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The New York Stock Exchange Provides Guidance on its Corporate Governance Rules

In November 2003, the SEC approved the NYSE's proposed corporate governance rules, which were codified in Section 303A of the NYSE's listed company manual. In a January 2004 response to frequently asked questions, the NYSE issued further guidance on the new rules. The following is an update of our memorandum entitled "SEC Approves New York Stock Exchange Corporate Governance Rules," revised to reflect this guidance.

General Application

The new corporate governance rules apply to all companies listing common equity securities on the NYSE.

Limited partnerships, companies in bankruptcy proceedings and "controlled" companies are exempt from Sections 303A.01, .04 and .05, which require a majority of independent directors and nominating and compensation committees composed entirely of independent directors, although they are required to comply with the remaining provisions of new Section 303A.

- A controlled company is one in which more than 50% of the voting power is held by an individual, group (as determined by Section 13(d)(3) of the Securities Exchange Act of 1934 (the "Exchange Act")) or another company, rather than the public.
- A controlled company that chooses to take advantage of any or all of the exemptions must disclose that choice, that it is a controlled company and the basis for that determination in its annual proxy statement or, if the company does not file an annual proxy statement, in its annual report on Form 10-K.

The listing standards do not apply to companies listing only preferred or debt securities on the NYSE, except to the extent required by Rule 10A-3 (which relates to audit committee independence) under the Exchange Act ("Rule 10A-3").

Non-U.S. issuers continue to be entitled to waivers from the NYSE corporate governance listing standards (other than the audit committee requirements under Rule 10A-3 and the requirement that the CEO promptly notify the NYSE in writing after any executive officer becomes aware of any material non-compliance with any provisions of the new rules), but are required to make disclosures as to the significant differences between their local standards and the requirements applicable to domestic companies.

Effective Dates

The effective dates and transition periods conform to those required for audit committees by the Sarbanes-Oxley Act of 2002 (the "Act") and Rule 10A-3. Accordingly, companies are required to comply with the new rules by the earlier of (i) their first annual meeting after January 15, 2004 and (ii) October 31, 2004. In addition,

- companies with classified boards have an additional year (but no later than December 31, 2005) to replace a director not scheduled to stand for election in 2004, unless otherwise required by Rule 10A-3;
- foreign private issuers have until July 31, 2005 to comply with applicable audit committee requirements under Rule 10A-3;

- companies listing in conjunction with their initial public offerings are required to phase in their independent nomination and compensation committees on the same schedule as Rule 10A-3 mandates for audit committees, namely, one independent director at the time of listing, a majority within 90 days and fully independent committees within one year;[1]
- companies listing in conjunction with an initial public offering are required to have a majority independent board within 12 months of listing. The 12-month transition period also applies to companies that transfer to the NYSE from other markets that do not impose the same requirements;
- a controlled company that ceases to be a controlled company is required to phase in its independent nomination and compensation committees by having one independent director as of the date it ceases to be controlled, a majority of independent directors on those committees within 90 days after it ceases to be controlled and fully independent nominating and compensation committees and a majority independent board within one year after it ceases to be controlled. The other requirements of Section 303A apply to a controlled company as of the date of listing with the NYSE and continue to apply after it ceases to be controlled;
- a previously reporting company listing in connection with an initial public offering must be fully compliant with the audit committee requirements as of the date of effectiveness of its registration statement, although the transition periods for fully independent nominating and compensation committees and a majority independent board are available for such reporting company; and
- as discussed below, there is a transition period for the director independence look-back provisions. A one-year look-back applies until November 4, 2004 and a three-year look-back applies thereafter.

References to Form 10-K

Certain provisions of new Section 303A require a company to disclose items in its Form 10-K. If a company subject to such a provision is not a company required to file a Form 10-K, then the provision should be read to mean the annual periodic disclosure form that the company files with the SEC. If a company is not required to file either an annual proxy statement or an annual periodic report with the SEC, the disclosure is to be made in the annual report required under Section 203.01 of the NYSE Listed Company Manual. The NYSE mandated disclosures are not required in any documents that predate the applicable Section 303A compliance date.

Final Listing Standards

Set forth below is a summary of the principal provisions of the NYSE's new corporate governance listing standards.

1. **Independent directors must comprise a majority of a listed company's board.**

2. **For a director to be deemed "independent," the board must affirmatively determine that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company). Companies must disclose the independent directors by name and discuss the basis for the board's determinations.**

   - The basis for a board determination that a relationship is not material must be disclosed in the annual proxy statement (or in the company's annual report on Form 10-K if the company does not file an annual proxy statement).

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1 The phase-in periods for initial public offerings are generally calculated from the date the company lists on the NYSE. However, the phase-in periods for audit committee independence is calculated from the date of effectiveness of a company's registration statement.

- A board may adopt and disclose categorical standards to assist it in determining director independence and may make a general disclosure if a director meets these standards. Any independence determination for a director who does not meet these standards must be specifically explained.
- The NYSE does not view the ownership of even a significant amount of stock, by itself, as a bar to an independence finding.

Certain *per se* bars to a determination that a director is independent will apply. They are:

A director who is an employee, or whose immediate family member is an executive officer, of the company is not independent until three years after the end of such employment relationship. However, employment as an interim Chairman or CEO does not disqualify a director from being considered independent following that employment.

A director who receives, or whose immediate family member receives, more than $100,000 per year in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service), is not independent until three years after he or she ceases to receive more than $100,000 per year in such compensation.

- Compensation received by a director for former service as an interim Chairman or CEO need not be considered in determining independence under this test.
- Compensation received by an immediate family member for service as a non-executive employee of the listed company need not be considered in determining independence under this test.
- Investment income and bona fide, documented reimbursed expenses need not be considered in determining independence under this test.
- A severance package or a non-compete agreement typically need not be considered in determining independence under this test.
- Loans from financial institutions are not considered payments, although interest payments or other fees paid in association with such loans would be considered payments.

A director is not independent if during the prior three years:

- the director was affiliated with or employed by, or a member of the director's immediate family was affiliated with or employed in a professional capacity by, the listed company's present or former internal or external auditor;
- the director was employed, or a member of the director's immediate family was employed, as an executive officer of another company where any of the listed company's present executives serve on that company's compensation committee; and
- the director was an executive officer or an employee, or a member of the director's immediate family was an executive officer, of a company that made payments to, or received payments from, the listed company for property or services in an amount which, in any single fiscal year, exceeded the greater of $1 million, or 2% of such other company's consolidated gross revenues.

In applying the test above, both the payments and the consolidated gross revenues to be measured shall be those reported in the last completed fiscal year of the director's company. Payments made to the listed company and payments received from the listed company should be aggregated separately and measured against consolidated gross revenue. The NYSE considers payments to an individual's solely-owned business entity as direct compensation. If the listed company is unable to make a clear determination that the 2%/$1 million threshold was not crossed for the last completed fiscal year, the board should assume that the director is not independent.

In addition, while charitable organizations are not considered "companies" for purposes of the above test, listed companies must disclose contributions to a charity of which an independent director serves as an executive officer, if, within the preceding three years, contributions in any single fiscal year of the charitable organization exceeded the greater of $1 million or 2% of the charitable organization's annual gross revenues from all sources (i.e., charitable contributions, ticket sales, investment portfolios and other activities). Listed company boards are obligated to consider the materiality of such relationships in assessing director independence generally.

When evaluating whether a director satisfies the independence requirements, it should be noted that:

- only a one-year look-back applies until November 4, 2004 (the one-year anniversary of the adoption of the new rules) — the three-year look-back applies from November 4, 2004;
- when applying the look-back periods, companies need not consider individuals who are no longer immediate family members as a result of legal separation or divorce, or those who have died or become incapacitated;
- "immediate family member" includes a person's spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law and anyone (other than domestic employees) who shares such person's home;[2]
- references to the "company" includes any parent or subsidiary in a consolidated group with the company; and
- "consolidated group" refers to a company, its parent or parents, and/or its subsidiaries that would be required under U.S. GAAP to prepare financial statements on a consolidated basis.

The per se bars to independence above are not intended to be an exhaustive list of circumstances or relationships that would preclude independence. A company may not take the position as a categorical matter that any director who passes the bright line tests is per se independent, or that all relationships other than those that would disqualify a director from being determined independent are per se immaterial.

3. The non-management directors of listed companies must meet at regularly scheduled executive sessions without management.

- Non-management directors are all those who are not officers of the company and includes such directors who are not independent by virtue of a material relationship, former status or family membership, or for any other reason.
- If not all of the non-management directors are independent, listed companies should at least once a year schedule an executive session including only independent directors.
- The NYSE is not requiring that a "lead" director be appointed. Non-management directors have some flexibility in how the executive sessions are to be conducted. Companies must either name the director chosen to preside at all such sessions (if one is selected) or, if none is

[2] It is important to note that the NYSE definition of "immediate family member" is different than the SEC's definition under Rule 10A-3. As a result, companies must apply the NYSE's definition of immediate family member when evaluating compliance with Section 303A.02 (Independence Test), and must apply the SEC's definition when evaluating compliance with Section 303A.06 (Audit Committee).

selected, disclose the procedure by which the presiding director is selected for each executive session (e.g., rotation of committee chairs).

- Companies must disclose the means by which interested parties can communicate with the presiding director or the non-management directors as a group.

- Any employee (including the Corporate Secretary or General Counsel) of the listed company can act as an agent for the non-management directors of the board in facilitating direct communications to the board. The non-management directors should establish procedures for how the listed company employee would deal with all direct communications, including if and when such communications should be shared with management.

4. **Listed domestic companies must have a nominating/corporate governance committee (or committees of the companies' own denomination with the same responsibilities), composed entirely of independent directors.**

The nominating/corporate governance committee must have a written charter that addresses:

- the committee's purpose and responsibilities – which, at minimum, must be to:
  - identify individuals qualified to become board members consistent with criteria approved by the board;
  - select, or recommend that the board select, the director nominees for the next annual meeting of shareholders;
  - develop and recommend to the board a set of corporate governance principles; and
  - oversee the evaluation of the board and management.
- an annual performance evaluation of the committee.

In addition, the charter should address committee member qualifications; committee member appointment and removal; committee structure and operations (including authority to delegate to subcommittees); and committee reporting to the board. The charter should also give the committee sole authority to retain and terminate search firms used to identify director candidates, including the sole authority to approve fees and other retention terms.

If a company is legally required by contract or otherwise to provide third parties with the ability to nominate directors, the selection and nomination of such directors need not be subject to the nominating committee process.

As noted above, "controlled" companies need not comply with the requirements outlined in this section 4.

5. **Listed domestic companies must have a compensation committee (or committees of the companies' own denomination with the same responsibilities) composed entirely of independent directors.**

The compensation committee must have a written charter that addresses:

- the committee's purpose and responsibilities – which, at minimum, must be to have direct responsibility to:
  - review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of those goals and objectives, and, either as a committee or together with the other independent directors (as directed by the board) determine and approve the CEO's compensation level based on this evaluation;

- make recommendations to the board with respect to non-CEO compensation, incentive-compensation plans and equity-based plans; and
- produce a compensation committee report on executive compensation as required by the SEC to be included in the company's annual proxy statement or annual report on Form 10-K filed with the SEC.

- an annual performance evaluation of the compensation committee.

In addition, the charter should address committee member qualifications; committee member appointment and removal; committee structure and operations (including authority to delegate to subcommittees); and committee reporting to the board. If a compensation consultant is to assist in the evaluation of a director, CEO or senior executive compensation, the charter should also give the committee sole authority to retain and terminate the consulting firm, including the sole authority to approve fees and other retention terms.

The NYSE has stated that the above provision should not be construed as precluding discussion of CEO compensation with the board generally.

As noted above, "controlled" companies need not comply with the requirements outlined in this section 5.

6. **Listed companies (both domestic and foreign) must have an audit committee that satisfies the requirements of Rule 10A-3.**

- Rule 10A-3 requires all members of the audit committee to be independent and provides that in order to satisfy the independence requirement an audit committee member may not accept any consulting, advisory, or other compensatory fee from the company other than for board service or be an affiliate of the company.
- For domestic companies, a director must meet the independence requirements of both Rule 10A-3 and the director independence requirements of Section 303A.02 discussed above.
- For foreign private issuers or U.S. companies that list securities other than equity securities on the NYSE, in order to serve on the audit committee, the director is only required to satisfy the audit committee requirements of Rule 10A-3.
- The audit committee independence requirement also applies to "controlled" companies.

7. **The audit committee must have a minimum of three members and each member must satisfy the NYSE's independence standards as set forth in 2 above.**

- Each member of the audit committee must be financially literate, as such qualification is interpreted by the company's board in its business judgment, or must become financially literate within a reasonable period of time after his or her appointment to the audit committee.
- At least one member of the audit committee must have accounting or related financial management expertise, as such qualification is interpreted by the company's board in its business judgment. Under the Sarbanes-Oxley Act, the company will be required to disclose whether or not the board has determined that there is an "audit committee financial expert" among the members of the audit committee. Any director who satisfies the SEC's "audit committee financial expert" definition will be deemed to satisfy the NYSE's "accounting or related financial management expertise" requirement although the opposite might not be true.

In its commentary, the NYSE notes that if an audit committee member simultaneously serves on the audit committees of more than three public companies, and the listed company does not limit the number of audit committees on which its audit committee members serve, then in each case, the board must determine that such simultaneous service would not impair the ability of such member to effectively serve on the listed company's audit committee and disclose such determination in the company's annual proxy statement or, if the company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC. The NYSE defines the term "public company" for this purpose as a company that is registered with the SEC under Sections 12(b) or 12(g) of the Exchange Act and subject to the reporting obligations of the Exchange Act.

The audit committee must have a written charter that addresses:

- the committee's purpose – which, at minimum, must be to:
  - assist board oversight of (i) the integrity of the company's financial statements, (ii) the company's compliance with legal and regulatory requirements, (iii) the independent auditor's qualifications and independence, and (iv) the performance of the company's internal audit function and independent auditors; and
  - prepare an audit committee report that SEC rules require be included in the company's annual proxy statement;
- an annual performance evaluation of the audit committee; and
- the duties and responsibilities of the audit committee – which, at minimum, must include those set out in Rule 10A-3(b)(2), (3), (4) and (5) (i.e. the sole power to hire and fire a company's outside auditors and the authority to arrange for funding and consult with and retain legal, accounting and other experts and the responsibility to establish procedures for the treatment of accounting and audit complaints), as well as to:
  - at least annually, obtain and review a report by the independent auditor describing: the accounting firm's internal quality-control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of the accounting firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the accounting firm, and any steps taken to deal with any such issues; and (to assess the auditor's independence) all relationships between the independent auditor and the company.

  In its commentary, the NYSE notes that this evaluation should include a review and evaluation of the lead partner of the independent auditor. In doing so, the committee should take into account the opinions of management and internal auditors. The committee should also consider whether regular rotation of the audit firm itself is appropriate. The committee should present its conclusions with respect to the auditor to the full board.

  - discuss the company's annual audited financial statements and quarterly financial statements with management and the independent auditor, including the company's disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations."
  - discuss the company's earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies.

  In its commentary, the NYSE notes that this may be done generally (i.e., discussion of the types of information to be disclosed and the type of presentation to be made). The committee need not discuss in advance each release or statement that provides guidance.

  - discuss policies with respect to risk assessment and risk management.

  In its commentary, the NYSE notes that the audit committee need not be the sole body responsible for risk assessment and management, but must discuss guidelines and policies to govern the process by which risk assessment and management is undertaken. Where other committees or mechanisms are in place, the processes should generally be reviewed by the audit committee.

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

– review with the independent auditor any audit problems or difficulties and management's response.

In its commentary, the NYSE notes that the audit committee may wish to review: accounting adjustments that were noted or proposed by the auditor but not made by management (due to materiality or otherwise); communications between the audit team and the auditor's national office regarding auditing or accounting issues; and management or internal control letters issued, or proposed to be issued, by the auditor to the company. The review should also include a discussion of the responsibilities, budget and staffing of the internal audit function.

– set clear hiring policies for employees or former employees of the independent auditors.

– report regularly to the board of directors.

In its commentary, the NYSE notes that this report should cover issues that arise with respect to the quality or integrity of the financial statements, compliance with legal or regulatory requirements, performance and independence of the auditors or performance of the internal audit function.

Every listed company must have an internal audit function.

- This function may be outsourced to a firm other than the company's independent auditor.

8. **Shareholders must be given the opportunity to vote on all equity-compensation plans.**

This provision was adopted separately. For further information on this topic see our August 6, 2003 memorandum "SEC Approves NYSE and NASDAQ Proposals for Shareholder Approval of Equity Compensation Plans," which is available on our website (www.paulweiss.com) under Securities Group publications.

9. **Listed companies must adopt corporate governance guidelines and publish them on their web sites, together with key committee charters (e.g. nomination, compensation and audit) and the company's code of business conduct and ethics.**

- The company's annual report on Form 10-K filed with the SEC must state that the foregoing information is available on the web site and that information is available in print to any shareholder who requests it.

The following should be addressed in the corporate governance guidelines:

- Director qualification standards
- Director responsibilities
- Director access to management and, as necessary and appropriate, independent advisors
- Director compensation
- Director orientation and continuing education
- Management succession
- Annual performance evaluation of the board

10. **Listed companies must adopt and disclose a code of business conduct and ethics for directors, officers and employees, and promptly disclose any waivers of the code for directors or executive officers.**

The following should be addressed in the code:

- Conflicts of interest
- Corporate opportunities
- Confidentiality
- Fair dealing
- Protection and proper use of company assets
- Compliance with laws, rules and regulations (including insider trading laws)
- Encouraging the reporting of any illegal or unethical behavior

The NYSE has stated that the distribution of a press release within 2-3 business days of a board's determination to approve any waiver from the company's code of business conduct and ethics is an example of prompt notification. A company might also choose to provide website disclosure of any waiver, or provide notice to the SEC on Form 8-K. These examples, however, are not an exclusive list of alternatives.

11. **Listed foreign private issuers must disclose any significant ways in which their corporate governance practices differ from NYSE rules.**

- The company is required to compare NYSE domestic corporate governance requirements against the specific practices followed by the company.
- This is not intended to be a "laundry list" and may be made in a brief, general summary of material differences.
- The NYSE will not provide a prescribed form and expects that each company will develop its own appropriate disclosures.
- Like other exchanges, the NYSE will continue to permit 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).
- If the company chooses to voluntarily comply with the NYSE corporate governance standards it must still comply with this disclosure requirement, even if the company only states in its annual report to shareholders that there are no significant differences in its corporate governance practices.
- If the company chooses to include the required disclosure on its website, it must do so promptly and has an obligation to update such disclosure promptly after a change occurs.
- If the company chooses to include the disclosure in its annual report to shareholders, the disclosure requirement applies to the next annual report distributed to shareholders after the company's 2004 annual shareholder meeting, or to annual reports mailed after October 31, 2004, whichever is earlier.

12. **CEO's of listed companies must certify to the NYSE each year that he or she is not aware of any violation by the company of NYSE corporate governance standards.**

- The CEO certification is to be submitted to the NYSE no later than 30 days after the annual shareholder meeting and the company's annual report should state that such CEO certificate has been submitted. The NYSE will make the form of CEO certifications available on its website at www.nyse.com.
- Each listed company must disclose in its annual report the CEO/CFO certifications required by Section 302 of the Act and the CEO certification submitted to the NYSE. If a company chooses to distribute a glossy annual report to shareholders rather than a "wrapped" Form 10-K that already includes the Section 302 certification as an exhibit, the company may disclose that it has filed the Section 302 certification as an exhibit to its Form 10-K, instead of including that certification in the glossy annual report.
- Companies are not required to include (a) Section 906 certifications required under the Act, (b) interim Section 302 certifications, or (c) the internal control attestations required by Section 404 of the Act.
- Each listed company CEO must promptly notify the NYSE in writing after any executive officer of the listed company becomes aware of any material noncompliance with any applicable provisions of Section 303(A).
- Companies will be required to continue to provide Written Affirmations (as required under Section 303.02) on an annual basis, 30 days after the annual shareholders meeting, as well as an interim Written Affirmation each time a change is made to the composition of the audit, nominating or compensation committee. The forms for both the annual and interim Written Affirmations will be available on the NYSE website.

13. **The NYSE may issue a public reprimand letter to any listed company that violates a NYSE corporate governance standard, in addition to the ultimate penalty of delisting.**

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Any questions concerning the foregoing should be addressed to any of the following. This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. In addition, memoranda on related topics may be accessed under Securities Group publications on our web site (www.paulweiss.com).

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