New York exchange demands corporate accountability

As revelation after revelation hits the headlines and the markets, the New York Stock Exchange has outlined tougher rules on corporate governance that aim to weed out mismanagement. Mark Bergman and Heather White of Paul, Weiss, Rifkind, Wharton & Garrison, London, look at the proposals

The New York Stock Exchange (NYSE) has reviewed its corporate governance listings standards with the goal of enhancing the accountability, integrity and transparency of listed companies. The result of this review – which followed a request from the chairman of the US Securities and Exchange Commission – is an NYSE Corporate Accountability and Listing Standards Committee Report. Final action on the report is expected at the August 1 meeting of the NYSE board. Thereafter, changes to the listing standards will be set out in one or more NYSE request for a rule change and submitted to the SEC for approval.

Nasdaq has submitted its own proposals for corporate governance rule changes to the SEC, which Nasdaq expects will become effective, following a public comment period, later this summer. These proposals would mandate shareholder approval of stock option plans in which officers and directors participate; narrow the definition of independence; require approval by the audit committee of related party transactions and require market notification of going concern qualifications in audit opinions. In addition, Nasdaq is considering reforms similar to the NYSE.

Like other exchanges, the NYSE has permitted listed non-US companies to follow home country practices with respect to a number of corporate governance matters (based on a submission of an opinion of local counsel). While the proposed new standards would not apply to such companies, they would be required to disclose the significant ways in which their corporate governance practices differ from the NYSE standards.

Increasing the role and authority of independent directors

A majority of a listed company's board would have to be independent directors, as defined under the proposed rules. Companies would be given 24 months to effect this change. Newly-listed companies would also have to be compliant within 24 months. Companies would be required to disclose when they became compliant. In addition, a listed company would be required to have an audit committee, a nominating committee and a compensation committee, each comprised solely of independent directors. Under existing rules, listed companies are not required to have either a nominating committee or a compensation committee.

Tightening the definition of independent director

For a director to be deemed independent, the board would be required to determine affirmatively that the director has no material relationship with the listed company. These determinations would have to be disclosed. Companies would be required to observe a five-year cooling-off period for purposes of satisfying the definition of independence for former employees of the listed company or of its independent auditor, former employees of any company whose compensation committee includes an officer of the listed company and immediate family members of these. Although the report suggests that being (or being affiliated with) a controlling shareholder is a bar to being an independent director, the limitation on chairing or being a voting member of an audit committee suggests that a 20% shareholding is not itself a bar to being deemed an independent director.

Enabling non-management directors to serve as a more effective check on management

The non-management directors of listed companies would be required to meet at regularly scheduled executive sessions without management. The independent directors would designate and publicly disclose the name of the director (the so-called lead director) who would preside at the executive sessions.

Adding new audit committee qualifications

Due to the critical role played by audit committees, additional limitations would be imposed on audit committee members. A director who meets the definition of independence mandated for all directors, but who also holds 20% or more of the company's stock (or who is a general partner, controlling shareholder or officer of any such holder) cannot chair, or be a voting member of, the audit committee. If a director serves on more

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than three audit committees, the board must determine whether such positions impair that director's ability to serve effectively and disclose such determination in the proxy statement. In addition, director's fees must be the sole compensation an audit committee member receives from the listed company.

The audit committee chair must have accounting or related financial management expertise.

The report proposes increasing the authority and responsibilities of the audit committee, including granting it the sole authority to hire and fire independent auditors and to approve any significant non-audit relationship with the independent auditors.

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The audit committee would be required, at least annually, to obtain and review a report by the independent auditor addressing various issues that bear on quality-control procedures of the firm and investigations of the firm respecting independent audits carried out by the firm, and addressing relationships between the firm and the company. The committee would be required to discuss the annual and quarterly financial statements with management and the independent auditor, including the company's management discussion and analysis (MD&A) disclosures and to discuss earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies.

The committee would also be responsible for discussing risk assessment and risk management policies and would be required to meet separately, at least quarterly, with management, internal auditors (or other personnel responsible for the internal audit function) and independent auditors; review with the independent auditor any audit problems or difficulties and management's response and set clear hiring policies for employees or former employees of the independent auditors.

Fostering a focus on good corporate governance

Listed companies would be required to adopt corporate governance guidelines, as well as charters for their audit, compensation and nominating committees. The guidelines, which would be posted on the company website, would address: director qualifications; director responsibilities; director access to management and, as necessary and appropriate, independent advisers; director compensation; director orientation and continuing education; management succession; and an annual performance evaluation of the board.

Companies would also be required to 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. These codes should address: 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); and reporting of any illegal or unethical behaviour.

Nominating and compensation committees

Each listed company would be required to have a nominating/corporate governance committee and a compensation committee. The committees would be composed entirely of independent directors.

The purpose of the nominating committee at a minimum would be to: identify individuals qualified to become board members; select, or 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. The purpose of the compensation committee at a minimum would 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, in accordance with applicable SEC rules.

Each committee would be required to have a written charter that sets out its purpose, its goals and responsibilities and the procedures for an annual performance evaluation of the committee. In addition, each charter should address committee member qualifications; committee member appointment and removal; committee structure and operations; and committee reporting to the board.

Potential impact

Overall, the authors of the report are to be commended for their comprehensive yet balanced proposals. However, there are elements that need to be more closely evaluated.

The most far-reaching aspects of the proposal are the requirements for a majority of independent directors and committees comprised solely of independent directors. It is unfortunate that the directors themselves would have to make determinations regarding independence on the basis of very few guidelines. The treatment of controlling shareholders is vague (if shareholdings of 20% or more are not bars to independence, what is the prohibition on 'controlling' shareholders?), which itself is unfortunate as controlling shareholders might be expected to have interests more closely aligned with public shareholders than with management, and to have expertise that would be indispensable to committee functions. The issue has been further complicated by a provision in the US Senate's investor protection legislation that treats affiliation as a bar to audit committee independence. The status of directors affiliated with controlling shareholders should be of particular concern to venture capital and similar investors that retain stakes after public offerings or acquire stakes when companies need cash infusions, as well as parent companies that have spun-off a portion of the stock of a subsidiary to the public.

In addition to the definitional issue, it is also worth asking whether the corporate governance goals can be achieved without requiring both a majority of independent directors and committees consisting only of independent directors. The burden, particularly for smaller companies, may not be commensurate with the benefit. As the rush to do something in the politically-charged atmosphere that now prevails – particularly in Washington DC – continues to prompt proposals for reform (the most recent examples being Bills in both houses of the US Congress), it will be critical that well-meaning proposals be tailored to produce the desired effect without creating a regime that is either impractical or falsely comforting. ∎

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