DIRECTORS MONTHLY

DM Extra!

May 12, 2003

Timely Commentary on Critical Events and Regulatory Developments

Stormy Weather:

Governance Whirlwind Dies Down for Public Companies, But Kicks Up for Private Firms

Director Summary

For the past 18 months, boards have endured a year of regulatory *Sturm und Drang*, with more "storm and stress" than most directors had seen in their lifetimes. To recap: the unanticipated bankruptcy of **Enron** in December 2001, followed by the equally surprising failure of **WorldCom** in June 2002, motivated **Congress** to pass legislation impacting boards in July 2002, and inspired the stock-listing bodies to propose upgrades to their listing rules shortly thereafter (August 2002 through April 2003). During the first half of 2003, the **Securities and Exchange Commission** busied itself with implementation. But now public company directors can begin to breathe a sigh of relief. For them, enforcement issues aside, the seemingly endless barrage of new "post-**Enron**" rules and regulations is finally beginning to subside.

For Public Companies, The Dust Settles

As of May 2003, the SEC has issued final rules on all the most important governance-related sections of the Sarbanes-Oxley Act (the Public Accounting Reform Act of 2002, sponsored by **Sen. Paul Sarbanes** (D-MD) and **Rep. Michael Oxley** (R-OH). Furthermore, **Nasdaq** and the **New York Stock Exchange** have revised their proposed listing rules to conform to those final rules. The SEC is likely to pass the revised rules as submitted, so little mystery remains. Finally, most major law firms (including the ones cited at the end of this *DMX*) have issued guides to relevant regulations, easing the burden of compliance.

For Private Companies, Winds of Change

So is the governance storm over? Hardly. At the state level, which affects private companies, a lot is happening.

- State legislatures are amending corporate statutes to conform to or even outdo Sarbanes-Oxley provisions.
- State CPA societies are passing new rules that will apply to all companies audited by any certified public accountant in the state.

This *DMX* outlines the scenarios facing public vs. private companies right now. First, we will summarize post-Enron reforms that have set in for public companies. Then we will report on the emerging reforms now stirring in the private company realm.

Part I: Public Company Overview

The main "storm center" for public company reform has been the SEC. This year, the Commission has had two major reform jobs. First, the agency had to issue rules implementing provisions of Sarbanes-Oxley (signed into law July 30, 2002, with most deadlines in the first half of 2003). Second, it needed to respond to the **American Stock Exchange (Amex)**, **Nasdaq**, and **New York Stock Exchange (NYSE)** on proposed new listing rules that came in to the SEC shortly thereafter. (We have covered these events in past *DMX*s, as shown in Box 1.)

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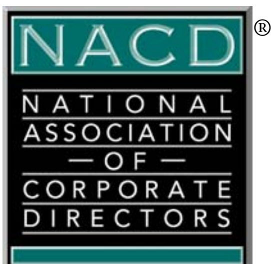

Box 1. *DMX* Eyes on the Storm
May 2002 - May 2003
For more details on the events detailed in this issue, see any of the following *DMX*s:

March 21, 2003 Director and Committee Independence, Plain and Simple: Revised Proposals from NYSE and Nasdaq Could Provide a Common Standard

February 7, 2003 The Thin Blue Line: SEC Casts Independent Directors in Starring Role for Fraud Prevention

January 14, 2003 The Heat Is Still On: Director Liability Warnings from Delaware

January 10, 2003 Governance Hot Zones: What's Ahead in 2003

October 25, 2002 SEC Takes Action on Sarbanes-Oxley, Stock Exchange Listing Requirements

August 2, 2002 Reforms Flood-Tide Crests

July 2, 2002 WorldCom: Six Questions for Directors

May 23, 2002 Current Governance Reforms: Passed vs. Pending vs. Proposed

With the exception of a new rule requiring shareholder approval of equity-based pay plans, the SEC has held off on the listing rules until now. This is just as well, since by and large the listing rules have been a moving target.

- Although the Amex has not revised its rules since publishing them on November 25, 2002, the other two exchanges have continued to make changes. **http://www.amex.com/atamex/news/am_corgov.htm**
- Nasdaq issued a series of proposals, which it most recently updated and summarized on February 26, 2003. **http://www.nasdaq.com/about/Web_Corp_Gov_Summary%20Feb-revised.pdf**
- The NYSE was "first in and last out" with changes, passing its rules on August 1, 2002; submitting them to the SEC on August 16, 2002; and later revising them. The NYSE published a detailed definition of director independence on March 12, 2003, and then referenced this in a comprehensive update of all of the proposed rules on April 9, 2003. **http://www.nyse.pdfs.amend1-04-09-03.pdf**

NYSE Developments

In early April 2003, the NYSE submitted to the SEC its first amendment to the proposed rule change its board approved last August (see *DMX* August 2, 2002).[1] The Commission published the full text of the revised rule on April 11, 2003, with a 21-day comment period. For the main points of the revised proposal, see Box 2 (on pp. 7–8).

Will the moving target move again? We predict only minor changes, for two reasons:

- First, the NYSE says that "the vast majority of commentators, including listed companies, institutional investors, and other interested organizations and individuals *enthusiastically embraced"* its recommendations for new corporate governance and listing standards for the exchange.
- Second, *the NYSE made very few changes to the rules.* The SEC release compares the new proposal of April 2003 to the original proposal of August 2002, and to SEC rules issued in 2003 for all public companies. Despite new wording throughout, the new proposal makes very few changes. It narrowed the exemption for foreign companies, and made its definition of director independence conform to the NYSE standards published in March 2003 (See *DMX* March 21, 2003), but other than that it is essentially the same as the old one. (In fact, it kept the stringent definition of "immediate family" originally proposed by the NYSE, despite a less stringent standard advanced by the SEC for all public companies.)

The revised rule will apply, in its entirety, to all companies listed on the NYSE, with a few exceptions.[2] Provisions regarding independent boards and committees will be effective in 18 months from passage, with up to 12 extra months to accommodate classified boards.

Here, from newest to oldest, is a list of the final rules the SEC has issued to implement the major governance provisions of Sarbanes-Oxley. All of these final rules are in effect now.

- Apr. 9, 2003. ***Standards Relating to Listed Company Audit Committees***. 33-8220; Release Nos: 34-47654; IC-26001. File No.: S7-02-03. **http://www.sec.gov/rules/final/33-8220.htm**

1 April 11, 2003. Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the New York Stock Exchange, Inc. Relating to Corporate Governance. Release No. 34-47672; File No. SR-NYSE-2002-33. **http://www.sec.gov/rules/sro/34-47672.htm**

2 Controlled companies (held 50 percent or more by a single person or institution), limited partnerships, and companies in bankruptcy need not comply with the independence provisions (at 303(A) 1, 4, and 5) governing the full board, nominating committees, and compensation committees. Other exemptions apply to closed-end mutual funds, trusts, foreign companies, and companies listing only debt or preferred instruments.

- Jan. 29, 2003. ***Implementation of Standards of Professional Conduct for Attorneys [Re Whistleblowing by Attorneys]***. 33-8185; Release Nos: 34-47276; IC-25919. File No.: S7-45-02.[3] **http://www.sec.gov/rules/final/33-8185.htm**
  See also the pending proposed rule on other aspects of the same topic in a release of the same date with the same title, but different release numbers (Release 33-8186; No.: IC-25920. File No.: S7-45-02).
- Jan. 28, 2003. ***Strengthening the Commission's Requirements Regarding Auditor Independence***. 33-8183; Release Nos: 34-47265; 35-27642; IC-25915; IA-2103, FR-68. File No.: S7-49-02. Effective Date: May 6, 2003.[4] **http://www.sec.gov/rules/final/33-8183.htm**
- Jan. 23, 2003. ***Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002 [Re Ethics Codes and the Audit Committee Financial Expert]***. 33-8177; Release Nos.: 34-47235. File No.: S7-40-02.[5] **http://www.sec.gov/rules/final/33-8177.htm**

The final rule of April 9, 2003, on audit committee standards, addressed the independence of audit committee members; the audit committee's responsibility to select and oversee the issuer's independent accountant; procedures for handling complaints regarding the issuer's accounting practices; the authority of the audit committee to engage advisors; and funding for the independent auditor and any outside advisors engaged by the audit committee.[6] Under the rule, listed issuers must be in compliance with the new listing rules by the earlier of their first annual shareholders meeting after January 15, 2004, or October 31, 2004.

In addition to these four broad areas, the SEC acted on other, narrower, aspects of Sarbanes-Oxley.[7] The following items are notable Sarbanes-Oxley provisions in addition to the ones highlighted here:

- Jan. 22, 2003. Insider Trades During Pension Fund Blackout Periods, 34-47225, Release Nos.: IC-25909, File No.: S7-44-02. Effective Date: January 26, 2003.
- Jan. 22, 2003. ***Conditions for Use of Non-GAAP Financial Measures***, 33-8176. Release Nos.: 34-47226; FR-65File No.: S7-43-02. Effective Date: March 28, 2003. Compliance Date: See text of release. See also: Release No. 33-8216.
- Aug. 27, 2002. ***Ownership Reports and Trading by Officers, Directors and Principal Security Holders***, 34-46421. File No.: S7-31-02. Effective Date: August 29, 2002.

All of these issues are largely resolved now.

Part II: Private and OTC Overview

Private companies have been sheltered from the governance storms described above. They do not sell shares to the general public in the U.S., so they are not listed on any stock market, and are not covered by Sarbanes-Oxley, although the full text of the law does include a suggestion to this effect.[8] But private companies are hardly immune from the changes sweeping governance. These changes are arriving via *state corporation laws*. Also, accounting practices of private companies are affected by the opinions expressed by *CPA organizations* such as the **National Association of State Boards of Accountancy (NASBA)** **(http://www.nasba.org/)** and the **American Institute of Certified Public Accountants (AICPA)** **(http://www.aicpa.org)**. Let's take a look at action on these two fronts.

State Corporate Laws

Many states have implemented reforms pertaining to audit committees and auditors, in the aftermath of Sarbanes-Oxley. By January 2003, half of all state legislatures (including, for example, Florida) had announced that they would not be implementing any Sarbanes-Oxley type laws in the first half of 2003.[9] Florida, for example, has chosen to take a cautious approach. "The Florida Board of Accountancy has taken a deliberate wait-and-see approach before deciding if Florida should adopt any of the provisions of Sarbanes or some variation for companies not covered under the act," said **John Johnson**, acting director of the division of certified public accounting in the state's **Department of Business and Professional Regulation**.[10]

3 The SEC is now reviewing comments that were due April 7, 2003.
4 See also update on Mar. 26, 2003, ***Strengthening the Commission's Requirements Regarding Auditor Independence***, 33-8183A. Release Nos: 34-47265A; 35-27642A; IC-25915A; IA-2103A, FR-68. File No.: S7-49-02.
5 See also Mar. 26, 2003, ***Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002***, 33-8177a. Release No: 34-47235A. File No.: S7-40-02.
6 The rule implements the requirements of Section 10A(m)(1) of the Securities Exchange Act of 1934, as added by Section 301 of the Sarbanes-Oxley Act of 2002.
7 For further background, see Box 1 on page 2.
8 See **http://www.aicpa.org/download/statelegis/complexity_whitepaper.pdf**.
9 Source: John T. Fakler, "State Slow on Adding New Accounting Rules, *South Florida Business Journal,* Jan 31, 2003.
10 Ibid.

The remaining 25 states have been announcing or accomplishing various legislative efforts since that time. Here are some highlights of *pending* Sarbanes-Oxley-type legislation in areas affecting boards of directors for companies both public and private operating in particular states.[11]

California

A California law effective January 1, 2003, requires a more stringent standard of disclosure for transactions involving board insiders.[12] (See Box 3, p. 8.) Four additional governance bills (which have numbers, but no final titles yet) are pending, and they are all on the "vote no" hit list of the **California Chamber of Commerce (http://www.calchamber.com)**:

- AB 664 adds a *new reporting requirement* for accountants and corporate counsels, with enhanced penalties for violations of the requirements. It requires a CPA who performs an audit for any corporation (public, private, or nonprofit) to report to the audit committee all accounting policies used during the audit. It also requires corporations to disclose whether they have adopted a code of ethics for their senior financial officers.
- AB 665 requires corporate boards be made up of a *majority of independent directors* and that various committees of the board (e.g., audit committee) be comprised of solely independent directors.
- SB 434 authorizes the attorney general to bring an action or initiate an investigation of alleged violations of *securities laws.*
- SB 821 creates a *Commission on Business Ethics* that is charged with developing an ethics exam to be administered to all persons graduating with specified business degrees.

Colorado

- HB116 amends the state's accountancy statute to reclassify *accounting fraud* from a class 3 misdemeanor to a class 3 felony. A second bill, HB 1277, was postponed indefinitely; it would prevent a *CPA from accepting employment* from a corporation within one year of auditing the firm.
- HB1218 prohibits a *board of directors from authorizing a loan* to a director of a public company.

Illinois

- SB1530 prohibits a business from bidding or entering into a *contract* with the state if the business has been convicted of a felony under Sarbanes-Oxley, within five years of the conviction.

Kentucky

- SB 10 increases penalties for falsifying *business records* or financial statements.

Maryland

- SB 560 is no longer pending. It would have forced stricter accounting and auditing rules on private companies in the state, but it was defeated in March 2003.[13] The **Maryland State Board of Public Accountancy** held a public hearing to address Sarbanes-Oxley rules on May 1. The board may also sponsor accounting regulation reform of its own next year. **http://www.dllr.state.md.us/license/occprof/account.html**

Montana

- SB 342 bans the state from entering into a *contract* with a corporation that is not in compliance with certain sections of Sarbanes-Oxley.

New Jersey

- A 2669 makes it a third degree felony a director or officer of a corporation to tamper with *corporate documents.* (Under existing law, this is a lesser crime of the fourth degree.)
- SJR 40 establishes a *New Jersey Corporate Accountability Task Force* to examine the feasibility of two items: 1) requiring corporate executives to sign corporate state tax returns, and 2) urging corporations to submit financial statements (on a voluntary basis) for review by investors and state officials.

New Mexico

- HB 495 prohibits a CPA from giving an opinion if the CPA or the CPA's firm had performed certain *non-audit services* for the same client within the past three years. These services include: management, financial, or tax advisory services. If passed, this would be stricter than the new rules for public companies under Sarbanes-Oxley, which allow tax advisory services under some circumstances.[14]

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11 Unless otherwise indicated, the source for this section is the Special Committee on State Regulation, American Institute of Certified Public Accountants (aicpa.org). Note: This description of pending legislation is not intended to advocate actions for or against the bills described, but is for information purposes only.

12 For more details, see Katie Kuehner-Hebert, "Sarbanes-Oxley Trumped in One State," *The American Banker*, January 30, 2003.

13 Source: Larry Rulison, "Senators Kill Stricter Maryland Accounting Rules," *Baltimore Business Journal*, March 7, 2003.

14 For a white paper on tax advisory services, see **http://www.burrwolff.com**.

New York

In New York, on Jan. 24, 2003, **New York State Attorney General Eliot Spitzer** proposed a series of reforms to strengthen New York's corporate accountability laws. Those proposals include guarding against abuses by not-for-profit organizations. Spitzer said he also wants to expand accounting reforms for auditors of publicly traded firms to cover "thousands of other accounting firms unaffected by the changes."[15] Here are some examples:

- A7238 prohibits auditors from providing *nonaudit services* to any business organization or public service corporation. This includes appraisal, assurance, bookkeeping, investment, legal, tax, or valuation service. (There are three other similar bills pending in the state.)
- SB3140 increases criminal penalties for business entities and their auditors for knowingly issuing financial statements for which the auditor engaged in "*professional misconduct*," a term to be defined by the **New York Board of Regents**.

Ohio

- HB 7 punishes managers or others who mislead auditors, and provides greater protections for shareholders. It also *increases the statute of limitations for lawsuits against directors* who commit certain acts. Finally, it criminalizes the act of making false statements.

Texas

- HB 2039 creates a *Corporate Integrity Unit* within the office of the Attorney General to help enforce laws against corporate fraud. The bill would also require a corporate official to sign a sworn statement certifying the correctness of the financial report—with felony charges in the case of a knowing misrepresentation.
- SB 536 places various restrictions on CPA *nonaudit services* to audit clients.
- SB 605 requires each corporation in the state to file an annual report with the State Securities Board. The officers who sign the report must review the financial report they are signing. They must also disclose to auditors the *internal controls* that could affect the corporation's ability to record, process, or summarize financial data. Finally, it makes it a felony for a director who misleads an auditor.

The AICPA and State Boards of Accountancy

Moving behind the scenes of all this activity (and tracking it for members) are two notable organizations: the **American Institute of Certified Public Accountants (AICPA)** in Jersey City, New Jersey, and the **National Association of State Boards of Accountancy (NASBA)** in Nashville, Tennessee.

The AICPA provides guidance to members on accounting issues not otherwise covered by official standards, and to influence standard-setters such as the **Financial Accounting Standards Board (FASB)** in Stamford, Connecticut (http://accounting.rutgers.edu/raw/fasb/), the **International Accounting Standards Board (IASC)** (http://www.iasb.org.uk/cmt/0001.asp), and, most recently, the **Public Accounting Oversight Board (PAOB)** (http://www.pcaobus.org/). It also keeps an eye on federal and state legislation impacting CPAs. As such, the AICPA is keeping a watchful eye on legislative issues that impact organizations using a certified public accountant. (See Box 4, p. 8.)

Since even mom and pop stores use CPAs, such issues potentially affect millions of corporations nationwide. As such, Sarbanes-Oxley will have a significant "cascade" effect, AICPA President **Barry Melancon** said in a Las Vegas speech in January.[16]

The NASBA, the only association for state accountancy boards, is also influential in state legislation. These boards are composed of CPA licensees and non-CPA "public" members who oversee the accounting industry at the state level. They are the only authorities empowered to revoke CPA licenses. Boards of accountancy set rules, and often sponsor legislations, or lobby for or against legislation.

In a January 2003 letter to the SEC, NASBA Chairman **K. Michael Conaway** and President and CEO **David A. Costello** urged the SEC to stay within the limits of Sarbanes-Oxley as it makes rules to implement the law. NASBA cited the Uniform Accountancy Act (UAA), which has been adopted in some form in a majority of states. Their letter expressed the hope that the new **Public Accounting Oversight Board** established by Sarbanes-Oxley and the SEC would strive for regulations of "vertical clarity" so that the state accountancy boards can easily translate SEC and PAOB results into swift, equitable, and defensible disciplinary actions against audit firms and individual licensees implicated in violations of the new rules."

One member of a State Board of Accountancy, speaking anonymously, observed: "While ethics cannot be legislated, it is (or should be) understood that there are legal ramifications for behavior." It the past 18 months can be boiled down to a single lesson, it is this. ■

(Boxes follow.)

15 Fakler, op. cit.
16 Ibid. [Fakler]

Box 2. Proposed New York Stock Exchange Listing Rules

(as posted on the SEC website April 11, 2003) **http://www.sec.gov/rules/sro/34-47672.htm**

1. Listed companies must have a majority of independent directors.[17]
2. In order to tighten the definition of "independent director" for purposes of these standards:
   (a) No director qualifies as "independent" unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company).[18] Companies must disclose these determinations.
   (b) In addition:
      (i) 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 presumed not to be independent until five years after he or she ceases to receive more than $100,000 per year in such compensation.
      (ii) 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 five years after the end of either the affiliation or the auditing relationship.
      (iii) 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 serves on that company's compensation committee is not "independent" until five years after the end of such service or the employment relationship.
      (iv) A director who is an executive officer or an employee, or whose immediate family member is an executive officer, of another company (A) that accounts for at least 2% or $1 million, whichever is greater, of the listed company's consolidated gross revenues, or (B) for which the listed company accounts for at least 2% or $1 million, whichever is greater, of such other company's consolidated gross revenues, in each case is not "independent" until five years after falling below such threshold.[19]
3. To empower non-management directors to serve as a more effective check on management, the non-management directors of each company must meet at regularly scheduled executive sessions without management.
4. (a) Listed companies must have a nominating/corporate governance committee composed entirely of independent directors.[20]
   (b) The nominating/corporate governance committee must have a written charter that addresses:
      (i) the committee's purpose - which, at minimum, must be to: identify individuals qualified to become board members, and to select, or to recommend that the board select, the director nominees for the next annual meeting of shareholders; and develop and recommend to the board a set of corporate governance principles applicable to the corporation;
      (ii) the committee's goals and responsibilities - which must reflect, at minimum, the board's criteria for selecting new directors, and oversight of the evaluation of the board and management; and
      (iii) an annual performance evaluation of the committee.
5. (a) Listed companies must have a compensation committee composed entirely of independent directors.
   (b) The compensation committee must have a written charter that addresses:
      (i) the committee's purpose - which, at minimum, must be to discharge the board's responsibilities relating to compensation of the company's executives, and to produce an annual report on executive compensation for inclusion in the company's proxy statement, or, if the company does not file a proxy statement, in the company's annual report filed on Form 10-K with the SEC, in accordance with applicable rules and regulations;
      (ii) the committee's duties and responsibilities - which, at minimum, must be to:
         (A) review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of those goals and objectives, and have sole authority to determine 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
      (iii) an annual performance evaluation of the compensation committee.
6. This provision defines independence for audit committee members, subject to the exemptions provided for foreign issuers.[21]
7. (a) Each company is required to have a minimum three person audit committee composed entirely of independent directors that meet the requirements of Section 303A(6).
   (b) The audit committee must have a written charter that addresses:
      (i) the committee's purpose - which, at minimum, must be to:
         (A) assist board oversight of (1) the integrity of the company's financial statements, (2) the company's compliance with legal and regulatory requirements, (3) the independent auditor's qualifications and independence, and (4) the performance of the company's internal audit function and independent auditors; and

17 Certain types of companies are exempt from this definition. Also, unders some circumstances, companies with multiple classes of stock have exemptions.

18 The SEC has clarified in subsection 2 of Section 303A that, since the concern is independence from management, ownership of even a significant amount of stock, by itself, is not necessarily a bar to an independence finding.

19 This provision includes a transition rule pertaining to a "look-back" period. See the rule for details.

20 The NYSE has clarified in subsection 4 of Section 303A that the nomination/corporate governance and compensation committee responsibilities could be allocated to other or different committees, as long as they have published charters.

21 See April 9, 2003. ***Standards Relating to Listed Company Audit Committees***, 33-8220; Release Nos: 34-47654; IC-26001. File No.: S7-02-03.

Box 2. Proposed New York Stock Exchange Listing Rules (Continued)

(B) prepare the report required by the SEC's proxy rules to be included in the company's annual proxy statement, or, if the company does not file a proxy statement, in the company's annual report filed on Form 10-K with the SEC;

(ii) the duties and responsibilities of the audit committee set out in Section 303A (7)[22](c) and (d); and

(iii) an annual performance evaluation of the audit committee.

(c) As required by Rule 10A-3(b)(2), (3), (4) and (5) of the Securities Exchange Act of 1934, and subject to the exemptions provided for in Rule 10A-3(c), the audit committee must:

(i) directly appoint, retain, compensate, evaluate and terminate the company's independent auditors;

(ii) establish procedures for the receipt, retention and treatment of complaints from listed company employees on accounting, internal accounting controls or auditing matters, as well as for confidential, anonymous submissions by listed company employees of concerns regarding questionable accounting or auditing matters;

(iii) obtain advice and assistance from outside legal, accounting or other advisors as the audit committee deems necessary to carry out its duties; and

(iv) receive appropriate funding, as determined by the audit committee, from the listed company for payment of compensation to the outside legal, accounting or other advisors employed by the audit committee.

(d) In addition to the duties set out in Section 303(A)(7)(c), the duties of the audit committee must be, at a minimum, to:

(i) at least annually, obtain and review a report by the independent auditor describing: the firm's internal quality-control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and (to assess the auditor's independence) all relationships between the independent auditor and the company;

(ii) discuss the annual audited financial statements and quarterly financial statements with management and the independent auditor, including the company's disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations;"

(iii) discuss earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies;

(iv) discuss policies with respect to risk assessment and risk management;

(v) meet separately, periodically, with management, with internal auditors (or other personnel responsible for the internal audit function) and with independent auditors

(vi) review with the independent auditor any audit problems or difficulties and management's response;

(vii) set clear hiring policies for employees or former employees of the independent auditors; and

(viii) report regularly to the board of directors.

(e) Each listed company must have an internal audit function.

8. [The NYSE left this part blank. It is "reserved" for final language on shareholder approval of equity compensation plans.]

9. Listed companies must adopt and disclose corporate governance guidelines.
   The following subjects must be addressed in the corporate governance guidelines:
   - Director qualification standards.
   - Director responsibilities
   - Director access to management and, as necessary and appropriate, independent advisors.
   - Director compensation.
   - Director orientation and continuing education.
   - Management succession.
   - Annual performance evaluation of the board.

10. Listed companies must adopt and disclose a code of business conduct and ethics for directors, officers and employees, and promptly disclose any waivers of the code for directors or executive officers.
    Each company may determine its own policies, but all listed companies should address the most important topics, including the following:
    - Conflicts of interest.
    - Corporate opportunities.
    - Confidentiality.
    - Fair dealing.
    - Protection and proper use of company assets.
    - Compliance with laws, rules and regulations (including insider trading laws).
    - Encouraging the reporting of any illegal or unethical behavior.

11. Listed foreign private issuers must disclose any significant ways in which their corporate governance practices differ from those followed by domestic companies under NYSE listing standards.

12. (a) Each listed company CEO must certify to the NYSE each year that he or she is not aware of any violation by the company of NYSE corporate governance listing standards.
    (b) Each listed company CEO must promptly notify the NYSE after any executive officer of the listed company becomes aware of any material non-compliance with any applicable provisions of this Section 303(A).

13. The NYSE may issue a public reprimand letter to any listed company that violates a NYSE listing standard.

Note: *For a discussion of comments received with respect to NYSE's proposal regarding shareholder approval of equity-compensation plans which was filed as a separate proposal, see Securities Exchange Act Release No. 46620 (October 8, 2002), 67 FR 63486 (October 11, 2002) (SR-NYSE-2002-46).*

22 General Commentary to Section 303A(7): To avoid any confusion, note that the audit committee functions specified in Section 303A(7) are the sole responsibility of the audit committee and may not be allocated to a different committee.

Box 3. Spotlight on California

A new corporate governance law, the California Corporate Disclosure Act of 2003, applies to companies and banks whose stocks are traded over the counter and on pink sheets but not registered with the Securities and Exchange Commission. California is considered to be the first state that passed its "own version" of Sarbanes-Oxley.

Under the new California law, all public companies doing business in the state (including those not subject to Sarbanes-Oxley) must report all stock options and loans made to their directors, as well as information on bankruptcies, fraud convictions, or fines for violations of securities or banking laws by the company or its directors or officers. It also requires that audit committees have a financial expert. The previous standard required much less disclosure. Public companies had to file a report every two years, telling what business they conducted, and giving the name and address of the company and its directors and officers.

Daniel J. Doyle, the president and CEO of the $283 million-asset Central Valley Community Bancorp in Clovis, California, complained to *American Banker*, "I would call this the big brother of Sarbanes-Oxley. It's definitely more onerous. Also, I think it's just another opportunity for regulators to find some little technical mistake where we forgot to dot an 'i' or cross a 't' and then fine us for it."

Source: Katie Kuehner-Hebert, "Sarbanes-Oxley Trumped in One State," *The American Banker*, January 30, 2003.

Box 4. The State Cascade—An Overview of the State Issues Related to the Sarbanes-Oxley Act

From the AICPA Special Committee on State Regulation

Corporate governance, Wall Street, and auditing reform regarding public companies have been in the forefront of Congressional activity during the last year. The AICPA and the State CPA Societies have actively participated in and supported the reforms that have been adopted at the federal level.

Congress passed, and President Bush signed, the Sarbanes-Oxley Act of 2002 providing unprecedented new requirements for auditors of public companies, corporations, and Wall Street. At the state level, several state legislators, regulators, and other elected or appointed officials are seeking to duplicate and or extend provisions of the Sarbanes-Oxley Act to private companies and their auditors at the state level.

While some measures may have merit and could possibly be supported, some of what is being discussed is overreaching and simply should not apply to CPAs and CPA firms that do not provide audits to publicly traded companies.

As states consider some of these provisions, the potential for an adverse impact on small businesses and the CPA firms which serve them is concerning.

Small businesses make up roughly half of the U.S. economy and are a primary source of economic growth and job creations. In an increasingly complex business world, these small businesses depend upon their CPAs for the expertise and trusted advice to put complicated issues into context so they can continue to fuel that growth.

One of the steps taken by the AICPA to respond to the state issues resulting from the Sarbanes-Oxley Act was the formation of the AICPA Special Committee on State Regulation. Working closely with state CPA societies, this high-level volunteer committee is tasked with addressing the state implications associated with the Sarbanes-Oxley Act, recommending positions to the AICPA Board of Directors, and providing resources and guidance to states with state legislative or regulatory proposals.

Three Themes for Reform

The Special Committee has identified three overarching themes:

- The profession should advocate for a reasoned approach to reform at the state level.
- Uniformity of state laws is essential to protecting the public interest.
- The complexity of the issues needs to be articulated and communicated

In January 2003, the Special Committee released the first edition of a series of white papers and issues briefs, known collectively as "A Reasoned Approach to Reform." These materials have been distributed to state CPA societies and are also available for download as PDF files by visiting ***http://www.aicpa.org***.

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