

DM Extra!

February 7, 2003

Timely Commentary on Critical Events and Regulatory Developments

The Thin Blue Line: SEC Casts Independent Directors in Starring Role for Fraud Prevention

The SEC wants you! Directors are being called to form a “thin blue line” against fraud—as never before. How did it happen? This *DMX* explains.

As everyone knows, the decisive line-up began on July 24 when the [Nasdaq \[www.nasdaq.com/about/ProposedRuleChanges.stm\]](http://www.nasdaq.com/about/ProposedRuleChanges.stm) (see “Selected Press Releases”) board voted for a 25-part package of governance requirements,

and continued through August 1 with the announcement by the [New York Stock Exchange \[www.nyse.com\]](http://www.nyse.com) (see “Corp. Governance”) of 13 detailed proposals for improved governance of listed companies. (Also see Box 1 on next page.) Between these two landmark events, on July 30, Congress passed the Public Accounting Reform and Protection Act of 2002. Known as the

Director Summary >>

Directors Get Respect—and Potential Liability Exposure

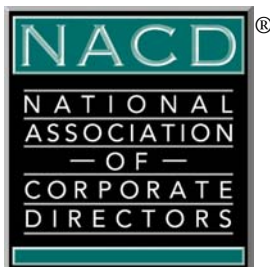
We directors have always known that we are the investor’s last bulwark of protection against fraud. Now this role is official. Are we ready for it?

Our chapters certainly are. Within a month of the passage of the “Sarbanes-Oxley” bill, our **New York Chapter**, headed by **Gerald S. Backman**, invited **Rep. Michael Oxley** to speak to our troops. “Sarbanes-Oxley: Impact on Board Directors” was the topic of the November 5 meeting of the **Connecticut Chapter** led by **Jack Veale**. Featured speakers included **Bob Hallagan**, **Ralph Ward**, and **John Doernberg**. **Southern California Chapter** chairman of the board **Dann V. Angeloff** was the keynote speaker at a program entitled “Sarbanes-Oxley D&O Insurance and Liability Challenges—Are You adequately Protected?” on December 10. **SEC Commissioner Harvey J. Goldschmid** spoke before the **New York Chapter** on December 16 on “The New Corporate Governance Challenges After Sarbanes-Oxley.” The **Silicon Valley Chapter**, under the leadership of **Mario O. Mariasch**, held a breakfast meeting entitled “Corporate Ripoffs: Who Watches the Watchers?” on December 19. Meanwhile, NACD’s national faculty has been busy explaining Sarbanes-Oxley at a variety of seminars and “in-board” sessions with major companies. On April 22, the **Washington, D.C. Chapter**, headed by **Jack Moore** and **Larry Schumann**, will hold a panel on all the new SEC rules pertaining to audit committees, as outlined in this *DMX*.

In the following pages, we bring directors up to date on a few recent, highly significant developments in the **Securities and Exchange Commission’s** slow but steady rulemaking pertaining to Sarbanes-Oxley and (more sporadically) the proposed rules for listing requirements for the **New York Stock Exchange**, **Nasdaq**, and **Amex**. As you will see, these developments put directors in a starring role as fraud busters. What new responsibilities will they shoulder? Will these responsibilities increase their exposure to liability, or is there a “safe harbor”? To find out, read on.

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1 For a calendar of rulemaking deadlines, see the [October 25, 2002, issue of DMX](#) [[www.nacdonline.org](#) (log on to “members” section)].

2 Final Rule 33-8177, Release Nos. 34-47235, File No. S7-40-02. Effective date March 3, 2003. Comments due February 18, 2003.

Sarbanes-Oxley Act after sponsors **Sen. Paul Sarbanes** (D-MD) and **Rep. Charles Oxley** (R-OH), this law tightens accountability standards for directors and officers, internal and external auditors, securities analysts, and legal counsel. In the fall, the **American Stock Exchange** [[www.amex.com](#) (see [Sept. 13, 2002 press release](#))] issued proposed new listing rules based in part on these developments.

SEC Action

For the past six months, the **Securities and Exchange Commission (SEC)** [[www.sec.gov](#)] has been implementing parts of all of these initiatives, while directors and their advisors have been scurrying to cope with a barrage of proposed and final rules.

The SEC’s main focus has been on Sarbanes-Oxley, which covers and supersedes many of the items in the stock market proposals. Some Sarbanes-Oxley provisions were effective immediately upon the signing of the bill or up to 30 days later. These congressionally “done deals” revolved around SEC sanctions against criminal

behavior, certification of financial reports by CEOs and CFOs, prohibition of personal loans to officers, insider transactions, and SEC power to bar officers and directors for “unfitness.” Most Sarbanes-Oxley provisions, however, required rulemaking by the SEC, which has been meeting a series of deadlines (nearly two dozen) that will continue through January 2004.¹

Most recently, the SEC has issued final rules defining the board’s role in *whistleblowing*, requiring *codes of ethics*, and clarifying the definition of the *audit committee financial expert*, among other matters. Also of note is a proposed rule concerning a variety of *standards for audit committees*.

Whistleblowing

Final Rule on Implementation of Standards of Professional Conduct for Attorneys² (Jan. 29, 2003)

Should attorneys blow the whistle on fraud? How should the board get involved? Section 307 of Sarbanes-Oxley addresses this important question. The SEC has adopted rules under this

Box 1

Stock Market Listing Proposals at a Glance

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. [This has passed with a final SEC rule.]
9. Adoption and disclosure of corporate governance guidelines.
10. Adoption and disclosure of code of business conduct and ethics—overlaps with S-O 406.
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 violations.

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 25 proposed **Nasdaq** rules:

- Strengthen board independence by requiring a majority-independent board, regular meetings of boards in executive session, tightening the definition of independence, and giving a three-year cooling-off period for certain nonindependent persons.
- Give a greater voice to independent directors and/or shareholders in board nominations and executive pay.
- Empower audit committees by giving them sole authority to hire and fire independent auditors and to approve all audit-related services. The new requirements also give audit committees authority to retain lawyers and consultants.
- Improve the quality of audit committees by requiring the ability to read and understand financial statements “at the time of appointment.”
- Empower shareholders by mandating their approval of all stock option plans (except for existing employee stock option plans).
- Mandate codes of conduct to address conflicts of interest and legal compliance, with enforcement mechanisms and full disclosure of the code and any waivers.
- Mandate continuing education for directors

For the **American Stock Exchange** corporate governance proposals of November 25, 2002, go to [www.amex.com/atamex/news/am_CorGov.htm](#)

For information about **NACD** programs, visit [www.nacdonline.org/seminars](#).

section that require public company attorneys (both internal and external) to report evidence of a “material” violation of law “up the ladder” within the company. According to prior SEC guidance, materiality “concerns the significance of an item to users of a registrant’s financial statements.” For the SEC, “a matter is ‘material’ if it has a substantial likelihood that a reasonable person would consider it important.”³

The final whistleblowing rules require an attorney who suspects a material legal violation to “report any evidence to the company’s chief legal officer, or to its chief legal officer and CEO. Furthermore, under the final rule, the company’s chief legal officer has to inquire into the evidence of the material violation and, unless he or she “reasonably believes that no material violation has occurred, is ongoing, or is about to occur,” then he or she must take “reasonable steps to cause the issuer to adopt an appropriate response to the attorney’s report.”

How does the board come into the picture? If an attorney who has made a report of the violation does not reasonably believe that the report is getting an appropriate and timely response, then he or she must “report the evidence to an appropriate committee of the [company’s] board of directors. An attorney who reasonably believes that the [company] has not made an appropriate response shall explain his or her reasons to the [company’s] chief legal officer, chief executive officer, or board of directors.” (Emphasis added.)

Alternatively, the attorney may report evidence of the suspected violation to a “qualified legal compliance, committee,” which the final rule defines as “a committee established to consider and investigate attorney reports under the rule and to recommend appropriate responses to such reports.”

The SEC has also issued a proposed rule of the same title (still pending) with further details, and asking for comments.⁴ For example, the SEC poses the example of an attorney who reports a suspected legal violation to an independent committee and then hears back from an independent committee that there has not been a material violation. Must the attorney take the committee’s word for it, or may the attorney still report the suspected violation to the SEC? The NACD, along with the [American Corporate Counsel Association \[www.acca.com\]](http://www.acca.com), is currently reviewing such questions for possible com-

ment by the closing date of April 7, 2003. (See Box 2.)

Ethics Codes and Financial Experts

Final Rule on Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002⁵

Should audit committees be filled with experts? Should companies have *ethics codes*? It might sound easy to say “yes,” but how does one implement these ideas? Not surprisingly, the SEC received over 200 comment letters in response to its release proposing requirements to implement these sections of the Sarbanes-Oxley Act. These comment letters came from a variety of sources, including corporations, professional associations, accountants, law firms, analysts, consultants, academics, investors and others. (For the response of **Edward Knight**, the general counsel of **Nasdaq**, see Box 3 on next page.) The final rule, which takes up 161 pages of fine print, incorporates many of these suggestions.

Code of Ethics (Section 406)

Section 406 of the Sarbanes-Oxley Act directed the SEC to issue rules requiring public companies to disclose whether or not they have adopted a code of ethics for their senior financial officers that applies to the companies’ principal financial officers and controllers or principal accounting officers, or persons performing similar functions. The law also asked the SEC to require that companies that have not adopted such a code of

3 The Financial Accounting Standards Board and the U.S. Supreme Court have also issued definitions of materiality. See [Risk Oversight—Report of the NACD Blue Ribbon Commission \(Washington, D.C.: NACD, 2002\)](#), especially p. 55, “Three Definitions of Materiality.”

4 Proposed Rule 33-8186 Jan. 29, 2003, Release No. IC-25-920, File No. S7-45-02. Comments due April 7, 2003.

5 Final Rule 33, Release Nos. 33-8177; 34-47235; File No. S7-40-02. Effective date March 3, 2003. Comments due February 18, 2003. The release also includes requirements to implement Section 404 of the Act, relating to internal control reports and auditor attestations of those reports. The SEC will issue the final rules at a later date.

Box 2

NACD is not a lobbying organization, and does not tell members or legislators how to vote on any issue. However, as a part of our public service, we do encourage participation in our democratic institutions. To this end, we are reprinting SEC instructions for submitting comments:

Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. Comments also may be submitted electronically at the following e-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7-40-02; if e-mail is used, this file number should be included in the subject line. Comment letters will be available for inspection and copying in the Commission’s Public Reference Room, 450 Fifth Street, NW, Washington, DC 20549-0102. Electronically submitted The SEC asks for comments by hard copy or e-mail, but not by both methods.

ethics to explain why they have not done so. The SEC fulfilled those rules, and also proposed rules to require disclosure as to whether the company has a code of ethics that applies to its principal executive officer.

The final rule defines the term “code of ethics” as written standards that are reasonably designed 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
- 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]
- Compliance with applicable governmental laws, rules and regulations

Box 3—Excerpts from a Letter of Edward Knight

January 14, 2003

Mr. Jonathan G. Katz, Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: File No. S7-40-02; Release Nos. 33-8138, 34-46701, and IC-25775:
Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002 (the “Proposing Release”)

Dear Mr. Katz:

The Nasdaq Stock Market, Inc. (“Nasdaq”) is grateful for this opportunity to comment on the proposed rules under Section 407 of the Sarbanes-Oxley Act (the “Act”), which define the term “financial expert” and require disclosure of the number and names of the persons determined to be the financial experts on a registrant’s audit committee. Nasdaq strongly supports the efforts of the Securities and Exchange Commission (the “Commission”) to reform corporate disclosure and financial reporting. However, we believe that the proposed definition of a financial expert is unduly restrictive, which will make compliance unnecessarily difficult....[Also] we note that the Proposed Rules would require disclosure of the number and names of the persons determined to be the financial experts serving on the audit committee. Nasdaq is concerned that, at least in the absence of *protections from additional liability as a result of the designation*,* disclosure of the names of financial experts will discourage people from serving on an audit committee, thus further reducing the pool of qualified individuals and depriving issuers and their investors of these individuals valuable service - a particular problem for smaller companies. ...

Sincerely,
Edward S. Knight
Executive Vice President and General Counsel

*Emphasis added.

- The prompt internal reporting to an appropriate person or persons identified in the code of violations of the code, and
- Accountability for adherence to the code.”

Audit Committee Financial Expert (Section 407)

Under the rules that the SEC is adopting, a company must disclose that its board of directors has determined that the company either:

- Has at least one audit committee financial expert serving on its audit committee, or
- Does not have an audit committee financial expert serving on its audit committee.

(The SEC insists on the importance of using the full phrase “audit committee financial expert,” rather than the broader term “financial expert,” or, even more broadly, “expert.” Use of the full phrase helps remove any suggestion that the committee member is an expert as covered in securities laws—specifically Section 11 of the Securities Act of 1933 pertaining to claims of expertise that could trigger civil liabilities for a false registration statement.)

A company disclosing that it does not have an “audit committee financial expert” must explain why it does not have such an expert. Under the final rules, if a company discloses that it has this kind of expert, it also must disclose this person’s name. The SEC states: “To the extent that there are liability concerns, we believe that they are best addressed by our inclusion of a safe harbor in our rules.” (See p. 5.)

The final rules permit, but do not require, a company to disclose that it has more than one audit committee financial expert on its audit committee. If a company’s board determines that a particular audit committee member qualifies as this type of expert, it may, but is not required to, decide whether additional audit committee members may also qualify as experts.

Every company subject to the audit committee disclosure requirements would, however, have to determine whether or not it has at least one audit committee financial expert; a company will not satisfy the new disclosure requirements by stating that it has decided not to make a determination or by simply disclosing the qualifications of all of its audit committee members. If the company’s board determines that at least one of the audit committee members qualifies as an expert, the company must say so. It will not be permissible for a company to state that it does not have an audit

committee financial expert if its board has in fact determined that such an expert serves on the audit committee.

The final rule also requires a company to disclose whether the person or persons identified as the audit committee financial expert is independent of management. It defines independent as consistent with federal securities laws—namely a provision of Schedule 14A, under Section 14 (a) of the Securities and Exchange Act of 1934, which asks the company to disclose whether the members are in compliance with stock market definitions of independence. These definitions have been updated recently.⁶

The final rule defines an audit committee financial expert as a person who has all of the following attributes:

- An understanding of generally accepted accounting principles and financial statements
- The ability to assess the general application of such principles in connection with the accounting for estimates, accruals, and reserves
- 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 registrant's financial statements, or experience actively supervising one or more persons engaged in such activities
- An understanding of internal controls and procedures for financial reporting, and
- An understanding of audit committee functions.

Under the final rules, a person must have acquired such attributes through any one or more of the following:

- 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
- Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor, or person performing similar functions
- Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing, or evaluation of financial statements, or
- Other relevant experience.

Finally, the SEC is keeping the requirement that an audit committee financial expert have experience with financial statements that present accounting issues that are “generally comparable” to those raised by the registrant's financial statements. The SEC believes that “a company's board of directors will make the necessary assessment based on particular facts and circumstances. In making its assessment, the board should focus on a variety of factors such as the size of the company with which the person has experience, the scope of that company's operations and the complexity of its financial statements and accounting.”

The SEC rejected arguments that this standard was too stringent, asserting that “a definition of ‘audit committee financial expert’ that leaves the meaning of the term entirely to the judgment of the board of directors would be highly subjective and could constitute an abrogation of our responsibilities under Section 407.”

Fortunately, the SEC does offer a “safe harbor.” In response to commenters' concerns about liability, the SEC stated as follows:

“We find that it would be adverse to the interests of investors and to the operation of markets and therefore would not be in the public interest, if the designation [of expert] and identification [of the persons who are expert] affected the duties, obligations, or liabilities to which any member of the company's audit committee or board is subject. To codify this position, we are including a safe harbor in the new audit committee disclosure item to clarify that:

- A person who is determined to be an audit committee financial expert will not be deemed an “expert” for any purpose, including without limitation for purposes of Section 11 of the Securities Act [of 1933], as a result of being designated or identified as an audit committee financial expert...
- The designation or identification of a person as an audit committee financial expert ... does not impose on such person any duties, obligations, or liability that are greater than the duties, obligations and liability imposed on such person as a member of the audit committee and board of directors in the absence of such designation or identification, and
- The designation or identification of a person as an audit committee financial expert ... does not affect the duties, obligations,

⁶ Under Section 10A(m) of the Exchange Act (as amended by Section 301 of the Sarbanes-Oxley Act), the SEC recently proposed rules directing the NYSE, American Stock Exchange, and Nasdaq to prohibit the listing of any security of an issuer that, among other things, does not have an independent audit committee as that term is used in Section 10A(m)(3). See Release No. 33-8173 (Jan. 8, 2003). As a result of those proposals, the current references Schedule 14A (i.e., Item 7(d)(3)(iv)) may be amended. For U.S. companies, the audit committee independence standard is found in new Regulation S-K Item 401(h)(1)(ii) (17 CFR 229.401(h)(1)(ii)) and Regulation S-B Item 401(e)(1)(ii) (17 CFR 228.401(e)(1)(ii)). See also Proposed Rule 34-47137, cited in Note 11 of this DMX.

- 7 Final Rule 33-8176, Release Nos.: 34-47226; FR-65, File No.: S7-43-02. Effective Date: March 28, 2003. Compliance Date: See text of release.
- 8 Final Rule 33-8180, Release Nos.: 34-47241; IC-25911; FR-66, File No.: S7-46-02. Effective Date: March 3, 2003. Compliance Date: October 31, 2003.
- 9 Final Rule 33-8182, Release Nos.: 34-47264; FR-67; International Series No. 1266, File No.: S7-42-02, Effective Date: 60 days after publication in the Federal Register. Compliance Date: See text of Release.
- 10 Final Rule 33-8183, Release Nos.: 34-47265; 35-27642; IC-25915; IA-2103, FR-68 File No.: S7-49-02, Effective Date: 90 days after publication in the Federal Register. Transition Dates: See text of Release.
- 11 Proposed Rule 34-47137, Release Nos. 33-8173; IC-25885; File No. S7-02-03. Comments due February 18, 2003.

or liability of any other member of the audit committee or board of directors.”

This safe harbor clarifies that any information in a registration statement reviewed by the audit committee financial expert is not “expertised” (*sic*) unless such person is acting in the capacity of some other type of traditionally recognized expert. Similarly, because the audit committee financial expert is not an expert for purposes of Section 11 “he or she is not subject to a higher level of due diligence with respect to any portion of the registration statement as a result of his or her designation or identification as an audit committee financial expert.”

But directors cannot breathe a deep sigh of relief. In closing the SEC offered these cautionary words:

“In adopting this safe harbor, we wish to emphasize that all directors bear significant responsibility. State law generally imposes a fiduciary duty upon directors to protect the interests of a company’s shareholders. This duty requires a director to *inform himself or herself of relevant facts and to use a ‘critical eye’ in assessing information prior to acting on a matter.* Our new rule provides that whether a person is, or is not, an audit committee financial expert does not alter his or her duties, obligations, or liabilities. We believe this should be the case under federal and state law.” (Emphasis added.)

Other Final Rules

In addition to these monolithic rules, the SEC has also issued final rules on the following items of interest to corporate directors, especially those serving on audit committees:

- [Conditions for Use of Non-GAAP Financial Measures \(Jan. 22, 2003\)](#)⁷
- [Retention of Records Relevant to Audits and Reviews \(Jan. 24, 2003\)](#)⁸

- [Disclosure in Management’s Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations \(Jan. 27, 2003\)](#)⁹
- [Final Rule re Strengthening the Commission’s Requirements Regarding Auditor Independence \(Jan. 28, 2003\)](#).¹⁰

To see the full text of these or other final rules, visit www.sec.gov, and click on “Final Rules.”

Saving the Best for Last?

With all these final governance rules enacted recently, there are very few proposed governance rules still pending. The most important one for directors is the proposed rule on “Standards Relating to Listed Company Audit Committees,”¹¹ which has a comment period to close February 18, 2003. It is a response to the proposed listing rules from the NYSE, American Stock Exchange, and Nasdaq. This one is a blockbuster, filling 173 pages with nuances on audit committees. The proposed rule, which every audit committee member should study, covers six important areas:

- Audit committee member independence
- Responsibilities of auditors
- Procedures for handling complaints
- Authority to engage advisors
- Funding
- Disclosure, including disclosure of the names of audit committee members in the annual report.

And even with this seemingly comprehensive rule now on the table, there are more to come—for example a future rule on the means for “prohibiting the listing of companies not in compliance with the audit committee provisions of the law”—due April 26, 2003.

Clearly, the thin blue line is here to stay. Hopefully the audit committee’s new responsibilities will not merely stretch it, but also strengthen it for the challenges ahead. ■

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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.