Paul|Weiss

March 2003

NYSE Updates Proposed New Rules To Strengthen Corporate Governance

The New York Stock Exchange has submitted to the Securities and Exchange Commission revisions to its proposed new Rule 303A, which sets forth the NYSE's proposed new corporate governance listing standards. The revisions reflect changes to the director independence elements of the NYSE's original proposal. The NYSE's original proposal was submitted to the SEC in August 2002. That proposal was based in large part on the June 6, 2002 Report of the NYSE's Corporate Accountability and Listing Standards Committee (the "Report"), with certain changes made in response to industry comments, as well as modifications resulting from the enactment of the Sarbanes-Oxley Act in July 2002.

This memorandum summarizes the principal provisions of the NYSE's proposed new corporate governance listing standards as they have been revised through March 12, 2003. Changes covered by the March 2003 revisions are noted herein with an "[N]".

Coverage

Proposed new Rule 303A would apply to all companies listing equity securities on the NYSE, as well as to business trusts, REITs and limited partnerships.

Non-U.S. issuers will continue to be entitled to waivers from the NYSE corporate governance listing standards, but will be required to make disclosures as to the significant differences between their local standards and the requirements applicable to domestic companies.

Effective dates

The proposed new rule must be submitted for review and approval by the SEC, which includes an additional public comment period. The new rule will become effective for all currently listed companies, as well as newly listed companies (either via IPO or transfer from another exchange), six months following SEC approval, with the following exceptions:

All currently listed companies will be required to have a majority of independent directors on their boards and must comply with the qualification standards for audit committee membership within 18 months of SEC approval of the new listing standards. In contrast, companies listing in connection with an IPO will have 24 months from the listing to comply. Similarly, companies transferring to the NYSE from another exchange will also have 24 months from the date of transfer to comply to the extent the exchange on which they were listed did not have the same requirement; to the extent the prior exchange had an unexpired transition period in respect of substantially similar requirements, transferring companies would have the benefit of the balance of the transition period. Companies with classified boards will have an additional year to comply (i.e., a total of 30 months). [N]

The 24-month approach will also apply to the independence requirements for membership on nominating and compensation committees, although during the one-year period commencing 12 months after the relevant measuring date, companies will be required to have at least one independent director on each such committee.

Although non-U.S. issuers will be required to comply with the independence standards for audit committee members under Section 301 of the Sarbanes-Oxley Act, non-U.S. issuers will not be required to comply with any additional NYSE independence standards (e.g., an independent nominating committee, a board consisting of a majority of independent directors). Instead, non-U.S. issuers may continue to seek waivers of the relevant listing standards and disclose the significant ways in which their home country corporate governance practices differ from those of U.S. listed companies.

Stockholder approval of equity compensation plans, and the related provisions regarding broker votes of uninstructed shares, will be effective immediately upon SEC approval, as will the provisions providing for public reprimand of issuers that do not comply with NYSE listing standards.

The proposed new listing standards

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

   - "Controlled" companies are exempt from this requirement, as well as the requirements to have nominating and compensation committees composed solely of independent directors, but must have a minimum three-person audit committee composed entirely of independent directors and must otherwise comply with the audit committee requirements.

   - A controlled company is one in which more than 50% of the voting power is held by an individual, group or another company, rather than the public.

   - A controlled company that chooses to take advantage of this exemption must disclose in its annual proxy statement that it is a controlled company and the basis for that determination.

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 these determinations in their annual proxy statements.**

   - The basis for a board determination that a relationship is not material must be disclosed in the annual proxy 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 in the company's annual proxy statement.

   - The NYSE has stated that it does not view the ownership of even a significant amount of stock, by itself, as a bar to an independence finding.

- A director who serves as an interim Chairman or CEO may be deemed independent immediately after his/her service as such ends.

- Employment of a family member in a non-officer position does not preclude a finding of independence. Family members of an executive who otherwise are independent may be classified as independent following the death or incapacity of the executive.

A director who receives (or whose family member receives) more than $100,000 per year in direct compensation from the company is presumed not to be independent until five years after he or she ceases to receive more than $100,000 per year in compensation. [N]

- Fees paid for service as a director, committee service and pension and other forms of deferred compensation paid for prior service (that is not contingent on continued service) are not counted for purposes of calculating the $100,000 threshold. [N]

- The board may negate the presumption of non-independence if the board determines (and no independent director dissents) that, based upon the relevant facts and circumstances, the compensatory relationship is not material. [N]

- Any affirmative determination of independence made by the board under these circumstances must be specifically explained in the company's proxy statement. [N]

In addition, listed companies must observe a five year "look back" period for purposes of satisfying the definition of independence for:

- A director who was affiliated with or employed, or whose immediate family member was affiliated with or employed in a professional capacity, by the listed company's present or former independent auditor;

- A director who was employed, or whose immediate family member was employed, as an executive officer of another company where any of the listed company's present executives serve on that companies compensation committee; and

- A director who was an executive officer or an employee, or whose immediate family member was an executive officer, of another company:

    - that accounted for at least 2% or $1 million (whichever is greater) of the listed company's consolidated gross revenues; or

    - for which the listed company accounted for at least 2% or $1 million (whichever is greater) of such other company's consolidated gross revenues.

The proposal provides a transition period for the "look back" requirement. During the five years immediately following the effective date of the board independence requirement set forth in Rule 303A, each five year "look back" period shall instead be the period since the effective date of the new board independence requirement. As a result, directors will not be disqualified under these independence provisions because of relationships that existed, and were terminated, prior to the effective date of the new board independence requirement.

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.

- 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 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.

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 – which, at minimum, must be to:

  - identify individuals qualified to become board members; and

  - 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 committee's goals and responsibilities – which must reflect, at minimum, the board's criteria for selecting new directors, and oversight of 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 – which, at minimum, must be to

    - discharge the board's responsibilities relating to compensation of the company's executives; and

    - produce an annual report on executive compensation for inclusion in the company's proxy statement, in accordance with applicable rules and regulations.

- The committee's duties and responsibilities – which, at minimum, must be 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 set the CEO's compensation level based on this evaluation; and

    - make recommendations to the board with respect to incentive-compensation plans and equity-based plans.

- 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.

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, composed entirely of independent directors.**

- The audit committee independence requirement also applies to "controlled" companies.

- Each member of the audit committee must be, or must within a reasonable time after appointment become, financially literate.

- At least one member of the committee must have accounting or related financial management expertise. The NYSE has not yet acted on its prior recommendation that the committee chair have accounting or financial management expertise. 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.

- The NYSE chose, at this time, not to act upon the prior recommendation that committee members who are, or are affiliated with, 20% shareholders not be voting members or chairs of the audit committee, in view of the provision of the Sarbanes-Oxley Act disqualifying affiliated persons from service on the audit committee.

Director's fees must be the sole remuneration an audit committee member receives from the listed company.

- Disallowed compensation for an audit committee member includes fees paid directly or indirectly to the director, or the director's firm, for services as a consultant or a legal or financial advisor, regardless of the amount.

- Boards may choose to provide audit committee members with greater levels of compensation reflecting the time and effort required to fulfill their duties.

- If a director satisfies the general definition of independence (see item 2 above), receipt of a pension or other form of deferred compensation for prior service (provided it is not contingent on continued service) will not preclude such director from satisfying the requirement that director's fees be the sole form of compensation from the company.

If a board does not place an upper limit on the number of audit committees on which an audit committee member may serve, and if any such member serves on more than three audit committees of public companies, the board must make a determination that such service would not impair the ability of the member to serve on the company's audit committee and the company must disclose such determination in its annual proxy statement.

This standard is consistent with proposed SEC rules implementing Section 301 of the Sarbanes-Oxley Act.

7. **Increase 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.**

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 the report that SEC rules require be included in the company's annual proxy statement;

- The duties and responsibilities of the audit committee – which, at minimum, must be to:

    - retain and terminate the company's independent auditors (subject, if applicable, to shareholder ratification).

    - In its commentary, the NYSE notes that the committee can obtain management input on audit and non-audit services, but cannot delegate its responsibility to management for approval.

- 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. 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 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 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.

- as appropriate, obtain advice and assistance from outside legal, accounting or other advisors.

  In its commentary, the NYSE notes that the committee must be empowered to retain these advisors without seeking board approval.

- 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.

  The Report's recommendation that these meetings be held quarterly was changed to "periodically."

- 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.

- An annual performance evaluation of the audit committee.

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**.

Shareholder approval is not required for employment inducement options, plans acquired through mergers or acquisitions, and tax qualified and excess benefit plans.

- Shareholder approval applies to all covered plans, as well as any material modifications, such as option repricing.

- Equity-compensation plans that are not subject to shareholder approval must be approved by the compensation committee.

- A broker may not vote a customer's shares on any stock option plans unless the broker has received that customer's instructions to do so.

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 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

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

    - This is not intended to be a "laundry list" and may be made in a brief, general summary of material differences.

    - 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).

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 certification is to be set forth in the annual report.

    - In light of the certifications required under the Sarbanes-Oxley Act and SEC rules, the NYSE withdrew its proposal for separate certification of financial statements.

13. The NYSE will be able to issue a public reprimand letter to any listed company that violates a NYSE corporate governance standard, in addition to the existing penalty of delisting.

* * * *

It has been several months since the NYSE and Nasdaq submitted their corporate governance reform proposals to the SEC. Both the NYSE and Nasdaq have revised their proposals in the interim. Nevertheless, Nasdaq's proposal, as revised, contains some provisions that are different from the proposed NYSE standards. Both sets of rules will be subject to public comment. In addition, as indicated by the SEC staff, presumably there will be efforts made by the SEC to create consistency between the NYSE and Nasdaq standards. In addition, during the proposal period, the SEC has proposed rules under Section 301 of the Sarbanes-Oxley Act regarding audit committees and audit committee member independence.

In the interim, the SEC has requested the exchanges to address certain proposals separately. Thus, although it is safe to predict the broad outlines of the new corporate governance listing standards, the details remain to be finalized.

* * * *

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).

Mark S. Bergman	(44 20) 7367 1601	John C. Kennedy	(1) 212-373-3025
Richard S. Borisoff	(1) 212-373-3153	Edwin S. Maynard	(1) 212-373-3024
Andrew J. Foley	(1) 212-373-3078	Raphael M. Russo	(1) 212-373-3309
Paul D. Ginsberg	(1) 212-373-3131		

PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP