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THE CORPORATE REFORM TIDAL WAVE - Continued

Sarbanes-Oxley and the Rest: The Wave Has Crested

While the shoreline is still a bit far off, we can discern the contours, at least, of the principal corporate governance, reporting and accounting changes imposed on public companies by Congress and the regulators, in their attempt to restore that fragile and elusive creature, investor confidence. Some of these changes are already in effect, while others will take final form and become effective at different times over the next couple of years.

By far the biggest artifact of this Congressional/regulatory crusade turned out to be the Sarbanes-Oxley Act of 2002 (SOX) signed into law by President Bush on July 30. In the wake of the breaking of the WorldCom accounting scandal in June, Congress and the Administration decided that strong medicine was needed, so the 67 separate sections of SOX place far more burdens on public companies, their insiders and accounting firms than had seemed likely earlier in the summer.

While SOX calls for considerable rulemaking by the SEC and others, the SEC, NYSE and Nasdaq have also continued to pursue a variety of significant separate proposals.

A comprehensive summary of SOX alone would require a memorandum several times the length of this, but we thought it might be helpful to provide a selective and very wide-angle review of some of the most significant changes facing public companies and their directors and officers, including some SEC proposals released earlier this week.

SOX – Already in Effect

Officer Certification Requirements

SOX contains two separate and somewhat redundant provisions requiring CEOs and CFOs to certify the accuracy of their companies' annual and quarterly SEC reports.

♦ **Section 302: "Disclosure Controls"**

This very detailed certification requirement took effect on August 29, 2002. The SEC's implementing rules require every CEO and CFO to certify in each annual and quarterly report (10Ks, 10Qs and certain of the "foreign private issuer" equivalents) in considerable detail on six different items, including:

- That the report does not contain any material misstatement or omission and that the financial statements and information clearly present, in all material respects, the issuer's financial condition and results of operations;

- That they have designed and are responsible for "**disclosure controls** and procedures," to ensure that material information is made known to them, and have evaluated the effectiveness of those controls and procedures within 90 days before the report, presenting their conclusions in the report. (Items have been added to Forms 10Q and 10K to report these conclusions.)

These "disclosure controls" are something different from the "internal controls" pertaining to financial reporting that public companies have long been required to maintain, as they go to all the other types of information that must be included in SEC reports. Paying allegiance to the mantra that one size does not fit all, the SEC Staff has offered little guidance on what companies should be doing with respect to these new "disclosure controls and procedures." In some recent statements, SEC Staffers have suggested that many public companies should not need to adopt any new procedures because, after all, they have been filing accurate reports all along, haven't they? In other words, a public company may already have had "disclosures controls and procedures" without knowing it.

Nevertheless, if only in light of the significant potential liabilities that CEOs and CFOs will face as a result of these certifications, most public companies will want to tighten up their procedures for preparing 10Ks and 10Qs, or at least better document their existing procedures.

The one specific SEC suggestion has been to create a "disclosure committee," with responsibility for considering the materiality of information and determining disclosure obligations on a timely basis. The SEC has stated that the members of the committee could logically include:

- The principal accounting officer or controller;
- The general counsel;
- Any separate principal risk management officer; and
- The chief investor relations officer.

Among smaller public companies, the CFO may also wear some or all of the above hats, like Pooh-Bah in *The Mikado.* Rather than declaring themselves a committee, CFOs of that stripe would probably want to be able to demonstrate that they paid serious attention to the draft report and made sure the heads of operations did so too.

At many companies, the two certifying officers have begun to require "sub-certifications" from subordinate personnel responsible for significant units or functions. Although these may be useful in concentrating the attention of these subordinates, it seems unlikely that they alone would carry much weight with the SEC Staff, should a problem ever arise.

For CEOs and CFOs facing such a certification, probably the one essential step they must take is to review the draft report critically (not just for typos), keeping in mind the SEC's unwavering insistence since at least the late '80s that reports, in particular the MD&A, must paint the big picture candidly, warts and all. Moreover, they should do this far enough in advance of the filing date that questions can be addressed or additional information developed. Companies should also consider distributing drafts earlier and more broadly not only to senior financial and operations management but to its auditors, the audit committee, the rest of the directors and outside counsel.

The new SEC proposal under Section 404 of SOX discussed below, regarding an annual "internal control report," would also extend the quarterly review of "disclosure controls" to encompass internal controls, and the Section 302 certification would be modified accordingly.

♦ Section 906

This section amended the criminal code to require CEOs and CFOs to certify in the same "periodic reports" covered by Section 302 that the information in the report fairly presents, in all material respects, the financial condition and results of operations of the issuer (which partially overlaps one of the Section 302 certifications) and that the report fully complies with the requirements of the 1934 Act (which is not covered by Section 302).

As a criminal provision, Section 906 is primarily within the jurisdiction of the Department of Justice, so the SEC has declined to give interpretative guidance on it. Nevertheless, SEC Staffers have been working with the Department of Justice to develop guidance, which could at least reduce the overlap between the two certifications.

Ban on Loans to Executive Officers and Directors: Section 402

This section prohibits any extension of, or arrangement for, credit in the form of a personal loan by a public company to an executive officer or director. This makes illegal such standard and, before SOX, uncontroversial practices as home relocation loans to officers who are required by the company to transfer. Extensions of credit already in effect on July 30, 2002, are grandfathered, provided there is no material modification to any term or any renewal of the credit. Loans by an insured depositary institution that are subject to Reg. O are exempt, and there are a few similar exemptions.

The breadth of this prohibition, in particular its ban on companies even "arranging" for personal loans by third parties, has raised questions about various types of executive compensation and payments that might be considered to involve "loans," such as split-dollar insurance and, most significantly, "cashless exercise" option programs. Because Section 402, unlike many other provisions of SOX, does not call upon the SEC to issue any implementing regulations, the SEC Staff has so far declined to give any guidance on Section 402, although there are some recent indications that it might address at least a few points under Section 402 in the not too distant future. It may be relevant that a number of Senators have publicly warned the SEC not to facilitate any backsliding by public companies on this loan prohibition.

With the SEC on the sidelines, law firms have attempted to fill the vacuum, and a tentative consensus has been reached by many large firms that the following common practices should not be considered to involve "personal loans" arranged by the issuer within the scope of the prohibition:

- Conventional "cashless exercise" option programs, at least where executives are not required to use a single broker selected by the issuer, and where the company does not deliver the stock certificate to the broker before receipt of the exercise price;

- Advancement of litigation expenses pursuant to standard indemnification arrangements.

Various law firms have expressed positions on a variety of other topics, which at some point will yield to more authoritative guidance from the SEC, the courts or perhaps Congress.

Acceleration of Insider Trading Reports: Section 403(a)

This requires executive officers, directors and 10% stockholders to report changes in their beneficial ownership of the company's equity securities within two business days following the date on which the reportable transaction was "executed," as a general rule. Previously, purchases, sales and option exercises did not need to be reported until the 10th calendar day following the month in which the transaction occurred, while certain other exempt transactions involving stock compensation plans did not need to be reported until after the end of the year.

See our memorandum of September 6, 2002 for a more detailed discussion of the SEC's rules implementing these requirements, with suggestions for complying with them. Public companies should keep in mind that, no later than the end of July 2003, the SEC is required by SOX to adopt rules compelling insiders to file Section 16 reports electronically by EDGAR. Moreover, companies will be required to post those reports on their websites. (The September 6 " Sarbanes Oxley – Remarks" memorandum is available at www.bingham.com. Click in Updates –Corporate Governance.)

Forfeiture of Bonuses or Stock Profits: Section 304

If a public company restates its financial statements "due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws," both the CEO and the CFO must forfeit any bonus or other incentive- or equity-based compensation, or any profits realized from the sale of securities of the issuer, during the 12-month period following the "first public issuance or filing" of the financials that were subsequently restated. The drafting of this section raises a number of significant ambiguities, none of which are resolved at this date. Any public company facing a restatement will need to factor Section 304 into its deliberations.

SOX – Coming Attractions

Internal Control Reports: Section 404

On October 16, 2002, the SEC approved proposed rules to implement the requirement of Section 404 of SOX that every 10K include an "internal control report" of management stating:

- Management's responsibilities for internal controls for financial reporting;
- Management's conclusions about the effectiveness of those internal controls; and
- That the company's independent accountant has attested to, and reported on, management's evaluation of the internal controls.

The SEC proposal would also go beyond Section 404's annual requirement by requiring <u>quarterly</u> reviews of internal controls, which could turn out to be a significant incremental burden.

Code of Ethics: Section 406

On October 16, the SEC also approved proposed rules to implement the requirement of Section 406 of SOX that companies disclose whether they have adopted codes of ethics for their CEOs and senior financial officers (or if not, why). To an extent, this proposal is subsumed by pending NYSE and Nasdaq proposals, summarized below, that would require listed companies to adopt codes of ethics covering those officers and others.

The proposed rules include a definition of "code of ethics" that is similar to but a little broader than the pending NYSE and Nasdaq requirements, which might be modified to conform. In addition to annual report disclosure whether it has a code of ethics, a company would be required to disclose by an 8K or on its website any changes to, or waivers of, its code of ethics.

"Financial Experts" on Audit Committees: Section 407

A third significant proposal approved by the SEC at its October 16 meeting implements the requirement of Section 407 that a public company disclose whether it has at least one "financial expert" (as defined by the SEC, following criteria spelled out in Section 407) on its audit committee, and if not, why.

Audit committee requirements of the NYSE and Nasdaq that took effect just last year require, in slightly different form, all committee members to be "financially literate" and at least one member to satisfy a higher standard of financial sophistication. To simplify, this higher standard can be satisfied not only by CPAs and others with specific financial reporting experience or responsibility such as public company CFOs and controllers, but also by CEOs, by virtue of their general responsibility for financial and other reporting.

Section 407's criteria for defining "financial expert," however, exclude CEOs *per se* as an eligible category, leaving only CPAs, CFOs, controllers or principal accounting officers of public companies (and not necessarily all of them) eligible for this new distinction. Some had hoped that the SEC might broaden this definition in its proposal, but it has not done so, although the discussion of relevant characteristics in the SEC's October 22 release leaves the door open slightly for unorthodox candidates.

While Section 407 is merely a disclosure requirement, Nasdaq has already proposed a change to its audit committee rules that would require at least one "financial expert" on the audit committee of any Nasdaq issuer, and the NYSE seems likely to follow suit. The Nasdaq proposal, if adopted, would not take effect until the first annual meeting after January 1, 2004, and any NYSE requirement presumably would take effect no earlier than that.

MD&A Discussion of Off-Balance-Sheet and Other Liabilities; Pro Forma Financial Information: Section 401

At a meeting scheduled to be held on October 30, the SEC will consider rules called for by Section 401 of SOX with respect to off-balance-sheet transactions and pro forma financial information. As to the former, it appears that the SEC will go beyond Section 401 by proposing to expand the MD&A requirements to include not only more information on off-balance-sheet arrangements, but also a table of aggregate contractual obligations, with short- and long-term breakdowns, and a table (or textual disclosure) of aggregate contingent liabilities, also broken down.

Prohibition of Specified Non-Audit Services and Required Pre-Approval for Audit and Non-Audit Services: Sections 201 and 202

The SEC is required to adopt final rules implementing these requirements by January 26, 2003, so it is likely that they will be proposing those rules in the near future. Companies already attempting to comply with these requirements have had some difficulties with the very broad nature of the nine categories of prohibited activities in Section 201, for instance, "expert services unrelated to the audit." Similarly, it has sometimes been difficult to determine whether particular non-prohibited services to be performed by the company's independent auditor are "non-audit services," so as to trigger the requirement for separate pre-approval by the audit committee in Section 202. An example is services by the independent auditor intended to assist the CEO and CFO in making their Section 302 certifications.

Audit Committee: Authority, "Independence" and "Whistleblower" Procedures: Section 301

By April 26, 2003, the SEC is required to adopt final rules directing Nasdaq and the national exchanges to prohibit the listing of any issuer with an audit committee that does not satisfy certain requirements spelled out in Section 301. These include having direct responsibility for the appointment, compensation and oversight of the work of the independent auditor, and the authority to engage independent counsel and other advisors, as it deems necessary, at the expense of the issuer.

One problematic requirement in Section 301 is its definition of "independence," which would be mandatory for all audit committee members. The definition includes a ban on receipt of consulting, advisory or other "compensatory" fees from the issuer, which is consistent with NYSE and Nasdaq proposals to bar the receipt of such fees by audit committee members.

The definition also, however, would bar any "affiliated person of the issuer or any subsidiary" from serving on the committee. Congress may or may not have been aware of an existing definition of "affiliated person" in the Securities Exchange Act, which incorporates a corresponding definition in the Investment Company Act. That definition includes any 5% stockholder, including any officer, director or employee of an entity that is a 5% stockholder.

If the SEC in its implementing rules decides that Congress intended this 5% stock ownership bar, that would disqualify many audit committee members who are affiliated with private equity or other institutional investors that own more than 5%. (That would hardly seem consistent with the reform goal of getting large institutional stockholders more actively involved in governance.)

(As discussed below, Nasdaq has in any event proposed a 20% stock ownership bar on audit committee membership, while the NYSE has rejected such a bar, for now.)

Section 301 will also require listed company audit committees to establish "whistleblower" procedures for the processing of complaints received by the issuer regarding accounting or auditing matters, including a procedure for "the confidential, anonymous submission by employees" of accounting concerns. It will be interesting to see how the SEC fleshes out these requirements, in particular with respect to anonymity.

NYSE and Nasdaq Proposals

Beginning in May 2002, the Nasdaq Stock Market and the NYSE announced a series of significant changes designed to enhance corporate governance procedures in listed companies.

While there is some overlap between these proposals and certain provisions of SOX, for the most part the NYSE/Nasdaq proposals, which are broadly similar but with many differences in detail, have independent significance. The NYSE submitted its package of rule proposals to the SEC in August, while Nasdaq submitted many of its proposed rules earlier this month. Some modifications are likely, if only to reflect ongoing SEC rulemaking under SOX.

The NYSE and Nasdaq also propose broadly similar approaches to transitioning compliance with the requirements. Those changes that may require the recruitment of new directors to satisfy tightened Board and committee criteria would not take effect earlier than 2004, while lesser requirements that will still require some work, such as the NYSE proposals requiring additional committees, will take effect six months after final approval of these rules. A few of the requirements, most significantly the broader requirement for shareholder approval of virtually all stock option and compensation plans, will take effect immediately. In brief, some of the key proposals are:

Full Board: A Majority of Independent Directors; Tighter Definition of "Independence"

Both Nasdaq and the NYSE will require listed companies to have a majority of independent directors, but will except "controlled companies," *i.e.,* a company of which more than 50% of the voting power is owned by an individual, group or other company.

The **NYSE** would retain its basic definition of "independence," leaving it to the Board of Directors to determine that a candidate has no material relationship with the company. Board determinations must be disclosed in the company's annual proxy statement, including any specific standards adopted by the Board in making these determinations. There will be a specific five-year cooling-off period for directors who have been employed or have certain other relationships with the company. This will extend to immediate family members of the director, but the NYSE's commentary states that employment of a family member in a non-officer position would not preclude a determination of independence.

Nasdaq will retain its more objective definition of independence, including the 5% of revenues/$200,000 threshold for transactions with a company of which a director is an executive officer or controlling shareholder, and a threshold of $60,000 on payments from the company, during any of the past three fiscal years. These will be broadened to pick up immediate family members, however, and there are a few other new restrictions, including an extension of the 5%/$200,000 threshold to any nonprofit organization of which a director is an executive officer.

The new **NYSE** requirements take effect two years after the NYSE rules are finally approved, while the **Nasdaq** rules will take effect as of the first annual meeting after January 1, 2004.

Executive Sessions of Independent Directors

Both Nasdaq and the NYSE will require regularly scheduled executive sessions of independent directors. The **Nasdaq** proposal contemplates that these will occur at least twice a year, and perhaps more frequently. The **NYSE** proposal states that, while there need not be a single director appointed to preside at these executive sessions, if one is so appointed, his or her name must be disclosed in the annual proxy. The annual proxy will also be required to disclose a method for parties to communicate directly with the presiding officer or with the non-management directors as a group.

For both the NYSE and Nasdaq, these requirements will become effective six months after adoption of the final rules.

Audit Committee: Composition

In addition to the general "independence" requirement, both **Nasdaq** and the **NYSE** would prohibit audit committee members from receiving consulting, advisory or other compensatory fees other than for their Board service. In addition, **Nasdaq,** but not the NYSE, proposes to add a bar based on stock ownership. Nasdaq would bar any director who "owns or controls, directly or indirectly, **20%** or more" of the company's voting stock, or any lower percentage that the SEC may establish pursuant to its rulemaking under SOX Section 301, discussed above (which could lower the bar to **5%**). If the SEC does include a 5% (or other) stock ownership bar in its definition of audit committee "independence" under Section 301, that would be binding on the NYSE also.

Nasdaq also proposes to require at least one audit committee member to be a "financial expert" as defined by the SEC in its rulemaking under SOX Section 407, summarized above. The NYSE seems likely to follow suit.

The new criteria will take effect 24 months after final rules adoption for **NYSE** companies, and at the first annual meeting after January 1, 2004 for **Nasdaq** companies.

Audit Committee: Duties

Both the NYSE and Nasdaq propose to increase the responsibilities of audit committees, with corresponding additions to their charters.

The **NYSE** list of new duties is considerably more extensive, including for instance, discussion both of annual and quarterly financial statements with management and the independent auditor (including the MD&A), and of earnings press releases and "guidance." (The NYSE commentary states that earnings release and guidance discussions may be general, *i.e.,* without advance discussion of each earnings release or instance of guidance.)

The new **Nasdaq** duties center on the audit committee provisions of SOX, summarized above, relating to pre-approval of audit and permissible non-audit services, exclusive authority over outside auditors and the establishment of procedures for handling "whistleblower" complaints.

In both cases, these changes will take effect six months after adoption of the final rules.

Nominating/Corporate Governance Committee – Selection of Nominees by Independent Directors

The **NYSE** will require a nominating/corporate governance committee composed entirely of independent directors, with a written charter that addresses its purpose and responsibilities. These are to include the selection, or recommendation to the full Board, of director nominees for the next annual meeting.

While **Nasdaq** would not require such a committee, any Nasdaq issuer without one would be required to determine Board nominations by a majority of its independent directors. Both proposals include a general exemption for controlled companies, and specific exemptions for situations where a party or group has a contractual right to nominate a director.

While **NYSE** companies would be required to establish the nominating/corporate governance committee within six months after adoption of the NYSE rules, they would have 24 months to satisfy the requirement that it comprise solely independent directors. The **Nasdaq** requirement would take effect at the first annual meeting after January 1, 2004.

Corporate Governance Guidelines (NYSE Only)

In addition to the nominating/corporate governance committee's charter, the NYSE proposals call for corporate governance guidelines for the full Board, which must address director qualifications and responsibilities, access to management and independent advisors, compensation and continuing education, management succession and an annual self-evaluation. NYSE companies will be required to include on their websites these corporate governance guidelines, as well as the charters of their most important committees (including at least the audit, nominating and compensation committees), and the code of business conduct and ethics discussed below.

These requirements take effect six months after approval of the NYSE rules.

Compensation Committee – Independent Director Approval of Executive Compensation

The **NYSE** proposes to require a compensation committee composed entirely of independent directors, with a written charter addressing its purpose and responsibilities. These must include setting the CEO's compensation.

If a **Nasdaq** company does not have a compensation committee comprised solely of independent directors, compensation of the CEO and of all other officers must be determined by a majority of the independent directors.

The **NYSE** requirement would take effect six months after adoption of the NYSE rules, except that companies would have 24 months to satisfy the requirement that it comprise solely independent directors. The **Nasdaq** proposal would take effect at the company's next annual meeting after January 1, 2004.

Code of Conduct

Both **Nasdaq** and the **NYSE** will mandate a code of conduct (the NYSE calls it "code of business conduct and ethics") for directors, officers and employees. While the NYSE proposal is more detailed in what the code must cover, both require it to address conflicts of interest and compliance with laws. The SEC's code of ethics proposal approved on October 16 and released on October 22 contains additional details, which are likely to be added to the Nasdaq and NYSE proposals. All proposals require prompt disclosure of any waivers of the code for directors or executive officers.

The **NYSE** requirement will take effect six months after adoption of the NYSE rules, while the **Nasdaq** counterpart will apply as of the first annual meeting after January 1, 2004.

Shareholder Approval of Employee Stock Plans

Both **Nasdaq** and the **NYSE** propose to tighten considerably existing shareholder approval requirements, to require advance shareholder approval of any stock option or purchase plan or other arrangement pursuant to which options or stock may be acquired by officers, directors or employees, regardless of whether officers or directors participate and of dilution level. Both proposals include exceptions for:

- Tax-qualified plans such as ESOPS or 401(k) plans, as well as non-qualified excess benefit plans;
- Plans assumed on an acquisition or merger; and
- Inducement grants in connection with the hiring of a new employee, subject to approval of the compensation committee (or, for Nasdaq issuers, a majority of the issuer's independent directors).

Separately, the NYSE proposes to amend its "broker non-vote" rule to prohibit discretionary voting by brokers of uninstructed customer shares on any equity compensation plan proposal. Since this rule is directed to brokers, it will make it more difficult for all issuers, wherever they are listed, to obtain shareholder approval of new plans.

These proposals will take effect immediately upon approval of the final rules.

Other SEC Proposals

While a few of the SEC proposals summarized in our first "regulatory tidal wave" memorandum, dated July 16, 2002, have been superseded by SOX, a number have independent significance, including in particular: (The first "tidal wave" memorandum is available at www.bingham.com. Click in Updates – Corporate Governance.)

Acceleration of 10K and 10Q Filing Deadlines

The SEC adopted this proposal in September. While the SEC is accelerating the 10K and 10Q filing deadlines, it deferred to the many critical comment letters by allowing a substantial transition period. The SEC also added exemptions for "small business issuers" and companies with a "public float" of less than $75,000,000.

For calendar year companies, the deadline will remain 90 days for the 10K for FY 2002, shortening to 75 days for FY 2003 and 60 days for FY 2004 and thereafter.

The 10Q filing deadline will remain 45 days through 2003, shortening to 40 days in 2004 and 35 days in 2005 and thereafter.

Mandatory 8K Disclosure of Many New Items, on an Accelerated Basis

This proposal remains very much alive. The SEC sees a vote of confidence for it in Section 409 of SOX, which gives the SEC authority (which it already had) to adopt rules requiring public companies to disclose material information in "real time" and plain English. At a meeting to be held on October 30, the SEC is scheduled to consider a proposal to require 8K filing of earnings announcements.

MD&A Disclosure of Critical Accounting Policies (Mainly Estimates)

As noted above, the SEC will shortly propose expanded MD&A disclosure of off-balance-sheet arrangements and contractual and contingent liabilities, pursuant to a provision of SOX. This proposal appears to remain alive as well, although pushed somewhat to the back burner by the SEC's more pressing SOX rulemaking duties. Members of the SEC Accounting Staff seem to have at least some sympathy for the very pointed criticisms made in the comment letters of the extremely burdensome and problematic level of detail that the proposal called for with respect to "critical accounting estimates." There seems to be a good chance for a revised proposal, which may call for less detail.

Of course, there is much else in SOX and in the SEC and stock exchange proposals that will have a significant effect on public companies, their insiders and those who counsel them. The "lawyer responsibility" provisions of Section 307 of SOX, for instance, which the SEC is required to implement by rule by January 26, 2003, may create significant difficulties for corporate staff attorneys in particular, with its requirement that attorneys go "up the ladder" possibly as far as the Board, if they see "evidence" of a violation of law or "breach of fiduciary duty or similar violation" by any "agent" of the company.

Change will continue to be driven by other players as well, including the ever more aggressive state attorneys general, institutional investor groups, the Department of Labor's pension enforcement division and class action plaintiffs' attorneys.

Michael P. O'Brien
michael.obrien@bingham.com
617.951.8302