

DM Extra

Research Edition

October 25, 2002
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Timely Commentary on Critical Events
and Regulatory Developments

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

“Hurry up and wait.” That seemed to be the pace of change in governance the past two months.

The summer hosted rush of reforms, with the stock markets, Congress, and White House all fast-tracking their agendas for change. The [Nasdaq {www.nasdaq.com}](http://www.nasdaq.com) board voted for a package of governance requirements on July 24, and the [New York Stock Exchange {www.nyse.com}](http://www.nyse.com) published its own set on August 1—just a day after **President Bush** signed into law the Public Accounting Reform and Protection Act of 2002, known as the

Sarbanes-Oxley Act after sponsors **Sen. Paul Sarbanes** (D-MD) and **Hon. Charles Oxley** (R-OH).

That was the “hurry” part. Then came the wait. All eyes have been on the [Securities and Exchange Commission {www.sec.gov}](http://www.sec.gov), which must approve the proposed stock exchange listing requirements, and must implement Sarbanes-Oxley. What has the SEC done to date in response to these events? What is the SEC’s calendar going forward? That is the subject of this *DMX*. At many of our recent chapter meetings, we have explored this topic (see box on p. 2).

Director
Summary >>

Maintaining a Sense of Urgency in the Race for Reform

There’s an old saying, “slow and steady wins the race.” We at NACD agree—to a point. We know all about the slow pace of progress. After all, we were “governance when governance wasn’t cool.” From 1977 to the present day, working with corporate directors, we persistently produced publications and seminars on then-arcane topics such as “the effective audit committee” at a time when few seemed to care. We were not alone. Consider years of standards-setting work by the **American Institute of Certified Public Accountants** and the **Financial Accounting Standards Board**—or the work of membership organizations such as the **Financial Executives Institute (FEI)**, the **Institute of Internal Auditors (IIA)**, and the **American Corporate Counsel Association (ACCA)**.

Those years of work prepared the ground for change. The seemingly “overnight” reforms of this past summer came about because stock market officials and lawmakers patiently listened to NACD and these other groups tell them about the best practices and standards it took us all decades to develop. But the time of slow and steady preparation has passed. The issue is now at the top of everyone’s agenda—directors and the SEC included.

NACD has held seminars with the FEI, IIA, and ACCA in the past several weeks to educate corporate directors on corporate governance standards. Similarly, you, as directors, have an opportunity to take part in this wave of the sea change in corporate governance. You can comment on pending rules (see box on p. 3). In addition, you can work with your internal and external auditors and legal counsel to implement relevant portions of Sarbanes-Oxley on your boards. You can also study newly proposed stock market listing requirements. Although none of the proposals are mandatory yet, you can decide which ones would be helpful to your board, and implement them on a voluntary basis now.

In the end, the race goes to the swift.

Roger W. Raber, NACD President and CEO

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Reforms at a Glance

The **Sarbanes-Oxley Act** www.thomas.loc.gov (and enter **H.R. 3763**) widely hailed as “the most dramatic change to federal securities laws since the 1930s.” (That is when the **SEC came into being**.) The Act changes federal regulation of public company reporting and corporate governance (audit committee) obligations. It also tightens accountability standards for directors and officers, auditors, securities analysts, and legal counsel. This bill has 80 sections.

The proposed **New York Stock Exchange** www.nyse.com/about/report.html and **Nasdaq** www.nasdaq.com/about/Corp_Gov_Summary101002.pdf listing requirements are also revolutionary. They have essentially codified virtually every “best practice” recommendation that has emerged around the world in the past three decades.¹

Sarbanes-Oxley Deadlines

Immediate Deadlines Under Sarbanes-Oxley

Some deadlines are immediate and some are general. Action is occurring in waves. Many provisions were effective upon the signing of the bill (on July 30, 2002), or up to 30 days

later. Most of these pertain to the sanctions that the SEC may impose upon criminal conduct. Some, however, focus on corporate governance. These include:

■ **Certification of financial reports by CEOs and CFOs.** This provision was effective 30 days after the signing of the bill. However, under an SEC action announced prior to the passage of Sarbanes-Oxley, CEOs of the largest 945 public companies had to certify financial reports by August 14. The deadline passed without a hitch. *Advisory: The certification requirement may not be as easy for the smaller companies (the other 14,000 listed firms) now required to comply with it.*

■ **Prohibition of personal loans to officers.** Sarbanes-Oxley makes it illegal for companies to extend credit or arrange for credit in the form of a loan to executives and directors. A group of 25 law firms headed by **Fried, Frank, Harris, Shriver & Jacobson** has issued an opinion on what types of transactions should be permissible under this new law, for example, the cashless exercise of options. **Pearl Meyer & Partners** has advised its clients to avoid the loan label by delivering shares to the broker before receiving the exercise price. PMP also says to open it up to many brokers, rather than having one captive broker. *Advisory: Ask the advice of experts about this provision.*

■ **SEC power to bar officers and directors who are “unfit.”** Under Sarbanes-Oxley, the SEC can bar any officer or director who proves (through an administrative proceeding) to be “unfit.” *Advisory: This should not be of concern to honest directors, but it does make easier for the SEC to impose disbarment. (The SEC used to have to go to court.)*

General Deadlines Under Sarbanes-Oxley

The remainder of the deadlines under Sarbanes-Oxley are dates by which the SEC or **General Accounting Office** must either submit reports or propose and adopt rules.² The SEC has nine deadlines for reports and 23 deadlines for the proposal and adoption of rules.

New SEC Rules Implementing Sarbanes-Oxley

To date, the SEC has already acted on four of deadlines—namely, deadlines calling for the SEC to issue rules on audits, internal controls,

1 For a summary of these developments, see the August 2, 2002, issue of DMX.

2 DMX Editors acknowledge helpful materials from several law firms: **Fried, Frank, Harris, Shriver & Jacobson** www.friedfrank.com; **Gibson, Dunn & Crutcher** www.gibsondunn.com; **Patton Boggs** www.pattonboggs.com; **Jones Day Reavis & Pogue** www.jonesday.com; and **Weil, Gotshal & Manges** www.weil.com.

NACD Chapter Action

NACD president **Roger Raber** and senior NACD staff have been serving as moderators or panelists in support of NACD Chapters in recent months, reporting breaking developments in these areas.

■ In September, at a **New York Chapter** event hosted by TIAA-CREF, attendees heard from **Hon. Michael Oxley** (R-OH), cosponsor of the Sarbanes-Oxley Act. Also on the panel was **Holly Gregory**, Partner, **Weil Gotshal & Manges**, the law firm of Chapter president **Gerald Backman** and NACD director **Ira M. Millstein**.

The October calendar was particularly crowded as well:

■ **National Capital Area Chapter** president **John (“Jack”) Moore** organized a panel featuring **Frank X. Bochanski**, director of independence policy and training with **KPMG LLP** in the firm’s national office in New York City, and **Mary M. Sjoquist**, a business practice leader and partner with the Washington, D.C., office of **Patton Boggs** law firm.

■ **Atlanta Chapter** president **Jim Reda** hosted a “Directors’ College” at the **Terry School of Business at the University of Georgia**, featuring Roger Raber and others.

■ **Minnesota Chapter** president **John Stout** organized a panel discussion on governance featuring **Thomas Holloran**, former president and longtime director of **Medtronic**, who received a Lifetime Achievement award for distinguished service on both corporate and nonprofit boards.

ethics, and financial expertise. First, the SEC held a meeting on **October 16** with a follow-up press release concerning all four of these matters. On **October 18**, it published a formal release on the first matter: “Proposed Rule: Improper Influence on Conduct of Audits.”³ On **October 22** it published “Disclosure Required by Sections 404, 406, and 407 of the Sarbanes-Oxley Act of 2002.”⁴

The SEC has asked for comments on these proposals. For guidance on submitting comments, see the box below.

Here are highlights (with quotes from the latest SEC Releases):

■ **Improper influence on the conduct of audits.**

This rule contains specific language pertaining to the Sarbanes-Oxley ban on officer or director deterrence of the proper conduct of an external audit of company financial records. The rule would “prohibit officers and directors of an issuer, and persons acting under the direction of an officer or director, from taking any action to fraudulently influence, coerce, manipulate, or mislead the auditor of the issuer’s financial statements for the purpose of rendering the financial statements materially misleading.”

Advisory: To conform to this standard, companies will need a strong program to detect and avoid fraud. NACD and other organizations such as the IIA, have publications that can be useful in this regard. Comments are due November 25, 2002.

■ **Management assessment of internal controls.** The proposed rule would require companies to include an “annual internal control report of management” stating the following:

- “management’s responsibilities for establishing and maintaining adequate internal controls and procedures for financial reporting for the company
- management’s conclusions about the effectiveness of the company’s internal controls and procedures for financial reporting as of the end of the company’s most recent fiscal year
- and that the company’s registered public accounting firm has attested to, and reported on, management’s evaluation of the company’s internal controls and procedures for financial reporting.”

Advisory: Companies with a well-developed internal audit function should have no problem conforming to this standard. For guidance on the internal auditing, contact the [Institute of Internal Auditors {www.theiia.org}](http://www.theiia.org). See

also the [Report of the NACD Blue Ribbon Commission on Audit Committees](#). Comments are due to the SEC within **30 days** after publication in the *Federal Register* (pending).

- **Code of ethics.** This proposed rule, which goes beyond the original Sarbanes-Oxley language, requires companies to disclose in its annual report whether they have “adopted a code of ethics that covers their principal executive officers and senior financial officers, or if they have not, an explanation of why they have not, as well as amendments to, and waivers from, the code of ethics relating to any of those officers.” It must include the code as an attachment to its 10-K report.

The rule would define a code of ethics as a “codification of standards that is reasonably necessary to deter wrongdoing and to promote:

- honest and ethical conduct*, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships
- avoidance of conflicts of interest*, including disclosure to an appropriate person or persons identified in the code of any material transaction or relationship that reasonably could be expected to give rise to such a conflict
- full, fair, accurate, timely, and understandable disclosure in reports and documents that a company files with, or submits to, the Commission and in other public communications made by the company*

³ Release Nos. 34-46685; IC-25773; File No. 57-39-02.

⁴ Release Nos. 33-8138; 34-46701; IC-25775; File No. 57-40-02.

SEC Instructions for Submitting Comments

NACD is not a lobbying organization, and does not tell members or legislators how to vote on any issue. Our mission is to educate NACD members and the wider public about corporate governance issues. As a public service, we encourage participation in our democratic institutions. To this end, we are reprinting SEC instructions for submitting comments:

Interested persons are invited to submit written data, views, and arguments concerning the foregoing...Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, ...will be available for inspection and copying in the Commission’s Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NYSE. All submissions should refer to File No. SR-NYSE-2002-46 and should be submitted by [21 days from date of this publication].

Margaret H. McFarland, Deputy Secretary, SEC

- compliance with applicable governmental laws, rules and, regulations
- the prompt internal reporting of code violations to an appropriate person or persons identified in the code, and
- accountability for adherence to the code.”

Comments are due to the SEC within **30 days** after publication in the *Federal Register* (pending).

- **Audit committee financial experts.** Under this proposed rule, “First, companies would be required to disclose the number and names of persons that the board of directors has determined to be the ‘financial experts’ serving on the company’s audit committee and whether they are independent of management, and if not, an explanation of why they are not.”

The SEC defines “financial expert” as a person with all the attributes listed in Section 407 of Sarbanes-Oxley, including an understanding of generally accepted accounting principles and financial statements, experience in the preparation or auditing of financial statements, experience with internal accounting controls, and an understanding of audit committee functions. *Comment: These standards apply to foreign issuers, according to Division of Corporate Finance director Alan Beller. They are narrower than those proposed under NYSE and Nasdaq proposed rules and may render those moot.* Comments are due to the SEC within **30 days** after publication in the *Federal Register* (pending).

Deadlines for the SEC or GAO Reports Due Under Sarbanes-Oxley

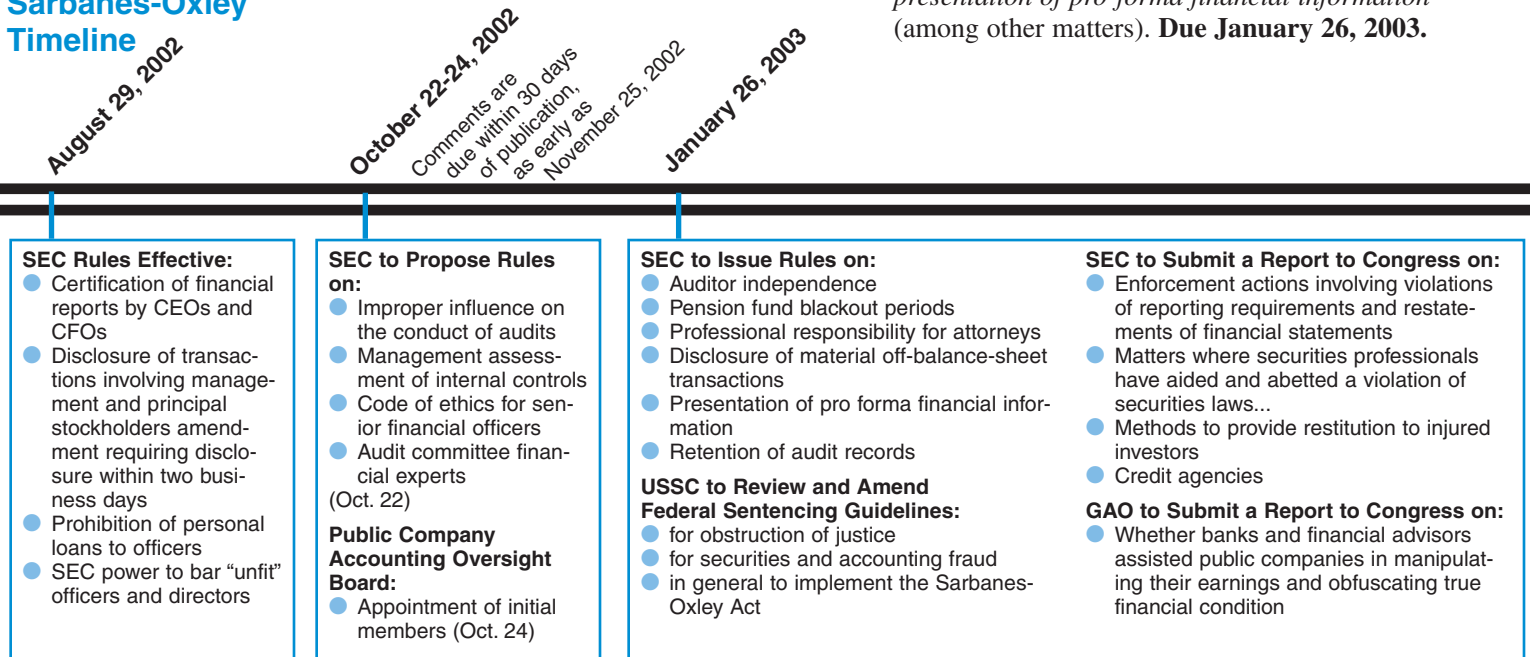
- Miscellaneous studies regarding violations of securities rules: due **January 26, 2003**.
- SEC report on principles-based accounting, GAO report on mandatory rotation of external auditors, and GAO report on public accounting firm mergers: due **July 30, 2003**.
- SEC report on off-balance-sheet financing: due **January 26, 2004**.

Deadlines for the 23 SEC Rules Due Under Sarbanes-Oxley

The timeline for proposals and rules under Sarbanes-Oxley is complex, with several different clusters of deadlines. Key dates pertaining to corporate governance matters include the following:

- SEC proposals for rules pertaining to improper influence on the *conduct of audits, code of ethics for senior financial officers, and definition of “financial expertise.” Completed October 22 (see above).*
- *Appointment of initial board members for the Public Company Accounting Oversight Board, with later dates (April 26, 2003, for budget, and October 23, 2003, for registration of public accounting firms to the Board): Announced October 24, 2002. (Judge William H. Webster was named chairman.)*
- SEC rules re *auditor independence, disclosure of material balance sheet transactions, and presentation of pro-forma financial information (among other matters). Due January 26, 2003.*

Sarbanes-Oxley Timeline



- SEC rules prohibiting the listing of companies not in compliance with the *audit committee* provisions of the law. (See August 2, 2002, *DMX*.) **Due April 26, 2003.**
- Provisions of Sarbanes-Oxley re disclosure of *insider transactions* involving management (among other matters). **Effective July 30, 2003.**

NYSE and Nasdaq Deadlines

(Assuming SEC approval)

In brief outline, the NYSE proposals cover the following topics, under Section 303.00: Corporate Governance Standards of the *Listed Company Manual*:

1. Majority independence of the board.
2. Definition of independence.
3. Executive sessions of board.
4. Independent governance/nominating committee.
5. Independent compensation committee
6. Independent audit committee (with stricter definition of independence).
7. New powers of audit committee.
8. Shareholder vote on equity compensation plans.
9. Adoption and disclosure of corporate governance guidelines.
10. Adoption and disclosure of code of business conduct and ethics.
11. Disclosure by foreign issuers of standards different from these NYSE governance standards.
12. CEO certification of conformity to these NYSE governance standards.
13. Public reprimand letter for companies that violate standards; possible delisting for repeated or flagrant violators.

The NYSE proposals must be implemented in **six months** from the time that the SEC approves them, except for the some of the independence proposals. The deadline for **Nasdaq** compliance is the first annual meeting after January 1, 2004.

Fast-Track: Effective Dates for Shareholder Approval of Shareholder Votes on Equity Compensation Plans (Section 303A, Item 8)

This proposal was the first one to draw SEC attention. After receiving the NYSE's corporate governance proposals, the SEC specifically requested that the NYSE file this proposal separately from its remaining proposals "to expedite review and processing" of these matters.⁵ www.sec.gov/rules/sro/34-46620.htm

After receiving this request from the SEC, the NYSE modified the language of its proposal, and submitted it with this new wording, as posted for comment October 8:

"8. To increase shareholder control over equity-compensation plans, shareholders must be given the opportunity to vote on all equity-compensation plans, except inducement awards, plans relating to mergers or acquisitions, and tax qualified and parallel nonqualified plans."

(The original language proposal said "excess benefit plans" rather than "parallel nonqualified plans.")

This new proposal will be **effective 35 days after publication** of this notice in the *Federal Register*. By that time (unless it needs an exten-

5 October 8, 2002:
Release No. 34-46620; File No. SR-NYSE-2002-46.

April 26, 2003

July 30, 2003

October 23, 2003

(Or sooner if SEC's determination on the Board's capacity to function occur before April 26, 2003)

January 26, 2004

Public Company Accounting Oversight Board:

- First annual budget
- Initial and transitional professional standards
- Proposed initial rules

SEC to Issue Rules on:

- Prohibiting listing securities of issuers that do not comply with amended audit committee rules

SEC Rules Effective:

- Disclosure of transactions involving management and principal stockholders amendments

SEC to Issue Rules on:

- Analyst conflicts of interest
- Disclosure of analyst conflicts of interest

SEC to Submit a Report to Congress on:

- Adoption of a principles-based accounting system

GAO to Submit a Report to Congress on:

- Effects of mandatory rotation of registered public accounting firms
- Factors that have led to the consolidation of public accounting firms since 1989

Public accounting firms must be registered with the Public Company Accounting Oversight Board

Once registered, the firms must comply with these provisions:

- Prohibitions on providing certain non-attest services to audit clients
- Mandatory audit partner rotation every five years
- Providing audit committees with detailed reports
- Conflicts of interest rules
- Financial reports must reflect all material correcting adjustments

SEC to Complete a Study of Filings/ Disclosures by Issuers on:

- Extent of off-balance sheet transactions
- Use of special purpose entities
- Whether GAAP results in financial statements reflect the economics of such transactions in a transparent way (Report due to Congress six months later)

6 NACD's Director's Registry™ is not affiliated with the anonymous website of a similar name that is attempting to solicit personal information about directors without revealing its own ownership or location. We would advise directors to avoid providing information to any such entity.

sion of up to 90 days) the SEC will either approve the proposed rule change or begin investigating reasons to disapprove it. Meanwhile, the rule is up for public comment. The deadline for comment is **21 days from publication** of the notice in the *Federal Register*.

Slow-Track: Effective Dates for Independence Proposals

(NYSE Section 303A, Items 1-6, and similar Nasdaq proposals)

Both the NYSE and the Nasdaq have proposed that the boards of all listed or quoted companies must have a *majority* of independent directors. Current guidelines set a number (three) rather than a percentage.

In recognition of the amount of time that it can take boards to recruit qualified directors, the NYSE has proposed a phase-in period of **24-months**. The NYSE already had a requirement that audit committees be entirely independent. The NYSE proposal would now require that compensation and governance/nominating committees also be independent. Following the board timeline, these committees have **24 months** to become independent, provided that at least one member is independent within **12 months**. *Advisory: Directors seeking qualified independent directors should place a priority on the establishment of an independent nominating committee to recruit and select such directors. The committee can consider using an executive recruiting firm to complete its work. Additionally, the committee can consider using NACD's Director's Registry,™ a free service connecting boards to our members.*⁶

According to a press release issued the week of October 7, "Nasdaq contemplates that rule changes affecting board of director or board committee composition will become effective with a listed company's first annual meeting after January 1, 2004." You can find the proposed text of this and other proposed Nasdaq announcements regarding the rules at www.Nasdaqnews.com, Corporate Governance button.

Open Deadline for Definition of "Financial Expert"

In addition to the independence requirements, all audit committee members must be financially literate and at least one member must be a financial expert. The NYSE is waiting on the SEC's interpretation of "financial expert" before enforcing this rule. That interpretation came out October 22 (see above).

The Ultimate Timeline: ASAP

Clearly, the timeline is long and complex. The exact wording of many rules remains open, pending SEC action and/or public comment. To be fully responsive to all these unfolding changes, boards must put their governance reforms on a rolling schedule, taking immediate action as each rule becomes clear. Once rule language is clear, boards should take action as promptly as possible. In cases where they must wait because the rule language is not final, boards should prepare themselves for change by focusing on the principles involved.

In its October 8, 2002, release concerning shareholder approval of stock-based compensation, the SEC staff makes some excellent points that directors should take to heart. The SEC says that the NYSE proposals "are designed to further the ability of honest and well-intentioned directors, officers, and employees to perform their functions effectively." Further, the Commission notes:

"While many of the requirements set forth in this new rule are relatively specific, the Exchange is articulating a philosophy and approach to corporate governance that companies are expected to carry out as they apply the requirements to the specific facts and circumstances that they confront from time to time. Companies and their boards are expected to apply the requirements carefully and in good faith, making reasonable interpretations as necessary, and disclosing the interpretations that they make."

The same philosophy could apply to all of the many rules that boards will be living with in the future. Prompt and responsive action is the key. ■

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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.