Exchange Act.

The application of the Sarbanes-Oxley Act to foreign issuers has been one of the most controversial aspects of the new legislation. Foreign private issuers have complained about, among others, the certification requirement, loan prohibition, audit committee provisions, auditor independence regulations, and up-the-ladder attorney reporting provision. Foreign banks complained that the loan prohibition allows U.S. banks--but not foreign banks--to make loans to their directors. German companies complained that the certification requirement conflicted with German law whereby a supervisory board and management board are responsible for the financial statements rather than one individual. Foreign lawyers complained that the SEC's proposed rules regarding up-the-ladder attorney reporting would violate foreign attorney-client privilege regulations.90

B. Nasdaq Listing Requirements

Nasdaq currently provides that nothing in its listing requirements should be construed to require a foreign issuer to do anything contrary to its home country law or generally accepted business practices, and Nasdaq is authorized to provide exemptions to carry out this intent. On October 9, 2002, Nasdaq proposed deleting and revising the current provision. Nasdaq amended its proposal on August 15, 2003 and October 9, 2003.

As proposed, Nasdaq would have the ability to provide exemptions from Nasdaq's corporate governance rules (Rule 4350) to a foreign private issuer when provisions are contrary to a law, rule or regulation of any public authority exercising jurisdiction over such issuer or contrary to generally accepted business practices in the issuer's country of domicile, except to the extent that such exemptions would be contrary to the U.S. federal securities laws (including the SEC's audit committee rules). Issuers may request exemptions under this provision by submitting a letter from their home country counsel briefly describing the company's practice and the applicable laws, rules, regulations or generally accepted business practices of the home country. This procedure would be available only to foreign private issuers (and not other foreign issuers).

90 For a discussion of the application of the Sarbanes-Oxley Act and the SEC's related rulemaking to foreign private issuers, see our client memorandum entitled "Sarbanes-Oxley Act Expands Corporate Governance and Accounting Requirements for SEC-Registered Non-U.S. Companies" which can be accessed at www.ffhsj.com/firmpubs.htm.
Nasdaq also proposed a new requirement that an issuer that receives an exemption under Nasdaq's corporate governance rules must disclose in its annual report filed with the SEC (e.g., Forms 20-F, 40-F or 10-K) each requirement from which it is exempted and describe the alternative practice, if any, of the issuer in lieu of these requirements. For example, the issuer might state that it complies with the relevant standards of its home market. In addition, foreign issuers making their initial public offering or first U.S. listing on Nasdaq must disclose any such exemptions in their registration statement (e.g., Forms F-1, 20-F or 40-F). Nasdaq stated in its rule proposal that the disclosure will not only alert investors that the issuer has been granted an exemption but may also cause foreign issuers to consider carefully their need for an exemption, rather than applying for one as a matter of course.\textsuperscript{91}

The Nasdaq proposal was published for comment by the SEC on July 2, 2003. The proposal regarding the procedure for foreign private issuers seeking exemptions would be effective on July 31, 2005. The proposal regarding disclosure would take effect for new listings and filings made on or after January 1, 2004.

C. NYSE Listing Requirements

The NYSE currently allows listed non-U.S. companies to follow home-country practices regarding certain corporate governance matters. The NYSE's corporate governance proposals would require listed foreign private issuers to disclose any significant ways in which their corporate governance practices differ from those followed by domestic companies under NYSE listing standards. However, the NYSE proposal emphasizes that foreign private issuers are not required to present a detailed, item-by-item analysis of these differences; what is required is a brief, general summary of the significant differences, not a cumbersome analysis. The disclosure may be provided either on the issuer's website (as long as it is in English and accessible from the U.S.) and/or in their annual report distributed to U.S. shareholders (again, in English). If it is only provided on the website, the annual report must so state and provide the website address.

The NYSE corporate governance proposal clarifies that foreign private issuers may continue to follow home country practices in lieu of the NYSE's corporate governance rules. However, foreign private issuers will be required to have a 3-person audit committee composed of independent directors and with responsibilities required by the SEC's rules, and CEO's of foreign private issuers must promptly notify the NYSE in writing after any executive officer of the company becomes aware of any material non-compliance with applicable NYSE rules.

\textsuperscript{91} The Nasdaq proposal is very different than the NYSE approach. The NYSE automatically exempts foreign issuers from all corporate governance requirements (except Rule 10A-3 dealing with audit committees) prior to any disclosure, and only requires disclosure of those exemptions that are deemed "significant."
governance rules (e.g., the audit committee rules and the requirement to disclose the significant differences between NYSE and home country practice).

This proposal was published for comment by the SEC on April 11, 2003. The requirements described above would be effective on the earlier of (1) the company's first annual meeting after January 15, 2004 and (2) October 31, 2004), except that foreign private issuers would not need to comply with the audit committee requirements until July 31, 2005.

7. **Electronic Disclosures**

One of the themes running through the Sarbanes-Oxley Act and the SEC's implementing rules is the increased use of websites, webcasts and electronic communications in order to disclose information to investors. Regulators appear to be testing the use of the issuer's website as a depository of all relevant disclosure regarding the issuer. Examples of this trend include the following:

- **10-K disclosure.** The SEC requires accelerated filers to disclose in their Form 10-K for fiscal years ending on or after December 15, 2002 (1) the issuer's Internet address, if it has one; (2) whether the issuer makes available free of charge "on or through" its Internet website--either directly, through a hyperlink to a third party vendor, or via hyperlink to the SEC website--its periodic reports as soon as reasonably practicable after (e.g., on the same day as) electronically filed with the SEC; and (3) if the issuer does not make filings available in this manner, the reasons why not.

- **Section 16 forms.** The Sarbanes-Oxley Act and the SEC require all Section 16 forms to be filed by EDGAR and to be included on the issuer's corporate website, either directly or by hyperlink to the SEC website or a third party vendor. The SEC has itemized in significant detail the conditions that must be satisfied in order for hyperlinking to be permitted.

- **Waivers of ethics codes.** Domestic issuers are required to disclose changes to, or waivers from, the code of ethics for their senior financial officers and principal executive officer on Form 8-K within five business days. Alternatively, these issuers may disclose such changes or waivers on the issuer’s Internet website, if the issuer’s most recent annual report on Form 10-K provided the issuer’s Internet address and stated that the issuer intended to disclose these events on its website. The website disclosure would need to be made within five business days of the event, would have to be maintained on the website for at least 12 months, and would have to be retained by the issuer for at least five years.
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- **Text of Ethics Codes.** Issuers may choose among the following three alternative methods of making their ethics code publicly available: (1) filing a copy of their code as an exhibit to their annual report on Form 10-K, 20-F or 40-F, (2) posting the text of their code, or the relevant portion thereof, on their Internet website (although an issuer choosing this option must disclose the Internet address and intention to provide disclosure in this manner in their annual report), or (3) providing an undertaking in their annual report to provide a copy of their code to any person without charge upon request.

- **NYSE website disclosure requirement.** The New York Stock Exchange corporate governance proposals would require issuers to include on their website their corporate governance guidelines, codes of ethics, and key committee charters.

- **Regulation G.** If an issuer releases a non-GAAP financial measure orally, telephonically, by webcast, by broadcast or by similar means, Regulation G permits an issuer to provide the required accompanying information by posting the disclosure on its website. The website information must be retained on the website for at least one year. The issuer is also required to disclose the location and availability of the required accompanying information during its presentation.

- **Earnings releases.** Companies must file their earnings releases electronically on Form 8-K. However, if non-public information is disclosed orally, telephonically, by webcast, by broadcast or by similar means in a presentation that is complementary to, and initially occurs within 48 hours after, a related written release or announcement that triggers the requirements of Item 12, an issuer is not required to furnish an additional Form 8-K if (1) the related written release or announcement has been furnished to the SEC on Form 8-K pursuant to Item 12 prior to the presentation, (2) the presentation is broadly accessible to the public by dial-in conference call, by webcast, by broadcast or by similar means, (3) the financial and statistical information contained in the presentation is provided on the issuer’s website, together with any information related to non-GAAP financial matters that would be required under Regulation G; and (4) the presentation was announced by a widely disseminated press release that included instructions as to when and how to access the presentation and the location on the issuer’s website where the information would be available.

- **Foreign Private Issuers.** Foreign private issuers listed on the New York Stock Exchange must disclose any significant ways in which their corporate governance practices differ from those followed by U.S. companies under NYSE standards. The disclosure can be provided either on their website and/or in the annual report distributed.
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to shareholders in the United States. If the disclosure is only provided in the website, the annual report shall so state and provide the web address at which the information can be obtained.

- **Mutual Fund Proxy Voting Record.** Mutual funds' annual and semi-annual reports to shareholders, as well as their statement of additional information, must disclose that information about the fund's proxy voting record is available (1) without charge, upon request, by calling a specified toll-free (or collect) telephone number; or on or through the mutual fund's website at a specified internet address; or both; and (2) on the SEC's website at www.sec.gov. If the mutual fund discloses that the proxy voting record is available on or through its website, it must make available free of charge the information disclosed in its most recently filed Form N-PX on or through its website "as soon as reasonably practicable" after filing the Form with the SEC. The adopting release states that "as soon as reasonably practicable" means that the information should be available, barring unforeseen circumstances, on the same day as filing with the SEC. A fund could satisfy this requirement through hyperlinking to a third-party service or to the SEC's EDGAR website.

In addition, the mutual funds' annual and semi-annual shareholder reports must state that a description of the fund's proxy voting policies and procedures is available (i) without charge, upon request, by calling a specified toll-free (or collect) telephone number; (ii) on the fund's website, if applicable; and (iii) on the SEC's website at www.sec.gov.

8. Underwriter Due Diligence

The Sarbanes-Oxley Act, accounting scandals and restatements and related corporate governance developments have had a significant impact on the due diligence investigation conducted by underwriters and initial purchasers in underwritten or Rule 144A offerings. The due diligence session with the auditors is more rigorous, particularly in the review of critical accounting policies, estimates used in the financial statements and off-balance sheet and contingent liabilities or where Arthur Andersen was dismissed as the auditor. There has also been a greater focus on transactions with related parties and nearly-related parties. It is increasingly common for the underwriters to conduct a due diligence session with the chairman or a member of the audit committee. Even underwriters’ legal due diligence document request lists have been Sarbanized, with many underwriters’ counsel now requesting copies of disclosure control procedures, ethics codes, FAS 61 reports from auditors to the audit committee, corporate governance guidelines, management representation letters to the external auditors, internal compliance certificates, and key committee charters.

Also becoming more common is a due diligence discussion with a senior company official and/or an audit committee member about various Sarbanes-
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Oxley Act and corporate governance issues. Discussion topics may include, among others:

- the company’s disclosure controls and procedures;
- the processes employed in connection with CEO/CFO certification;
- recent discussions regarding the independence of board members;
- loans to directors and officers;
- the company’s ethics policies and ethics code;
- corporate governance guidelines;
- issues raised by the company’s internal and external auditors;
- non-audit services provided by the external auditor;
- whistleblowing policies and procedures adopted by the company;
- any ethical or fraud-related issues which have arisen;
- use of non-GAAP financial measures;
- related party transactions;
- off-balance sheet transactions and the use of special purpose entities;
- the company’s critical accounting policies;
- questions regarding the company’s internal controls;
- director compensation; and
- the use and expensing of stock options.

Finally, underwriters have had to improvise their due diligence procedures for companies previously audited by Arthur Andersen. With Arthur Andersen no longer providing comfort letters, underwriters have used company comfort letters, officer’s certificates, underwriting agreement representations, new risk factor disclosure, enhanced accounting due diligence sessions and audit committee due diligence sessions in order to show their reasonable investigation. In some cases, companies have also agreed to have their successor auditor reaudit, or rereview, prior periods so that the successor auditor could provide comfort on those periods, and some successor auditors will provide incremental comfort by tying financial data in an offering document or periodic report back to Arthur Andersen’s original audit.

9. Studies

A. General

The Sarbanes-Oxley Act required preparation and submission to Congress of the following studies by January 26, 2003:

- Enforcement actions involving violations of reporting requirements and restatements of financial statements (SEC)
- Methods of restitution to injured investors (SEC)
- Role of investment banks in assisting companies to manipulate earnings (GAO)
- Role and function of rating agencies (SEC)
- Violations by securities professionals (SEC) (due January 30, 2003)
The Sarbanes-Oxley Act also required preparation and submission to Congress of the following studies by July 30, 2003:

- Principles-based accounting system (SEC)
- Mandatory rotation of registered public accounting firms (GAO)
- Consolidation of accounting firms (GAO)

In addition, by January 26, 2004 the SEC must complete a study of filings by issuers and their disclosures to determine the extent of off-balance sheet transactions and the use of special purpose entities. The SEC must submit to Congress and the President a report based on this study within six months after the date of completion of the study.

B. Report on Rating Agencies

The SEC was required by the Sarbanes-Oxley Act to prepare a report by January 26, 2003 on the role and function of credit rating agencies. In connection with this report, the SEC held hearings on November 15, 2002 and November 21, 2002 that discussed a wide range of issues related to the function of credit rating agencies in the securities markets. At the same time, the French Finance Ministry asked a former chairman of the French Commission des Operations de Bourse (COB) to prepare proposals on the regulation of international rating agencies for France to present to its Group of Seven partners.92

The SEC issued its report on credit rating agencies on January 24, 2003. In the report the SEC said that it planned to publish a concept release by March 25, 2003 to address concerns related to credit rating agencies and expected to issue proposed rules within a reasonable period of time after the close of the comment period for the concept release.

The SEC stated in the report that the issues to be studied in more depth include (1) whether rating agencies should disclose more information about their ratings decisions, (2) whether issuers need to improve the quality of their disclosure (such as disclosures of ratings triggers), (3) whether rating agencies need to implement procedures to manage potential conflicts of interest that arise when issuers pay for ratings, (4) whether rating agencies should prohibit direct contacts between rating analysts and subscribers, (5) whether rating agencies need to implement procedures to manage potential conflicts that arise when rating agencies sell ancillary fee-based businesses, (6) whether large rating agencies engage in anticompetitive or unfair practices, (7) whether the SEC's system for recognizing rating agencies should be modified, (8) whether more direct, ongoing regulation of rating agencies is warranted, and (9) whether rating agencies should incorporate general standards of diligence in performing their analysis and

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whether new regulation is needed regarding the training and qualifications of credit rating analysts.

On June 4, 2003, the SEC issued a concept release on rating agencies and the use of credit ratings under the federal securities laws. Among other things, the SEC suggested that it would consider (1) no longer using credit ratings issued by rating agencies for regulatory purposes, (2) no longer designating rating agencies as Nationally Recognized Statistical Rating Organizations (NRSROs) and (3) exiting the business of rating agency oversight altogether. In order to implement this result, the SEC stated that it would need to develop alternatives to using NRSROs for current SEC rules which specifically rely on the NRSRO designation, including for computing a broker-dealer's net capital under the net capital rule, determining a money market fund’s permissible investments under Rule 2a-7 and determining an issuer's eligibility to use Form S-3. On the other hand, the SEC also said that it would consider imposing a stricter and more pervasive regulatory regime on rating agencies, including new recordkeeping and examination requirements and prohibitions on certain practices (such as charging issuers after issuing unsolicited ratings or performing ancillary services for ratings clients).

In September 2003 the technical committee of IOSCO issued a report on the activities of credit rating agencies, and on September 23, 2003 the technical committee of IOSCO issued a set of principles regarding the activities of credit rating agencies. Among other things, IOSCO recommended that (1) credit rating agencies should adopt and implement written procedures to ensure that their opinions are based on a fair and thorough analysis, (2) credit rating agencies should adopt written internal procedures to identify and eliminate, or manage and disclose, any actual or potential conflicts of interest that may influence their opinions, (3) credit rating agencies and their staff should not engage in any securities or derivatives trading presenting inherent conflicts of interest, (4) rating agency analysts should not be compensated or evaluated based on the amount of revenue they derive from issuers the analyst rates, (5) rating agencies should disclose the nature of the compensation arrangements that exist with an issuer that they rate, (6) rating agencies should disclose to the public any rating regarding publicly issued fixed income securities if the rating is based in whole or in part on material nonpublic information, (7) rating agencies should publish sufficient information about the historical default rates of their rating categories and whether the default rates have changed over time, and (8) rating agencies should disclose if a rating is unsolicited.
C. Report on Securities Industry Professionals

The SEC was also required by the Sarbanes-Oxley Act to issue a report by January 30, 2003 on securities law violations by securities industry professionals. In connection with this report, the SEC was required to consider both primary liability and secondary liability of investment banks, accountants, law firms and other securities professionals.

The SEC issued its report on violations by securities industry professionals on January 24, 2003. The report covers violations by public accountants, public accounting firms, investment bankers, investment advisers, brokers, dealers, attorneys and other securities professionals during calendar years 1998 through 2001. Overall, the SEC concluded enforcement actions against 1,713 professionals, including 1,299 found to be principal violators, 13 found to be aiders and abettors, 284 found to be both primary violators and aiders and abettors, 74 found to have failed to reasonably supervise others, and 43 barred from practicing before the SEC for engaging in improper professional conduct or based on a criminal conviction. The most frequent violators were individuals associated with broker-dealers (788), followed by broker-dealer firms (236), individuals associated with investment advisers (172), stock promoters (124), investment adviser firms (92), CFO's (84), outside auditors (66), attorneys (48) and transfer agents (28). The most common types of cases involved securities offerings (385), fraud against broker-dealer customers (323), investment adviser violations (228), issuer financial disclosure (163), market manipulation (110), and touting (98). The most frequently violated sections of the securities laws were Section 10(b) (antifraud) (965), Section 17(a) (antifraud) (741), Section 5(a) (302), Section 5(c) (290), and Section 15(a) (broker-dealer registration) (265).

Based on the SEC's study, the most frequently imposed penalties were permanent injunctions (782), penalties (730), disgorgement (673) and permanent cease-and-desist orders (613). Of a total amount of $799.4 million of disgorgement assessed, $167 million has been collected, $145 million was waived and $487.3 million has not been collected. Of total civil penalties of $226 million assessed, $77.7 million has been collected and $148.2 million has not been collected.

D. Report on Methods of Restitution for Injured Investors

On January 24, 2003, in accordance with the Sarbanes-Oxley Act, the SEC issued a report on methods of restitution for injured investors. As part of this study, the SEC examined a representative sample of SEC enforcement actions during the past five years in which the SEC obtained disgorgement or monetary penalties.

The study confirmed that the SEC's collection success rate depends on collection of just a few large individual payments (for example, of 65 broker-dealer defendants, three paid nearly all of the $50 million in disgorgement...
collected from these cases, including $47 million from Michael Milken). Conversely, a handful of delinquent defendants account for a disproportionate share of money not collected.

The SEC's report included three recommendations for legislation:

- The SEC recommended that the "Fair Fund" provision in the Sarbanes-Oxley Act be expanded to allow penalty money paid by defendants to be added to restitution funds for investors. Under the current provision, only disgorgement amounts can be added to the fund, but if a defendant only is required to pay a penalty then that penalty amount cannot be added to the disgorgement fund. In many cases the SEC does not seek disgorgement because the defendant did not tangibly profit from his fraud.

- The SEC recommended that new legislation be enacted which gives the SEC express authority to contract with private debt collection litigation attorneys. This would be similar to the express authority which the Department of Justice currently has. Moreover, local counsel knowledgeable about state law could provide quicker returns.

- The SEC recommended that Congress enact legislation to remove state law impediments to the recovery of SEC judgments and orders. All states have statutes that exempt certain property (particularly real estate) from collection by creditors. Some debtors use their exemptions to shelter their assets from collection.

E. Report on Enforcement Actions Involving Financial Fraud

On January 24, 2003, in accordance with the Sarbanes-Oxley Act, the SEC issued a report on enforcement actions involving violations of reporting requirements and restatements of financial statements.

During the five year period ending July 30, 2002, the SEC filed 515 enforcement actions for financial reporting and disclosure violations arising out of 227 SEC investigations. Of the 227 investigations, 126 involved improper revenue recognition (fraudulent reporting of fictitious sales, improper timing of revenue recognition, and improper valuation of revenue), 101 involved improper expense recognition (improper capitalization or deferral of expenses, or improper use of reserves, and other understatement of expenses), 23 involved improper accounting for business combinations, and 130 involved other accounting issues, such as inadequate MD&A (43), failure to disclose related party transactions (23) and improper use of off-balance sheet arrangements (3). In 10% of the cases the accounting or disclosure issue was reflected in financial statements that were included in connection with an IPO.
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The majority of the persons held responsible were members of issuer senior management. 157 of the 227 investigations involved charges against at least one senior manager, including 75 Chairman, 111 CEO's, 111 Presidents, 105 CFO's, 21 COO's, 16 CAO's, and 27 Vice Presidents. 135 issuers in the 227 investigations eventually filed restatements related to the investigation, including 94 out of the 126 enforcement matters involving improper revenue recognition.

The report includes the following recommendations:

- The SEC should adopt a uniform mechanism for issuer's to report restatements of financial statements. Currently, some restated financial statements are included in a "10-Q/A" filing, while other issuers simply include them in their regular filings with no specific notification that the issuer has restated. Investors cannot always determine whether and when an issuer has restated its financials.

  The report states that the SEC plans to propose two amendments to its forms to address this issue. First, the SEC proposes adding a line-item to Form 8-K which would require the issuer to disclose what was restated and why and to include a link to the Form 10-K or Form 10-Q that includes the restated financials. Second, the SEC proposes adding a box to the Form 10-K or Form 10-Q, which the issuer would check if the filing contains restated financial statements.

- The SEC should issue an interpretative release or adopt new rules regarding the MD&A. The report states that the SEC is considering rule proposals or interpretative releases regarding MD&A such as providing an overview about a company's financial situation and information about the trends that a company's management follows and evaluates. The SEC is also evaluating comments received in response to its proposals regarding the application of critical accounting policies.

- New legislation should be enacted which allows companies to give the SEC internal reports and other documents pertaining to investigations (such as an internal investigation conducted by an outside law firm) without having to fear that their attorney-client privilege, work-product doctrine or other privilege is waived with respect to a third party.

- New legislation should be enacted which allows for access by SEC staff to grand jury material.

- New legislation should be enacted which allows for nationwide service of process for testimony in SEC litigation in court. The SEC already utilizes nationwide service of process in administrative proceedings but not in court proceedings.
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F. Report on Investment Banks

On March 17, 2003, in accordance with the Sarbanes-Oxley Act, the U.S. General Accounting Office issued a report on the role of investment banks and their analysts with Enron Corporation and Global Crossing Ltd. The report did not include any recommendations.

G. Report on Principles-Based Accounting

On July 25, 2003, in accordance with the Sarbanes-Oxley Act, the SEC issued a report on principles-based accounting.

The report endorsed an objectives-oriented approach—rather than a rules-only approach or a principles-only approach—which (1) is based on an improved and consistently applied conceptual framework, (2) clearly states the accounting objective of the standard, (3) provides sufficient detail and structure so that the standard can be operationalized and applied on a consistent basis, (4) minimizes exceptions from the standard, and (5) avoids use of percentage tests (bright lines) that allow financial engineers to achieve technical compliance with the standard while evading the intent of the standard. The report stated that neither U.S. GAAP nor international accounting standards, as presently comprised, is representative of the optimum type of objectives-oriented standards.

The report concluded that standard setters in the U.S. need to (1) ensure that newly-developed standards articulate the accounting objectives and are devoid of scope exceptions, bright-lines and excessive detail, (2) ensure that new standards are aligned with an improved conceptual framework, (3) address current standards that are more rules-based (such as U.S. standards on leases, derivatives, stock compensation, and derecognition of financial assets and liabilities), (4) address deficiencies in the current conceptual framework, (5) redefine the GAAP hierarchy, and (6) continue efforts on convergence of U.S. and international accounting standards (in October 2002 the FASB and IASB jointly announced their intention to work towards convergence of U.S. and international accounting standards).

H. Report on Accounting Firm Consolidation and Competition

On July 30, 2003, in accordance with the Sarbanes-Oxley Act, the U.S. General Accounting Office issued a report on consolidation and competition among public accounting firms. The GAO stated in the report that it had found no evidence of impaired competition, but that the significant changes that have occurred in the profession may have implications for competition and public company choice, especially in certain industries, in the future. The report also stated that it did not identify a direct correlation between consolidation and audit fees, quality and independence, or capital formation. The report did not make any recommendations.
I. Report on the Implications of the Growth of Hedge Funds

In September 2003, in response to request from SEC Chairman William H. Donaldson, the SEC staff issued a report on the implications of the growth of hedge funds. The report included the following recommendations:

- **Registration of Hedge Fund Advisers.** The SEC should consider requiring hedge fund advisers to register as investment advisers under the Investment Advisers Act of 1940. By requiring hedge fund advisers to look through any hedge funds under their management and count each investor in each hedge fund as a separate client of the adviser, most large hedge fund advisers would be required to register. Once registered, hedge fund advisers would become subject to the SEC's regular inspections and examinations program.

- **Disclosure Document.** The SEC should consider amending its rules to require that registered hedge fund advisers file with the SEC, and deliver to investors, a disclosure statement specifically designed for hedge fund investors. The disclosure statement could be in the form of a brochure and might include, for example, disclosure about various conflicts of interest, what risk management measures are used, how the adviser values securities held by hedge funds and what lock-up periods may apply to an investor's investment.

- **Valuation of Hedge Fund Interests.** The SEC should consider requiring that all registered investment companies that invest their assets in hedge funds, including registered funds of hedge funds ("FOHFs"), have policies and procedures designed to ensure that funds and their boards value their interests in hedge funds in a manner consistent with the Investment Company Act.

- **Layered Fees of Funds of Funds.** To address concerns that registered FOHF investors do not understand the impact of multiple layers of fees, the SEC should require all registered investment companies, including registered FOHFs, to disclose in their prospectus fee tables the estimated expenses of the company's underlying fund interests.

- **Suitability Concerns.** To address concerns that FOHFs expose their investors to inappropriate risks, the SEC should continue to encourage the examination staffs of the SEC and NASD to be vigilant in identifying violations of broker-dealer suitability obligations with respect to the sale of all registered FOHFs.
General Solicitation in 3(c)(7) Hedge Fund Offerings. The SEC should consider eliminating the prohibition on general solicitation or advertising in offerings by hedge funds that rely on the exclusion from the definition of an investment company for hedge funds that permit investments only by highly sophisticated investors.

Capital Introduction Services. SEC and NASD examiners should continue to monitor prime brokers' capital introduction practices. In addition, the SEC staff should consider whether broker-dealers' suitability and other regulatory obligations are being met in connection with the offering of hedge fund interests.

Best Practices. The SEC should encourage the hedge fund industry to embrace and further develop "best practices."

Investor Education. The SEC should continue its efforts to improve investor education regarding hedge funds.

Concept Release. The SEC should consider issuing a concept release to examine whether (1) current restrictions placed on registered funds' use of leverage and short selling should be relaxed, (2) an absolute return strategy has a positive effect on aligning the interests of hedge fund advisers and investors and (3) additional investor education initiatives would be necessary to educate investors about absolute return strategies and risks.

10. SEC Review of Proxy Rules

A. SEC Staff Report

On July 15, 2003 the SEC's Division of Corporation Finance issued a report which recommended that the SEC consider revisions to the proxy process regarding the nomination and election of directors.\(^{93}\) When the Report was issued, SEC Chairman William H. Donaldson asked the SEC staff to prepare rule proposals effecting the Report's recommendation.

Shareholder Access to the Company's Proxy Materials

Under current rules, a company is not required to include in its proxy materials any nominees other than the company's own nominees. Shareholders that wish to nominate directors must prepare, at their own expense, materials which are mailed separately to shareholders.

\(^{93}\) See Staff Report: Review of the Proxy Process Regarding the Nomination and Election of Directors, Division of Corporation Finance (July 15, 2003).
The report describes two possible alternatives for shareholder access to the company's proxy statement for nominations of directors.

- **Shareholder Nominees In the Company's Materials.** Under one alternative, a company would include on its proxy card the shareholder nominee(s) and would include specified information, such as biographical information, about the shareholder nominee(s) in the company's proxy statement. Arguments for and against each of the company's and the shareholder's nominees could be included either in a word-limited form in the proxy statement or outside the proxy statement, for example, on designated websites. All soliciting materials, including website postings, would be filed with the SEC.

- **Two Sets of Proxy Cards.** Under the second alternative, companies would be required to include a nominating shareholder's proxy card along with the company's proxy materials and proxy card. The company would be required to note in its proxy materials that a shareholder had nominated one or more candidates for election to the board, that the shareholder's proxy card was included in the company's mailing, and that additional disclosure about the shareholder's nominees may be found on a specified website. Any disclosure relating to nominating shareholders and their nominees would appear on nominating shareholders' websites and would be filed with the SEC.

The report suggests that shareholder access would be subject to certain limitations and requirements:

- **Triggering Event.** Shareholder access should be conditioned upon the occurrence of one or more triggering events. Examples of "triggering events" might include (1) a company's failure to act on shareholder proposals that receive majority votes, (2) receipt of significant percentages of "withhold" votes in director elections or (3) shareholder approval of a shareholder proposal to activate the shareholder access rule. The Division does not support triggering events based on financial performance, such as lagging a peer index for a number of years or having to restate earnings more than once in a specified period.

- **Minimum Shareholding Amount/Holding Period.** There should be minimum eligibility standards with regard to size of shareholdings and holding period. Potential ownership thresholds might range from the $2,000 threshold required to submit a Rule 14a-8 shareholder proposal to larger share ownership percentages (from 3% to 10% or more). Potential holding periods might range from one to three years.
• **Maximum Number/Amount of Shareholder Nominees.** The shareholder access process should not be a vehicle for effecting a change in control of the board of directors. Accordingly, the report indicates that there would be limitations on the total number or percentage of permitted shareholder nominees.

• **Independence of Nominees.** There should be appropriate standards for independence of shareholder nominees.

• **State Law.** Access rights would be conditioned upon the company's shareholders having the right to nominate a candidate for election as a director under applicable state law.

• **Violations of Law.** Neither the candidacy nor the election of a shareholder nominee may otherwise violate, or cause the company to violate, controlling state law, federal law or listing standards.

Other securities law issues that the report indicates the SEC will consider, depending upon the level of any shareholder eligibility threshold, include:

• **Schedule 13D/G.** Whether nominating shareholders, including groups, would be deemed to have a control purpose that would create Schedule 13D or 13G reporting requirements?

• **Section 16.** Whether a nominating shareholder group which owns more than 10% of the company's common stock would be subject to Exchange Act Section 16 reporting requirements, as well as possible short-swing profit liability and the related short sale prohibitions?

• **"Affiliate" Status.** Whether a nominating shareholder would be deemed an "affiliate" of the company as a result of using a shareholder access rule?

• **"Soliciting" Activity.** Whether activities in connection with forming a shareholder nomination group or in support of a shareholder nominee would be deemed "soliciting activity," requiring compliance with the disclosure and proxy requirements of the federal proxy rules?

Amendments to Exchange Act Rule 14a-8

In addition to the specific recommendations made by the Division to the SEC, the report describes another alternative: amending Exchange Act Rule 14a-8(i)(8), which allows companies to exclude shareholder proposals that "relate to an election for membership on the company's board of directors or analogous governing body." Under current SEC interpretations, a company can exclude a proposal if it directly or indirectly may result in an election contest. The report states that, as an alternative to a shareholder access rule, the SEC could amend...
Rule 14a-8(i)(8) to allow for inclusion of proposals seeking to establish a process to allow shareholders to access a company's proxy card in a non-control context. However, the report observes that state law would still require many of the proposals to be precatory, leaving the board to decide whether to implement a process to allow shareholders to nominate directors.

B. Proposal on Nominating Committees and Board Communication

On August 8, 2003, the SEC proposed new proxy statement disclosure requirements regarding the operation of nominating committees and procedures by which security holders may communicate with board members.

The SEC's proposed rules would require companies to disclose the following additional information in proxy statements distributed in connection with the election of directors:

- **Basis for Lack of Nominating Committee.** If the company does not have a standing nominating committee, the company should disclose the specific basis for the view of the board that it is appropriate not to have such a committee and the name of each director who participates in the consideration of director nominees.

- **Charter.** If the nominating committee has a charter, the company should disclose the material terms of the charter and where a current copy of the charter is available, which can be the company's website. Alternatively the proxy statement should disclose that the committee does not have a charter.

- **Independence.** If the company is listed on a national securities exchange or Nasdaq, the company should disclose any instance in the last fiscal year where any member of the nominating committee did not satisfy the definition of independence under applicable listing standards. This disclosure would not be needed if a director was permitted by the exchange rules to not be independent. If the company is not listed, the company should state whether each member of the committee is independent, using any definition of independence that has been approved by the SEC and stating which definition is being used.

- **Policy.** If the nominating committee has a policy regarding consideration of any director candidates recommended by shareholders, the company should provide a description of the material elements of that policy, which must include at least a statement as to whether the committee will consider director candidates recommended by security holders. Alternatively, the proxy statement should disclose that the company does not have such a policy.
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- **Qualifications.** The company should describe any specific, minimum qualifications that the nominating committee believes must be met by a nominating committee-recommended nominee for a position on the board, any specific qualities or skills that the committee believes are necessary for one or more of the directors to possess, and any specific standards for the overall structure and composition of the company's board.

- **Process of Identifying Nominees.** The company should describe the nominating committee's process for identifying and evaluating nominees for director, including shareholder recommended nominees, and any differences in the manner in which the nominating committee evaluates nominees for director based on whether or not the nominee is recommended by a security holder.

- **Source of Nominees.** The company should state the specific source, such as the name of an executive officer, director or other individual sponsor, of each nominee (other than nominees who are executive officers or directors standing for re-election).

- **Search Firms.** If the company pays a fee to any third party or parties to identify or assist in identifying or evaluating potential nominees, the company should disclose the function performed by each such third party.

- **Rejected Shareholder Recommendations.** If the committee receives a recommendation from a shareholder or group of shareholders who beneficially owned more than 3% of the voting common stock for at least one year as of the date the recommendation was made, and if the committee chooses not to nominate that candidate, the company should state the name or names of the shareholders who recommended the candidate and the specific reasons for the nominating committee's determination not to include the candidate as a nominee. The name of the recommended candidate would not need to be included.

The SEC's proposed rules also would require companies to disclose in proxy statements the following information about shareholder communications:

- **Whether or Not The Board Has a Process for Communications.** The company should disclose whether or not the board provides a process for shareholders to send communications to the board and, if it does not have such a process, the company should state the specific basis for the view of the board that it is appropriate not to have such a process.

- **Description of Process.** If the company has a process, the company should describe:
  
  - the manner in which shareholders can send communications to the board;
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- the identity of those board members to whom security holders can send communications;
- if all shareholder communications are not sent directly to the board, the company's process for filtering which communications will be relayed to the board, including identification of the department or other group within the company that is responsible for making the determination; and
- any material action taken by the board during the preceding fiscal year as a result of communications from shareholders.

C. Proposal on Security Holder Director Nominations

On October 14, 2003, the SEC proposed new rules that would, under certain circumstances, require companies to include in their proxy materials security holder nominees for election as director. As proposed, if certain conditions are satisfied, in connection with an annual shareholders meeting (or, in lieu of an annual meeting, a special meeting) at which directors are to be elected, a company must include in its proxy statement (1) the name of a person or persons nominated by a shareholder or group of shareholders for election to the board, (2) specified required disclosures about the nominating shareholder and the nominee, and (3) if the company includes a statement supporting its own nominees or opposing the shareholder nominees, at the election of nominating shareholder, a statement of support for the shareholder nominee or nominees of up to 500 words.

1. Triggering Events

The procedure of Rule 14a-11 would apply to all companies that are subject to the Exchange Act proxy rules, including registered investment companies. The procedure would not apply to foreign private issuers, who are exempt from the proxy rules. The company would be required to include the shareholder nominees if the following conditions are met:

- One or more of the following triggering events occurred during the calendar year in which the meeting is being held or in the prior two calendar years:
  a. At least one of the company’s nominees to the board for whom the company solicited proxies received “withhold” votes from more than 35% of the votes cast at an annual meeting held after January 1, 2004 at which directors were elected. The SEC’s proposing release states that, based on a sample of 2,227 director elections, approximately 1.1% of
companies had total withhold votes in excess of 35% of the votes cast.

b. A shareholder proposal providing that the company become subject to the Rule 14a-11 regime was submitted pursuant to Rule 14a-8 by a shareholder or a shareholder group that held more than 1% of the securities entitled to vote for at least one year as of the date the proposal was submitted to the company (and provided evidence of such holding), and the shareholder proposal received more than 50% of the votes cast on that proposal at an annual meeting held after January 1, 2004. For purposes of calculating 50%, only votes for and against a proposal are included (compared to votes outstanding), and abstentions and broker non-votes are not included. The company would not be permitted to exclude the shareholder proposal from its proxy statement on the ground that it relates to an election for board membership (which absent Rule 14a-11 would be grounds for exclusion).

c. The SEC’s proposing release states that the SEC is considering a third triggering event where (1) any shareholder proposal is submitted pursuant to Rule 14a-8 (other than a direct access shareholder proposal) by a shareholder or group that held more than 1% of the company’s securities for one year, (2) the proposal received more than 50% of the votes cast and (3) the board of the company did not implement the proposal by the 120th day prior to the date that the company mailed its proxy materials for the annual meeting.

- Applicable state law does not prohibit the shareholders from nominating a candidate or candidates for election as a director.
- The nominee’s candidacy or board membership does not violate controlling state law or federal law or rules of a national securities exchange or national securities association applicable to the company (other than rules regarding director independence).
- Information required to be included in the shareholder notice to the company must be so included.
- Any representation required to be included in the shareholder notice to the company cannot be false in any material respect.
- The number of shareholder nominees does not exceed the limit on the number of shareholder nominees permitted to be included.
The SEC proposing release indicates that the SEC is also considering conditioning the use of Rule 14a-11 on the company being an “accelerated filer” ($75 million public float, subject to periodic reporting requirements for 12 months, and previously filed at least one annual report).

2. Nominating Shareholder Eligibility

A shareholder or shareholder group making a director nomination must satisfy the following requirements:

- The shareholder individually, or the group collectively, must beneficially own more than 5% of the company’s securities eligible to vote for directors at that meeting.

- The shareholder or each member of the group must have held the securities that are used to determine the 5% ownership amount continuously for at least two years and intend to continue to hold those securities through the date of the election. The SEC’s proposing release states that 42% of filers have at least one shareholder that can meet this threshold individually.

- The shareholder or each member of the group must be eligible to file on Schedule 13G (rather than Schedule 13D) because either (1) it is an institutional investor (registered broker/dealer, bank, insurance company, registered investment company, registered investment advisor, among others) or (2) it is a passive investor beneficially owning less than 20% of the securities.

- The shareholder or the group must have filed a Schedule 13G, or an amendment to Schedule 13G, reporting beneficial ownership as a passive investor or an institutional investor, which must include a certification that the shareholder or group has held more than 5% of the securities for at least two years. The Schedule 13G must disclose the filing person’s intention to nominate one or more directors under Rule 14a-11.

3. Shareholder Notice

In order to have a nominee included in the company’s proxy statement, the nominating shareholder must provide notice to the company of its intent to require the company to include the shareholder nominee. The notice must be sent no later than 80 days before the date that the company mailed its proxy materials for the prior year’s annual meeting (if there was no annual meeting for the prior year, or the date has changed more than 30 days, then the notice must be provided a
reasonable time before the company mails its proxy materials as specified by the company in Item 13 of Form 8-K).

The shareholder’s notice must include the following:

1. A representation that, to the knowledge of the shareholder or group, the nominee’s candidacy or board membership will not violate controlling state law, federal law or applicable exchange requirements (other than a standard related to independence).

2. A representation that the shareholder or group satisfies the nominating shareholder eligibility requirements.

3. A representation that (a) if the shareholder or any member of the group is a natural person, the nominee is not the nominating shareholder, a member of the group, or a member of the immediate family of the nominating shareholder or any member of the group, (b) if the shareholder or any member of the group is an entity, neither the nominee nor any immediate family member of the nominee has been an employee of the nominating shareholder or any member of the group during the then-current calendar year or during the prior calendar year, (c) the nominee and his immediate family members have not accepted during the then-current year or during the prior year directly or indirectly any consulting, advisory or other compensatory fee from the nominating shareholder or any member of the group or any affiliate of any such holder or any such member, and (d) such nominee is not an executive officer or director or affiliate of the nominating shareholder or any member of the group, and does not intend to control the nominating shareholder or any member of the group.

4. A representation that the nominee meets the objective criteria for “independence” of the exchange applicable to the company. This would not require the nominee to meet the higher audit committee standards.

5. A representation that neither the nominee nor the nominating shareholder or any member of the group has a direct or indirect agreement with the company regarding the nomination of the nominee.

6. A copy of the Schedule 13G filed by the nominating shareholder or group.

7. A statement from the nominee that the nominee consents to be named in the proxy statement and, if elected, to serve, for inclusion in the proxy statement.
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8. Disclosure about the nominee providing all information necessary to comply with the disclosure requirements of the proxy statement (e.g., biographical data and work experience as required by Item 7 of Schedule 14A), for inclusion in the proxy statement.

9. Information about each nominating shareholder or member of the group unless it is already in the Schedule 13G, for inclusion in the proxy statement, including (a) name and business address, (b) present principal occupation or employment and the name, principal business and address of any corporation or other organization in which such employment is carried on, (c) the amount of each class of securities that the individual owns beneficially, and (d) whether or not, during the past ten years, the individual has been convicted in a criminal proceeding and, if so, the dates and the nature of the conviction, and whether the individual has been involved in any other legal proceeding during the past five years as required by Item 401(f) of Regulation S-K.

If the nominating shareholder is a general or limited partnership, syndicate or other group, the information called for must be given with respect to each partner of the general partnership, each partner who functions as a general partner of the limited partnership, each member of the syndicate or group, and each person controlling the partner or member. If the nominating security holder is a corporation, the information called for must be given with respect to each executive officer and director of the corporation, each person controlling the corporation, and each executive officer and director of any corporation ultimately in control of the corporation.

10. The methods by which the nominating shareholder or group may solicit shareholders, including, at their election, any website address on which they may publish soliciting materials.

Any notice sent to the company by a shareholder or group indicating an intent to nominate a candidate for director in accordance with Rule 14a-11 must be filed with the SEC no later than two business days after it is submitted to the company. The notice would be viewed as “soliciting material” and would be subject to the provisions of Exchange Act Rule 14a-9. The filing would be made under the subject company’s Exchange Act file number and would include a cover page in the form set forth in Schedule 14A.

The SEC’s proposing release states that the nominating shareholder will be liable for any false or misleading statements included in the notice. The proposed rules also state that the company is not responsible for any information in the notice or otherwise provided by the nominating shareholder or group.
4. Number of Shareholder Nominees

The company is not required to include in its proxy statement more than (1) one shareholder nominee where the total number of directors is 8 or fewer, (2) two shareholder nominees where the total number of directors is more than 8 and less than 20, and (3) three shareholder nominees where the total number of directors is 20 or more. If more than one shareholder or group is otherwise permitted to nominate a director, the company must include in the proxy statement the nominee of the shareholder or group with the largest two-year beneficial ownership at the time of the delivery of the notice.

5. Company Action After Receiving a Shareholder Notice

After the company receives a request from a shareholder or group to include a director nominee in its proxy materials, the company must determine whether it is entitled to exclude the nominee from the proxy materials. The company may elect to exclude the nominee because among other things (1) Rule 14a-11 is not applicable to the company, (2) the nominating shareholder did not comply with Rule 14a-11, (3) the nominee did not meet the requirements of Rule 14a-11, (4) any required representation is false in any material respect, or (5) the company received more nominees than it is required to include.

- If the company determines to exclude the nominee, the company must notify the shareholder nominator promptly but in no case less than 30 calendar days before the date of the proxy statement released to shareholders in connection with the prior year’s annual meeting (or, if there was no annual meeting in the prior year or the meeting date was changed by more than 30 days, the notice must be provided a reasonable time before mailing the proxy statement). The company’s notice must include (a) a description of the determination made by the board to exclude the nominee, (b) a discussion of the specific requirement that permits the exclusion of the nominee, and (c) a discussion of the specific basis for the board’s view that the company is permitted to exclude the nominee. The company must also disclose in its proxy statement a statement that it has made such an exclusion and provide the information included in the notice to the nominating shareholder with regard to the basis for its determination to exclude the nominee.

- If the company determines to include the nominee, it must advise the nominating shareholder of this determination and state whether the company intends to include disclosure supporting the company’s nominees and/or opposing the shareholder nominee. A statement merely recommending a vote in favor of its nominees or against the shareholder nominees is not deemed to be an opposing or supporting statement for these purposes. If the company intends
to include such a statement, it must advise the nominating shareholder (a) that it may submit a statement of up to 500 words supporting the shareholder nominee and (b) of the date by which this statement must be received, which must be at least 10 business days from the date of the company’s notice to the shareholder. The nominating shareholder’s supporting statement would be viewed as soliciting material and would therefore be required to be filed with the SEC on or about the date that the proxy statement is first released.

6. Amendments to Schedule 14A

As proposed, the SEC would amend Item 7 of Schedule 14A to require additional disclosures in the proxy statement. If a shareholder nominee is submitted to the company and the company is not permitted to exclude the nominee pursuant to the provisions of Rule 14a-11, the company must include the following information in the proxy statement:

- A statement from the nominee that the nominee consents to be named in the proxy statement and, if elected, to serve.

- Disclosure about the nominee’s background and business experience as required by Item 7 of Schedule 14A.

- Information about each nominating shareholder or member of the group unless it is already in the Schedule 13G, including (a) name and business address, (b) present principal occupation or employment, (c) the amount of each class of securities that the individual owns beneficially, and (d) whether or not, during the past ten years, the individual has been convicted in a criminal proceeding and, if so, the dates and the nature of the conviction, and whether the individual has been involved in any other legal proceeding during the past five years as required by Item 401(f) of Regulation S-K.

- The methods by which the nominating shareholder or group may solicit shareholders, including, at their election, any website address on which they may publish soliciting materials.

- If the company includes a statement supporting its nominees or opposing the shareholder nominee, the company must also include, at the election of the nominating shareholder or group, a statement of support for the shareholder nominee, of a length not to exceed 500 words.
None of this disclosure would be deemed incorporated by reference into any filing under the Securities Act or the Exchange Act, unless specifically incorporated by reference by the company.

The SEC proposal also includes two other disclosure requirements applicable to the proxy statement:

- If the proxy statement includes a shareholder proposal submitted pursuant to Rule 14a-8 providing that that registrant become subject to Rule 14a-11, the company must disclose that the shareholder vote on that proposal may determine whether the company will become subject to the shareholder nomination procedure of Rule 14a-11 for the annual meetings at which directors are elected during the remainder of the calendar year in which the subject vote was held, the following calendar year and the portion of the next calendar year up to and including the annual meeting during that calendar year.

- If the company receives a shareholder nomination that purports to be submitted pursuant to Rule 14a-11, but the company determines it is not required to include the nominee in the proxy statement, the company must describe the determination made by its board, discuss the specific provisions of Rule 14a-11 that it relied on in excluding the nominee, and discuss the specific basis for the belief of the company’s board that the company is permitted to not include the nominee in the proxy statement.

The SEC also proposed two amendments to the proxy card:

- A proxy card for the election of directors must include any person whose nomination by a shareholder or group satisfies the requirements of Rule 14a-11.

- Means to grant authority to vote for any nominees as a group or to withhold authority for any nominees as a group may not be provided if the proxy card includes one or more shareholder nominees pursuant to Rule 14a-11.

7. Exempt Solicitations

As proposed, most of the proxy rules would not apply to a solicitation to form a nominating shareholder group or a solicitation in support of a shareholder nominee, subject to specified conditions. In particular, a proxy statement would not need to be distributed in connection with these two types of solicitations.

A solicitation to form a nominating shareholder group would be exempt if:
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- either (a) the total number of persons solicited is not more than 30, or (b) each written communication includes only a statement of intent to form a group to nominate a director, the percentage of securities that each soliciting shareholder owns, and the means to contact the soliciting party; and

- any soliciting material published, sent or given to shareholders is filed with the SEC by the soliciting party under the company’s Exchange Act file number, no later than the date it is first published, sent or given.

A solicitation by a nominating shareholder or group in support of a nominee placed on the company’s proxy card pursuant to Rule 14a-11 is exempt if:

- the soliciting party does not seek the power to act as proxy for a shareholder and does not furnish or request a form of revocation, abstention, consent or authorization;

- each written communication includes the identity of the nominating shareholder and a description of his interests, by shareholdings or otherwise, and a prominent legend that a shareholder nominee is or will be included in the company’s proxy statement and that they should read the proxy statement, among other things; and

- any soliciting material published, sent or given to shareholders is filed with the SEC by the soliciting party under the company’s Exchange Act file number, no later than the date it is first published, sent or given. Three copies must be delivered to the applicable securities exchange.

8. Amendment to Form 8-K

The SEC’s proposals also include new Item 13 of Form 8-K. If either of the triggering events for the shareholder nominee regime occurs (either 35% of votes are withheld from a nominee, or 50% of the shareholders approve the shareholder nominee regime), but the company did not hold an annual meeting the previous year, or the date of the current year’s annual meeting is changed by more than 30 days from the date of the prior year’s annual meeting, the company must disclose in Item 13 of Form 8-K the date by which a shareholder or shareholder group must submit the shareholder notice nominating a director, which date shall be a “reasonable time” prior to the date the company mails its proxy materials.

As proposed, this Form 8-K requirement would apply not only to domestic companies but also to investment companies. The only other Form 8-K
requirement that applies to investment companies relates to notices of blackout periods in benefit plans.

9. Notice of Triggering Event on Form 10-K and Form 10-Q

The SEC’s proposals would require companies to give notice of the occurrence of a triggering event in Item 4 (“Submission of Matters to a Vote of Security Holders”) of Form 10-K and Form 10-Q. As proposed, if the meeting involved the election of directors or a vote on a shareholder proposal and, as a result of that vote, the company will become subject to the shareholder nomination procedure of Rule 14a-11, the company must (1) provide disclosure of that result, (2) disclose that the company will be subject to Rule 14a-11 for the annual meeting at which directors are elected during the remainder of that calendar year, the following calendar year and the next calendar year up to and including the annual meeting during that calendar year, and (3) state the date by which shareholders must submit their nominations.

10. Amendments to Schedule 13G

The SEC proposal would add a new certification to the Schedule 13G. As proposed, if a Schedule 13G is filed in connection with a Rule 14a-11 shareholder nomination, the Schedule 13G must certify that “__% of the securities referred to above have been held continuously for at least two years.” This certification will be used both to determine the eligibility of the shareholder to submit a nomination pursuant to Rule 14a-11 and also, where more than one eligible shareholder submits a nomination, to determine who has a larger beneficial ownership. A shareholder or group that already has a Schedule 13G on file would be required to amend the schedule to provide the required certification in order to make a nomination under Rule 14a-11. Upon termination of the nominating shareholder group, the group would file a final amendment to its Schedule 13G disclosing termination of the group and, therefore, the group’s filing obligation on Schedule 13G.

The SEC proposal would also add an instruction to Rule 13d-1 which clarifies that, for purposes of filing a Schedule 13G as either an institutional investor or a passive investor (both of which require certification of passive intent), a beneficial owner who acquires securities in connection with a Rule 14a-11 nomination will not be deemed to have a purpose or effect of changing or influencing the control of the company solely by virtue of acquiring or holding the securities, a solicitation for the election of that director nominee, or the election of that director nominee.

11. “Affiliate” Status of Nominating Shareholder

As proposed, a nominating shareholder will not be deemed an “affiliate” of the company solely as a result of nominating a director or soliciting for the election of such a director nominee. Also, where a shareholder nominee is
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elected, and the nominating shareholder or group does not have an agreement or relationship with the director, other than relating to the director’s nomination and solicitation for his election, then the nominating shareholder or group will not be deemed an affiliate solely by virtue of having nominated that director.

12. **Section 16**

The SEC proposal clarifies that a group formed solely to nominate a director under Rule 14a-11, solicit in connection with that election, or have its nominee elected as a director, should not be deemed to be a 10% holder and thus subject to Section 16.

The SEC’s proposing release also states the SEC’s view that successful use of the director nomination procedure should not result in the nominating shareholder being deemed to be a director by deputization.
### Status of Sarbanes-Oxley/NYSE/Nasdaq Provisions

<table>
<thead>
<tr>
<th>Provision</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Disclosure</strong></td>
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<tr>
<td>1. <strong>CEO/CFO certification</strong></td>
<td></td>
</tr>
<tr>
<td>A. Section 906</td>
<td>Effective 7/30/02; SEC proposed exhibit requirement on 3/21/03, adopted 6/5/03, and effective for reports due on or after 8/14/03</td>
</tr>
<tr>
<td>B. Section 302</td>
<td>SEC adopted 8/29/02; effective 8/29/02; SOX FAQ's issued 11/8/02 (revised 11/14/02); SEC proposed amendments on 10/22/02 and 3/21/03 and adopted amendments on 6/5/03 which are effective for reports due on or after 8/14/03 (but some parts become effective only at such time as the first internal controls report is filed)</td>
</tr>
<tr>
<td>C. Items 307 and 308(c) of Regulation S-K</td>
<td>SEC adopted 8/29/02; effective 8/29/02; SEC proposed amendments on 10/22/02, adopted them on 6/5/03 and they become effective for reports due on or after 8/14/03</td>
</tr>
<tr>
<td>D. NYSE Certification</td>
<td>Proposed by NYSE on 8/16/02, 4/4/03 and 10/8/03; published for comment by the SEC on 4/11/03; would be effective upon the earlier of (1) the company's first annual meeting after 1/15/04 and (2) 10/31/04</td>
</tr>
<tr>
<td>2. Disclosure controls</td>
<td>SEC rule effective 8/29/02; adopted amendments on 6/5/03 which become effective for reports due on or after 8/14/03</td>
</tr>
<tr>
<td>3. Internal control report</td>
<td>Proposed 10/22/02; adopted 6/5/03; PCAOB standard proposed 10/7/03; for internal control report, auditor attestation, requirement to maintain internal controls, the required annual evaluation of internal controls and the quarterly evaluation of changes in internal controls, an accelerated filer must comply in the annual report for its first fiscal year ending on or after 6/15/04, otherwise in the annual report for its first fiscal year ending on or after 4/15/05 (the quarterly evaluation of internal controls must be done in the first periodic report due after the first annual report that must include the internal controls report)</td>
</tr>
<tr>
<td>4. Off-balance sheet transaction disclosures</td>
<td>Proposed 11/4/02; adopted 1/27/03; off-balance sheet disclosures required in registration statements, annual reports and quarterly reports and proxy statements for fiscal years ending on or after 6/15/03; contractual obligations disclosures required in registration statements, annual reports and proxy statements for fiscal years ending on or after 12/15/03.</td>
</tr>
</tbody>
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5. Non-GAAP Financial Measures Disclosures
   - Proposed 11/4/02; adopted 1/22/03; effective 3/28/03; Regulation G applies to all disclosures as of 3/28/03; S-K amendments apply to any annual or quarterly report filed with respect to a fiscal period ending after 3/28/03; frequently asked questions issued 6/13/03

6. Real time issuer disclosure
   - A. The Sarbanes-Oxley Act
     - No requirement that SEC adopt rules
   - B. SEC Form 8-K proposal (June 2002)
     - Proposed 6/17/02; comment period expired 8/26/02
   - C. 10b5-1(c) plans and insider loans
     - Proposed 4/12/02; SEC announced on 8/6/02 it was still considering this proposal
   - D. Earnings releases
     - Proposed 11/4/02; adopted 1/22/03; modified 3/27/03; frequently asked questions issued 6/13/03; 8-K requirement applies to releases made after 3/28/03
   - E. Waivers of code of ethics
     - Proposed 10/22/02; adopted 1/23/03; must be complied with on or after the date on which the company files its first annual report in which the code of ethics disclosure is required (disclosure is required in annual reports for fiscal years ending on or after 7/15/03)
   - F. Notice of blackout periods
     - Proposed 11/6/02; adopted 1/22/03; modified 3/27/03; effective 1/26/03 but compliance required beginning 3/31/03.
   - G. Attorney up-the-ladder reporting
     - SEC proposed 1/29/03; Form 8-K proposal not yet adopted
   - H. Nasdaq going concern opinion proposal
     - Nasdaq proposed 6/11/02; SEC published for comment 7/2/03.

7. Acceleration of Form 10-K/10-Q deadlines
   - A. New 10-K/10-Q deadlines
     - Adopted 9/5/02 (and updated 4/8/03); effective 11/15/02; three-year phase-in period (for accelerated filers, Form 10-K for fiscal years ending after 12/15/03 must be filed within 75 days of the fiscal year end and 10-Q’s for quarters in the following year must be filed within 40 days of the quarter end)
   - B. Website disclosure requirement
     - Adopted 9/5/02; effective 11/15/02; applies to accelerated filers for fiscal years ending on or after 12/15/02

8. Critical accounting estimates
   - SEC proposed 5/10/02; comment period expired 7/19/02

9. Repurchase of equity securities
   - Proposed 12/10/02; comment period expired 2/18/03

10. Audit Committee Disclosures
    - Proposed 1/8/03; adopted 4/9/03; compliance required beginning with reports covering periods ending on or after (or proxy statements for actions occurring on or after) the compliance date for the listing standards applicable to the issuer, which for domestic companies is the earlier of their first annual shareholders meeting after January 15, 2004, or October 31, 2004, and for foreign private issuers is July 31, 2005.

11. Regulation FD
    - Nasdaq harmonization provision proposed 7/31/02; approved by SEC 11/25/02.
### Board of Directors

<table>
<thead>
<tr>
<th>1. Independent director requirement</th>
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</thead>
<tbody>
<tr>
<td><strong>A. NYSE</strong></td>
<td>NYSE submitted proposal to SEC on 8/16/02, 3/12/03, 4/4/03 and 10/8/03; SEC published for comment on 4/11/03; would be effective upon the earlier of (1) the company's first annual meeting after 1/15/04 and (2) 10/31/04 (for certain issuers with classified boards, until the second annual meeting following such date, but no later than 12/31/05).</td>
</tr>
<tr>
<td><strong>B. Nasdaq</strong></td>
<td>Nasdaq submitted proposal to SEC on 10/9/02, 3/11/03, 7/15/03 and 10/9/03; SEC published rules for comment on 3/17/03; compliance will be required by (A) for foreign private issuers, July 31, 2005 and (B) for all other issuers, the earlier of the issuer's first annual meeting after January 15, 2004, or October 31, 2004.</td>
</tr>
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<table>
<thead>
<tr>
<th>2. Nominating Committee</th>
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</thead>
<tbody>
<tr>
<td><strong>A. NYSE</strong></td>
<td>NYSE submitted proposal to SEC on 8/16/02, 4/4/03 and 10/8/03; SEC published proposal for comment on 4/11/03; would be effective upon the earlier of (1) the company's first annual meeting after 1/15/04 and (2) 10/31/04</td>
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<tr>
<td><strong>B. Nasdaq</strong></td>
<td>Nasdaq submitted proposal to SEC on 10/9/02, 3/11/03, 7/15/03 and 10/9/03; SEC published rules for comment on 3/17/03; compliance will be required by (A) for foreign private issuers, July 31, 2005 and (B) for all other issuers, the earlier of the issuer's first annual meeting after January 15, 2004, or October 31, 2004.</td>
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<thead>
<tr>
<th>3. Compensation Committee</th>
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</tr>
</thead>
<tbody>
<tr>
<td><strong>A. NYSE</strong></td>
<td>NYSE submitted proposal to SEC on 8/16/02, 4/4/03 and 10/8/03; SEC published proposal for comment on 4/11/03; would be effective upon the earlier of (1) the company's first annual meeting after 1/15/04 and (2) 10/31/04</td>
</tr>
<tr>
<td><strong>B. Nasdaq</strong></td>
<td>Nasdaq submitted proposal to SEC on 10/9/02, 3/11/03, 7/15/03 and 10/9/03; SEC published rules for comment on 3/17/03; compliance will be required by (A) for foreign private issuers, July 31, 2005 and (B) for all other issuers, the earlier of the issuer's first annual meeting after January 15, 2004, or October 31, 2004.</td>
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<table>
<thead>
<tr>
<th>4. Audit committee independent director requirement</th>
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</tr>
</thead>
<tbody>
<tr>
<td><strong>A. The Sarbanes-Oxley Act</strong></td>
<td>SEC proposed rules 1/8/03; SEC adopted rules 4/9/03; exchanges must submit rules by 7/15/03 and SEC must approve exchange rules by 12/1/03; compliance will be required by (A) for foreign private issuers, July 31, 2005 and (B) for all other issuers, the earlier of the issuer's first annual meeting after January 15, 2004, or October 31, 2004.</td>
</tr>
<tr>
<td><strong>B. NYSE</strong></td>
<td>NYSE submitted proposal to SEC on 8/16/02, 4/4/03 and 10/8/03; SEC published it for comment on 4/11/03; would be effective upon the earlier of (1) the company's first annual meeting after 1/15/04 and (2) 10/31/04, except that the effective date for foreign private issuers is 7/31/05.</td>
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</table>
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C. Nasdaq
Nasdaq submitted proposal to SEC on 10/9/02, 3/11/03, 7/15/03 and 10/9/03; SEC published rules for comment on 3/17/03; compliance will be required by (A) for foreign private issuers, July 31, 2005 and (B) for all other issuers, the earlier of the issuer's first annual meeting after January 15, 2004, or October 31, 2004

5. Audit Committee responsibilities

A. The Sarbanes-Oxley Act
SEC proposed rules 1/8/03; SEC adopted rules 4/9/03; exchanges must submit rules by 7/15/03 and SEC must approve exchange rules by 12/1/03; compliance will be required by (A) for foreign private issuers, July 31, 2005 and (B) for all other issuers, the earlier of the issuer's first annual meeting after January 15, 2004, or October 31, 2004

B. NYSE
NYSE submitted proposal to SEC on 8/16/02, 4/4/03 and 10/8/03; SEC published it for comment on 4/11/03; would be effective upon the earlier of (1) the company's first annual meeting after 1/15/04 and (2) 10/31/04, except that the effective date for foreign private issuers would be 7/31/05

C. Nasdaq
Nasdaq submitted proposal to SEC on 10/9/02, 3/11/03, 7/15/03 and 10/9/03; SEC published rules for comment on 3/17/03; compliance will be required by (A) for foreign private issuers, July 31, 2005 and (B) for all other issuers, the earlier of the issuer's first annual meeting after January 15, 2004, or October 31, 2004

D. Nasdaq related party transactions proposal
Nasdaq proposed 6/11/02, 12/30/02, 10/2/03 and 10/3/03; SEC published rules for comment 7/8/03; as proposed, would be effective 1/15/04

6. Financial expert on audit committee
SEC proposed on 10/22/02; SEC adopted 1/23/03 and amended 3/26/03; must be complied with in annual reports for fiscal years ending on or after 7/15/03 (12/15/03 for small business issuers).

7. Proposed NYSE corporate governance guidelines
NYSE proposed 8/16/02, 4/4/03 and 10/8/03; published by SEC for comment on 4/11/03; would be effective upon the earlier of (1) the company's first annual meeting after 1/15/04 and (2) 10/31/04

8. Nasdaq program regarding interpretations of rules
Nasdaq proposed 7/2/03; SEC published for comment 7/28/03; SEC approved 9/4/03; pilot program extends from 10/1/03 to 3/31/04

9. Nasdaq proposal regarding applicability of rules
Nasdaq proposed 2/25/03 and 10/9/03

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Auditors and Auditing

1. Non-audit services
SEC proposed 12/2/02; SEC adopted 1/28/03; FAQs issued 8/13/03; rules apply to services contracted for on or after 5/6/03; rules do not apply to non-audit services contracted for before 5/6/03 as long as completed by 5/6/04

2. Audit committee administration of the engagement
SEC proposed 12/2/02; SEC adopted 1/28/03; apply to all services contracted for on or after 5/6/03
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<tr>
<td>3. Audit partner rotation</td>
<td>SEC proposed 12/2/02; SEC adopted 1/28/03; FAQ’s issued 8/13/03; applicable to lead partner for first fiscal year beginning after 5/6/03 (time served before 5/6/03 as lead partner is included); applicable to concurring partner beginning with the first fiscal year beginning after 5/6/04 (time served before 5/6/03 as concurring partner is included); applicable to other audit partners as of the beginning of the first fiscal year beginning after 5/6/03 (time served before 5/6/03 is not included)</td>
</tr>
<tr>
<td>4. Auditor “Cooling Off” periods</td>
<td>SEC proposed 12/2/02; SEC adopted 1/28/03; auditor independence will not be impaired if employment with issuer begins before 5/6/03</td>
</tr>
<tr>
<td>5. Restriction on audit partner compensation</td>
<td>SEC proposed 12/2/02; SEC adopted 1/28/03; effective in fiscal years of the accounting firm that commence after 5/6/03</td>
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<tr>
<td>6. Auditor reports to the audit committee</td>
<td>SEC proposed 12/2/02; SEC adopted 1/28/03; effective 5/6/03</td>
</tr>
<tr>
<td>7. Disclosure of audit fees</td>
<td>SEC proposed 12/2/02; SEC adopted 1/28/03; effective for annual filings for the first fiscal year ending after 12/15/03</td>
</tr>
<tr>
<td>8. Retention of corporate audit records</td>
<td>SEC proposed 11/21/02; adopted 1/24/03; effective 3/3/03; compliance is required for audits and reviews completed on or after 10/31/03</td>
</tr>
<tr>
<td>9. Improper influence on audits</td>
<td>SEC proposed 10/18/02; SEC adopted 5/20/03; effective 6/27/03</td>
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</tbody>
</table>
| 10. Public Company Accounting Oversight Board | A. 4/25/03: SEC determines the Board is organized  
B. 10/22/03: U.S. accounting firms must register with the Board  
C. 4/19/04: non-U.S. accounting firms must Register with the Board |

#### Ethics/Compliance

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<td>1. Code of ethics</td>
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</tr>
<tr>
<td>A. The Sarbanes-Oxley Act code of ethics</td>
<td>SEC proposed on 10/22/02; adopted 1/23/03; must be complied with in annual reports for fiscal years ending on or after 7/15/03</td>
</tr>
<tr>
<td>B. Nasdaq code of ethics</td>
<td>Proposed 10/9/02, 1/15/03 and 10/3/03; published for comment by the SEC on 7/2/03; compliance would be required six months after SEC approval.</td>
</tr>
<tr>
<td>C. NYSE code of ethics</td>
<td>Proposed 8/16/02, 4/4/03 and 10/8/03; published for comment by the SEC on 4/11/03; would be effective upon the earlier of (1) the company's first annual meeting after 1/15/04 and (2) 10/31/04</td>
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<tr>
<td>2. Whistleblower provisions</td>
<td></td>
</tr>
<tr>
<td>A. Audit committee procedures</td>
<td>SEC proposed rules 1/8/03; SEC adopted rules 4/9/03; exchanges must submit rules by 7/15/03 and SEC must approve exchange rules by 12/1/03; compliance will be required by (A) for foreign private issuers, July 31, 2005 and (B) for all other issuers, the earlier of the issuer's first annual meeting after January 15, 2004, or October 31, 2004.</td>
</tr>
<tr>
<td>B. New civil action (Sarbanes section 806)</td>
<td>Effective 7/30/02</td>
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<td>C. New felony (Sarbanes section 1107)</td>
<td>Effective 7/30/02</td>
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#### 3. Attorney up-the-ladder reporting requirement

| A. Up-the-ladder reporting | SEC proposed 11/21/02; SEC adopted 1/29/03; rules effective 8/5/03 |
| B. Noisy withdrawal | SEC proposed noisy withdrawal alternative on 1/29/03; comment period expired 4/7/03 |

#### Compensation

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<td>B. Foreign Banks</td>
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<tr>
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<tr>
<td>A. Prohibition on insider trades</td>
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<tr>
<td>B. 30-day notice provision</td>
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| 4. Forfeiture of certain bonuses and profits | Effective 7/30/02; no rulemaking necessary |

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<th>5. Stockholder approval of equity compensation plans</th>
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<td>C. Discounted private placements</td>
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<td>D. Change of control</td>
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</table>

#### Other

| 1. Analyst conflicts of interest | Regulation AC proposed on 8/2/02 and adopted 2/6/03; NYSE/NASD rules proposed on 12/31/02, amended on 5/22/03 and approved by SEC 7/29/03 and mostly effective on 9/27/03. |
| 2. IPO allocation process | NASD comment period expired 9/9/02 |
| 3. Voting of proxies by mutual funds and investment advisers | SEC proposed 9/20/02; SEC adopted 1/31/03; adviser rules effective 3/10/03 and must be complied with by 8/6/03; fund rule effective 4/14/03; mutual funds must file their first N-PX by 8/31/04; initial registration statements filed on or after 8/31/03 must include disclosure about proxy voting policies; initial registrations filed on or after 8/31/04 must include disclosure about the fund's proxy voting. |
| 4. Compliance programs for mutual funds | SEC proposed 2/5/03; comment period expires 4/18/03; no deadline for adoption of rules |
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<td>5. Rule 10b-18 Modifications</td>
<td>Proposed 12/10/02; comments were due 2/18/03</td>
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<td>6. Impact on foreign private issuers</td>
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<tr>
<td>A. Nasdaq listing requirements</td>
<td>Nasdaq proposed 10/9/02, 8/15/03 and 10/9/03; SEC published for comment 7/2/03; disclosure rule would be effective for new filings made after 1/1/04; amended rule regarding exemptions would be effective 7/31/05</td>
</tr>
<tr>
<td>B. NYSE listing requirements</td>
<td>NYSE proposed 8/16/02, 3/12/03, 4/4/03 and 10/8/03; published for comment by the SEC on 4/11/03; would be effective upon the earlier of (1) the company's first annual meeting after 1/15/04 and (2) 10/31/04</td>
</tr>
<tr>
<td>7. Studies</td>
<td></td>
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<td>A. Enforcement actions (SEC)</td>
<td>Due by 1/26/03; prepared 1/24/03</td>
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<td>Due by 1/30/03; prepared 1/24/03</td>
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<td>Due by 1/26/03; prepared 1/24/03</td>
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<td>D. Role of investment banks (GAO)</td>
<td>Due by 1/26/03; prepared 3/17/03</td>
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<tr>
<td>E. Role of rating agencies (SEC)</td>
<td>Due by 1/26/03; SEC hearings on 11/15-21/02; report prepared 1/24/03; concept release issued 6/4/03</td>
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<td>F. Principles-based accounting system (SEC)</td>
<td>Due by 7/30/03; prepared 7/25/03</td>
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<td>G. Mandatory auditor rotation (GAO)</td>
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<td>H. Consolidation of auditors (GAO)</td>
<td>Due by 7/30/03; prepared 7/30/03</td>
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<td>I. Off-balance sheet transactions (SEC)</td>
<td>Study must be complete by 1/26/04; report due six months after study is complete</td>
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<td>J. Implications of the growth of hedge funds (SEC)</td>
<td>SEC issued report 9/29/03</td>
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<td>8. SEC Review of Proxy Rules</td>
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<tr>
<td>A. SEC Staff Report</td>
<td>Issued 7/15/03</td>
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<td>B. Proposal on nominating committees</td>
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*(available at http://www.ffhsj.com/firmpubs.htm)*

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<td>SEC Staff Issues Hedge Fund Report</td>
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<td>SEC Proposes Insider Lending Exemption For Foreign Banks</td>
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<td>Non-GAAP Financial Measures SEC Implements Conditions for the Use of Non-GAAP Financial Measures</td>
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