



DM Extra

Research Edition

August 2, 2002
Research Edition

Timely Commentary on Critical Events
and Regulatory Developments

Reforms Flood-Tide Crests

After months of parallel activity in response to major corporate failures—from the Enron bankruptcy to more recent catastrophes—the stars are aligning for change. The [House](#), the [Senate](#), and the [White House](#) have recently completed major initiatives in corporate reform, while the [Nasdaq Stock Exchange](#) and the [New York Stock Exchange](#) have submitted new listing requirements to a newly strengthened [Securities and Exchange Commission](#). This *DMX* reports the key facts for each development, along with background and impact analysis for directors.

[H.R. 3763ENR](#), known as the Sarbanes-Oxley bill after its sponsors **Sen. Paul Sarbanes** (D-MD) and **Rep. Michael Oxley** (R-OH). (See Box 1 on p. 2.) The new law has been hailed as a landmark comparable to the securities and securities exchange acts that created the SEC. As **Sen. Phil Gramm** (R-TX) declared after the bill passed, “No one sitting on a corporate board or audit committee will ever be the same.”

With nearly a dozen sections and more than 80 subsections, the legislation covers many topics—from analyst conflicts of interests to document shredding. Among other goals, the law creates a publicly funded oversight board to monitor auditors, strengthens auditor independence in other ways, increases CEO accountability for financial statements, increases criminal penalties for fraud, makes CEOs and CFOs sign off on financials, eases private

Director Summary >>

House and Senate July 25: Sarbanes-Oxley Bill

Key Facts: On July 30, President Bush signed into law The Public Accounting Reform and Investor Protection Act—technically,

The Time is Now for Board Excellence

Timing is everything, and right now, the time is right for board excellence. To quote **William Shakespeare's** *Julius Caesar*, “There is a tide in the affairs of men/Which, taken at its flood, leads on to fortune.” If ever there were a “flood” of governance developments, it is now.

What can directors learn from this deluge? First, it is important to get on a high ground. Directors need to ask themselves what they can do to ensure the viability and health of the corporations they serve as fiduciaries. This certainly means learning what they must do from a legal and exchange listing perspective—especially now, with so much change underway. But it also means asking what is best for their organizations before, during, and after reform periods. If a proposed law or requirement is still in the comment stage, directors need to weigh in on it. Once a change is final, directors should conform at the least, or exceed the standard if appropriate.

This commitment to excellence requires ongoing director education. As described in this *DMX*, the tide is moving in this direction. NACD is honored to have played a part in these developments. Through our comments, publications, and educational programs, we are striving for better “fortune”—above all for the shareholders that directors represent.

Roger W. Raber, NACD President and CEO

A publication of the
National Association of
Corporate Directors
1828 L Street NW
Suite 801
Washington, D.C. 20036
(202) 775-0509
www.nacdonline.org



Box 1: H.R.3763

Sarbanes-Oxley Act of 2002

(Enrolled as Agreed to or Passed by Both House and Senate)

Beginning

Sec. 1. Short Title; Table Of Contents.

Sec. 2. Definitions.

Sec. 3. Commission Rules And Enforcement.

Title I—Public Company Accounting Oversight Board

Sec. 101. Establishment; Administrative Provisions.

Sec. 102. Registration With The Board.

Sec. 103. Auditing, Quality Control, And Independence Standards And Rules.

Sec. 104. Inspections Of Registered Public Accounting Firms.

Sec. 105. Investigations And Disciplinary Proceedings.

Sec. 106. Foreign Public Accounting Firms.

Sec. 107. Commission Oversight Of The Board.

Sec. 108. Accounting Standards.

Sec. 109. Funding.

Title II—Auditor Independence

Sec. 201. Services Outside The Scope Of Practice Of Auditors.

Sec. 202. Preapproval Requirements.

Sec. 203. Audit Partner Rotation.

Sec. 204. Auditor Reports To Audit Committees.

Sec. 205. Conforming Amendments.

Sec. 206. Conflicts Of Interest.

Sec. 207. Study Of Mandatory Rotation Of Registered Public Accounting Firms.

Sec. 208. Commission Authority.

Sec. 209. Considerations By Appropriate State Regulatory Authorities.

Title III—Corporate Responsibility

Sec. 301. Public Company Audit Committees.

Sec. 302. Corporate Responsibility For Financial Reports.

Sec. 303. Improper Influence On Conduct Of Audits.

Sec. 304. Forfeiture Of Certain Bonuses And Profits.

Sec. 305. Officer And Director Bars And Penalties.

Sec. 306. Insider Trades During Pension Fund Blackout Periods.

Sec. 307. Rules Of Professional Responsibility For Attorneys.

Sec. 308. Fair Funds For Investors.

Title IV—Enhanced Financial Disclosures

Sec. 401. Disclosures In Periodic Reports.

Sec. 402. Enhanced Conflict Of Interest Provisions.

Sec. 403. Disclosures Of Transactions Involving Management And Principal Stockholders.

Sec. 404. Management Assessment Of Internal Controls.

Sec. 405. Exemption.

Sec. 406. Code Of Ethics For Senior Financial Officers.

Sec. 407. Disclosure Of Audit Committee Financial Expert.

Sec. 408. Enhanced Review Of Periodic Disclosures By Issuers.

Sec. 409. Real Time Issuer Disclosures.

Title V—Analyst Conflicts Of Interest

Sec. 501. Treatment Of Securities Analysts By Registered Securities Associations And National Securities Exchanges.

Title VI—Commission Resources And Authority

Sec. 601. Authorization Of Appropriations.

Sec. 602. Appearance And Practice Before The Commission.

Sec. 603. Federal Court Authority To Impose Penny Stock Bars.

Sec. 604. Qualifications Of Associated Persons Of Brokers And Dealers.

Title VII—Studies And Reports

Sec. 701. GAO Study And Report Regarding Consolidation Of Public Accounting Firms.

Sec. 702. Commission Study And Report Regarding Credit Rating Agencies.

Sec. 703. Study And Report On Violators And Violations.

Sec. 704. Study Of Enforcement Actions.

Sec. 705. Study Of Investment Banks.

Title VIII—Corporate And Criminal Fraud Accountability

Sec. 801. Short Title.

Sec. 802. Criminal Penalties For Altering Documents.

Sec. 803. Debts Nondischargeable If Incurred In Violation Of Securities Fraud Laws.

Sec. 804. Statute Of Limitations For Securities Fraud.

Sec. 805. Review Of Federal Sentencing Guidelines For Obstruction Of Justice And Extensive Criminal Fraud.

Sec. 806. Protection For Employees Of Publicly Traded Companies Who Provide Evidence Of Fraud.

Sec. 807. Criminal Penalties For Defrauding Shareholders Of Publicly Traded Companies.

Title IX—White-Collar Crime Penalty Enhancements

Sec. 901. Short Title.

Sec. 902. Attempts And Conspiracies To Commit Criminal Fraud Offenses.

Sec. 903. Criminal Penalties For Mail And Wire Fraud.

Sec. 904. Criminal Penalties For Violations Of The Employee Retirement Income Security Act Of 1974.

Sec. 905. Amendment To Sentencing Guidelines Relating To Certain White-Collar Offenses.

Sec. 906. Corporate Responsibility For Financial Reports.

Title X—Corporate Tax Returns

Sec. 1001. Sense Of The Senate Regarding The Signing Of Corporate Tax Returns By Chief Executive Officers.

Title XI—Corporate Fraud Accountability

Sec. 1101. Short Title.

Sec. 1102. Tampering With A Record Or Otherwise Impeding An Official Proceeding.

Sec. 1103. Temporary Freeze Authority For The Securities And Exchange Commission.

Sec. 1104. Amendment To The Federal Sentencing Guidelines.

Sec. 1105. Authority Of The Commission To Prohibit Persons From Serving As Officers Or Directors.

Sec. 1106. Increased Criminal Penalties Under Securities Exchange Act Of 1934.

Sec. 1107. Retaliation Against Informants.

securities litigation, and gives the SEC more resources and authority to enforce securities laws. Perhaps most notably for boards, it strengthens the role of the audit committee (as described further below re “main impact”).

Background: The new law came in on the coattails of reformist zeal in both the House and Senate. The House voted 423-3, and the Senate 99-0 (with the ailing **Sen. Strom Thurmond** (R-SC) not voting). The law was a long-awaited reconciliation of two previous bills: the Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002 (H.R. 3763), sponsored by **Michael Oxley** (R-OH), passed by the House April 24; and the Public Company Accounting Reform and Investor Protection Act of 2002 (S. 2673), sponsored by **Paul Sarbanes** (D-MD). This truly bipartisan and bicameral legislation preserved the number of the House bill and used the title of the Senate bill. Although the final legislation drew content from both bills, it reflects the greater scope of the tougher Sarbanes bill, both for procedural reasons and because Congress was feeling the public heat from accumulating corporate scandals (see Box 2).

The new law exacts new penalties for fraud: disbaring of directors and officers found guilty of fraud, longer prison sentences for certain types of white-collar crime, and disgorgement of ill-gotten gains to benefit defrauded shareholders. The “message from Congress to CEOs and corporate boardrooms is clear,” said House Speaker **Dennis Hastert** (R-IL). “If you steal, cheat or commit some other white-collar crime, you’ll face the same consequences as lawbreaking street thugs by spending time behind bars.” The biggest impact for directors, however, will come from provisions that set new powers for the audit committees.¹ The legislation requires:

- New standards for auditor independence, banning of *nine types of consulting services* that auditors have been able to provide in the past, namely:
 - bookkeeping or other services related to the accounting records or financial statements of the audit client
 - financial information systems design and implementation
 - appraisal or valuation services, fairness opinions, or contribution-in-kind reports
 - actuarial services
 - internal audit outsourcing services
 - management functions or human resources

Box 2. Scandals: A 90-Day “Notice”

On April 24, when the House passed the Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002, sponsored by Michael Oxley (R-OH), the bill may have seemed comprehensive enough to many directors. But moderates were “put on notice” by a series of corporate scandals. Here is a chronology.

- April 24 🗳️ House passes the Oxley bill.
- May 2 Adelphia Communications restates earnings by \$1.6 billion due to its treatment of off-balance sheet loans and guarantees to its founder’s family.
- May 15 Kmart Corp. posts \$2.42 billion loss for its most recent fiscal year after restating its quarterly financial statements.
- May 21 Merrill Lynch agrees to pay \$100 million in penalties and revamp stock analyst compensation in a settlement agreement with the New York Attorney General.
- June 5 Henry M. Paulson, Jr., chairman and CEO of Goldman Sachs Group, decries “a crisis in confidence” in the way companies do business. Calls for change in corporate accounting, governance, and conflicts of interest.
- June 15 A federal grand jury convicts Arthur Andersen LLP of a felony count of obstructing justice.
- June 17 Enron Corp. discloses that it made \$754 million of payments and stock awards to senior executives in the year prior to the company’s bankruptcy-law filing.
- June 25 WorldCom Inc. unveils massive accounting fraud, with \$3.8 billion in expenses that were improperly booked as capital expenditures.
- June 26 WorldCom Inc. announces that 17,000 of the company’s 80,000-strong workforce are expected to lose their jobs.
- June 27 The California Public Employees’ Retirement System (CalPERS), which has more than \$150 billion in assets, estimates that it lost more than \$580 million on WorldCom bonds and stock.
- July 10 Qwest Communications announces that it is under criminal investigation by the U.S. Justice Department.
- July 11 Bristol-Myers Squibb announces that the SEC is investigating whether the company improperly inflated revenues by as much as \$1 billion through the use of sales incentives.
- July 12 ImClone Systems ex-CEO is indicted on insider trading charges.
- July 13 Announced losses among 25 states’ public pension funds due to just WorldCom and Enron reaches \$3 billion.
- July 15 🗳️ Senate passes the Sarbanes bill.
- July 17 PricewaterhouseCoopers agrees to pay \$5 million in a settlement with the SEC, stemming charges concerning a lack of auditor independence between PwC and 16 clients.
- July 18 The Dow closes at 8,409.49, down from 10,089.24 (16.6 percent) on April 24th. The Nasdaq closes at 1,356.98, down from 1,730.29 (21.5 percent) on April 24th.
- July 24 🗳️ Joint House Senate Conference approves the Sarbanes-Oxley bill.

¹ The bill defines the audit committee as the “committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer [or] if no such committee exists with respect to an issuer, the entire board of directors of the issuer.”

Box 3. New Powers for the Audit Committee

Section 301 of the Sarbanes-Oxley bill (noe law) says that the audit committee must now:

- assume responsibility for the appointment, compensation, and oversight of the auditor
- meet strict new independence requirements (having no affiliations and accepting no fees)
- establish 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”
- have authority to engage “independent counsel and other advisers, as it determines necessary to carry out its duties,” and
- receive any necessary funding from the company, “as determined by the audit committee in its capacity as a committee of the board of directors,” for payment of compensation to the auditor or any advisors to the committee.

The time frame for these new requirements is less than 10 months (270 days) from the effective date of the bill, which was July 30.

- broker or dealer, investment adviser, or investment banking services
- legal services and expert services unrelated to the audit, and
- any other service that the [new oversight] board determines, by regulation, is impermissible.

Impact = New oversight challenge: Companies will now need to seek new vendors for nonaudit services, and directors will need to monitor this transfer carefully.

- A new section of the annual report on internal control, describing the responsibility of management for this function and assessing its effectiveness.
Impact = Better understanding of internal audit: This will make clear the vital role that internal control plays in governance. Remember: internal control is far more than book-keeping. It is, as defined by [The Institute of Internal Auditors](#) and the [Committee of Sponsoring Organizations of the Treadway Commission \(COSO\)](#) “the process, effected by an entity’s board of directors, management, and other personnel in order to provide reasonable assurance regarding the achievement of objectives in the following categories: effectiveness and efficiency of operations; reliability of financial reporting; and compliance with applica-

ble laws and regulations. This includes the safeguarding of assets.”

- That auditors give reports to the audit committee on all critical accounting policies and practices to be used, as well as reports on the auditors’ discussions with management about accounting policies and any material matters.
Impact = Better information, less “hound-ing”: In the past, the burden was on audit committees to obtain the information; now the information is more likely to come to them automatically (though audit committees should still insist on timely delivery).
- That the SEC mandate stock exchange listing requiring committee disclosure of the presence or absence of at least one member who is a “financial expert,” defined as a person with understanding of generally accepted accounting principles and financial statements, experience in the preparation or auditing of financial statements of generally comparable issuers and the application of such principles in connection with the accounting for estimates, accruals, and reserves, experience with internal accounting controls, and an understanding of audit committee functions. (The SEC must implement requirement within 270 days.)
Impact = More recruitment work: Audit committees that do not have such an expert will be striving to recruit one. Retired audit firm partners would be ideal, if they worked on the audit side of the business; but boards should not recruit a partner that worked on the company’s audits, which would compromise the new director’s independence.
- That the SEC prohibit the listing of any company, after giving it a chance to “cure defects” that does not comply with new congressionally imposed listing standards that give the audit committee new powers, such as the exclusive power to appoint the auditor, and new access to funding, such as funds to pay for legal advice (see Box 3).
Impact = More AC power: Audit committees will have new clout—and the funds to wield it. Audit committees will be under scrutiny as they select advisors. Advice: Boards should use them only when needed, pay them only what is appropriate (not excessively), select only those who are qualified and independent.

Nasdaq July 25: 25+ New Listing Requirements

Key Facts: On July 24, the board of directors of Nasdaq approved more than 25 proposed new listing requirements, including a majority of independent directors on all listed company boards, more powers for boards and audit committees, faster disclosure of insider trading, and, importantly, ongoing education for directors. These recommendations will now go to the board of the **National Association of Securities Dealers** (NASD) for approval and then to the SEC for a comment period.

Background: Nasdaq has been introducing listing requirements on a “rolling” schedule. Starting May 22, the Nasdaq board and the NASD (Nasdaq’s parent), approved new listing rules, which are now at the SEC for review and comment. Those rules tightened the definition of independent director, required that related-party transactions be approved by an issuer’s audit committee or a comparable body, and required that company’s disclose the receipt of an audit opinion with a “going concern qualification” (that is, a statement that the company is still a going concern, or solvent). They also mandated *shareholder approval of any stock option plans* that cover executive officers or directors (amended on July 24 to require approval for all stock option plans).

Adding the two sets of Nasdaq rules—from May 22 and July 24—creates a comprehensive set of governance standards that will change board life for Nasdaq-listed companies.

The rules:

- Strengthen board independence by requiring a majority-independent board, regular meetings of boards in executive session, tightening the definition of independence (by excluding large shareholders, relatives of executives, and former employees of the outside auditor), and giving a three-year cooling-off period for certain nonindependent persons.²

Impact = New boardroom culture: *Taken together, this group of recommendations will raise the profile and numbers of outside directors, with obvious implications for boardroom climate.*

- Give a greater voice to independent directors and/or shareholders in board nominations and executive pay. Nomination and compensation votes must be cast by independent committees, or by a majority of the independent directors.³

Impact = Increase in nominating/governance committees: *Only 40 percent of public company boards have such a committee now.⁴ The time is now to build one.*

- Improve the quality of audit committees by requiring the ability to read and understand financial statements “at the time of appointment,” rather than within a reasonable period (the previous standard).

Impact = Reconfiguration of audit and other committees: *If existing audit committee members do not have such expertise, they will have to rotate off while new committee members (recruited from other committees or from outside the board) will have to rotate on.*

- Empower shareholders by mandating their approval of all stock option plans (except for existing employee stock option plans).

Impact = Pay plan overhauls: *Plans that are not likely to pass muster with shareholders will need redesigning—and board compensation committees will be looking for compensation consultants—notably those not affiliated with the company’s Big Five (soon to be Big Four) auditor.*

- Mandate codes of conduct to address conflicts of interest and legal compliance, with enforcement mechanisms and full disclosure of the code and any waivers.

Impact = Greater board awareness of ethics: *Boards will devote energy to remodeling existing codes for closer inspection by a broader audience.*

- Mandate continuing education for directors “pursuant to rules to be developed by the **Nasdaq Listing and and Hearing Review Council** and approved by the Nasdaq board.”

Impact = Short-term search for qualified providers; long-term improvements stemming from greater knowledge: *Several organizations, including universities, offer director education programs. For more information about NACD programs, visit www.nacdonline.org/seminars.*

2 The cooling-off period applies to former external auditors involved in the company’s audit, and individuals who have received more than \$60,000 in payments from the company, or those who serve on interlocked compensation committees. Committees interlock if the CEOs two companies serve on each others’ compensation committees.

3 One nonindependent director will be allowed on these committees in some cases, which must be disclosed.

4 Source *NACD 2001-2002 Public Company Governance Survey*. See also *The Governance Committee Handbook* (2002), coming soon.

NYSE August 1: Board Approval of Proposed Listing Requirements

On August 1, the **New York Stock Exchange** board met to vote on proposed listing requirements presented to the board on June 6. The board voted to accept the proposal, with certain modifications. The proposal is now at the **SEC**. As reported in our *DMX* dated June 6, the proposed requirements require listed companies to:

- have a board composed of a majority of independent directors
- narrow the definition of independence for all directors and for members of the audit committee
- require regular executive sessions of independent directors
- require independent audit, compensation, and nominating/governance committees with charters, and
- require companies to adopt and disclose codes for corporate governance and for business conduct.

They also require CEOs to certify to the NYSE each year that the company has set up a process to verify the accuracy and completeness of the information provided to investors. The standards also include items relating to the monitoring and enforcement of these listing standards. Importantly, the NYSE proposal would “urge” director orientation, and start a Director’s Institute in conjunction with “leading authorities in corporate governance,” including, we respectfully anticipate, the **NACD**.

A Stronger SEC

On July 25, the **Senate** confirmed four Presidential nominees for the **SEC** (two Democrats and two Republicans), and gave it some \$300 million in extra funds to hire approximately 200 auditors and investigators. The Democrats are **Roel Campos**, a Texas broadcasting executive, and **Harvey Goldschmid**, who was SEC general counsel under former chairman Arthur Levitt.⁵ The Republicans are **Cynthia Glassman** and **Paul Atkins**, who come from major accounting firms.

Framework

Sen. Sarbanes described the The Public Accounting Reform and Investor Protection Act of 2002 as a “statutory framework within which the **SEC**, the other public regulatory and law enforcement agencies, and private sector entities such as the **NYSE** and the **NASD** can act to come to grips with the problems which confront us.” Indeed it is.

Combined with the newly proposed listing requirements for **Nasdaq** and the **NYSE**, boards now have a clear framework for governance. Thankfully, much of the territory will be familiar for boards that have been following the precepts of **NACD** and other advocates of governance progress. ■

⁵ For Mr. Goldschmid’s views on governance, see “The Board Audit Committee: In the Vanguard of Change, *Director’s Monthly*, January 2000, pp. 6-7.