PAUL, WEISS, RIFKIND, WHARTON & GARRISON

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NYSE PROPOSES NEW CORPORATE ACCOUNTABILITY AND LISTING STANDARDS FOR LISTED COMPANIES

In response to a request in February 2002 from the Chairman of the U.S. Securities and Exchange Commission (the "SEC"), the New York Stock Exchange (the "NYSE") recently reviewed its corporate governance listing standards with the goal of enhancing the accountability, integrity and transparency of NYSE listed companies. The result of this review was a Report of the NYSE Corporate Accountability and Listing Standards Committee that was submitted to the NYSE Board of Directors on June 6, 2002.

The NYSE Report contains recommendations for reforms to be implemented by the NYSE and for reforms that should be implemented by other institutions, such as the SEC. The approach adopted by the NYSE recognizes that listing standards and other reforms cannot guarantee effective corporate governance and that shareholders will continue to depend on the competence and integrity of corporate directors. In its introduction to the Report, the Committee emphasizes its view that the service of competent, ethical people as directors of public companies is critical to effective corporate governance and that no action should be taken to deter responsible people from serving as directors.

It should be noted that the Committee specifically rejected proposals imposing additional liability on directors or reducing the protections currently available through director and officer liability insurance and state law exculpation provisions, and repealing or weakening the Private Securities Litigation Reform Act.

The Report states that the recommendations are designed to further the ability of honest and well-intentioned directors, officers and employees to perform their functions effectively, while allowing shareholders to more easily and efficiently monitor the performance of companies and directors in order to reduce instances of lax and unethical behavior. The Committee encourages all listed companies to establish an orientation program for new directors and recommends the development of a Directors Institute that offers continuing education forums around the US for current and newly elected directors.

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

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submission of an opinion of local counsel). While the proposed new standards would not apply to non-US companies, such companies would be required to disclose the significant ways in which their corporate governance practices differ from the NYSE standards.

Final action on the Report is expected to be taken at the August 1, 2002 meeting of the NYSE Board of Directors. Thereafter, changes to the listing standards would be set forth in one or more NYSE requests for 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, following publication in the *Federal Register* and a public comment period, become effective 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 through issuance of a press release. In addition, Nasdaq announced that it expects to consider in late June a series of corporate governance reforms similar to the proposals discussed in the NYSE Report.

We have summarized the Report below. The full Report is available on the NYSE website at www.nyse.com. As indicated in the third section of this memorandum, the Report contains various recommendations to the SEC, certain of which are reflected in proposals submitted for public comment. These proposals are summarized in memoranda available on our website at www.paulweiss.com.

Highlights of Recommended New Listing Standards:

- **Increasing the role and authority of independent directors.**
  - Independent directors must comprise a majority of a listed company's board.
    - Listed companies are given 24 months from the enactment of the rule to effect this change.
    - Newly listed companies must be compliant within 24 months.
    - Listed companies must disclose when they become compliant with this requirement.
  - Boards must convene regular executive sessions in which the non-management directors meet without management.
  - Listed companies must have an audit committee, a nominating committee and a compensation committee, each comprised *solely* of independent directors.
  - The chair of the audit committee must have accounting or financial management experience.
  - Audit committees must have sole responsibility for hiring and firing the company's independent auditors, and for approving any significant non-audit work by the auditors.

- **Tightening the definition of "independent" director and adding new audit committee qualification requirements.**
  - For a director to be deemed "independent," the board must *affirmatively* determine that the director has no material relationship with the listed company. These determinations must be disclosed.
  - Listed companies must 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 the foregoing.
  - Director's fees must be the sole compensation an audit committee member receives from the listed company.
  - An audit committee member associated with a major shareholder (i.e., owning 20% or more of the listed company's equity) may not vote in audit committee proceedings.
- **Fostering a focus on good corporate governance**.
  - Listed companies must adopt corporate governance guidelines, as well as charters for their audit, compensation and nominating committees.
  - Listed companies must adopt a code of business conduct and ethics.
- **Giving shareholders more opportunity to monitor and participate in the governance of their companies.**
  - Shareholders must be given the opportunity to vote on all equity-based compensation plans; brokers may only vote customer shares on proposals for such plans pursuant to customer instructions.
  - Listed companies must publish codes of business conduct and ethics, and key committee charters.
  - Waivers of codes of business conduct or ethics for directors or executive officers must be promptly disclosed.
  - Listed foreign private issuers must disclose any significant ways in which their corporate governance practices differ from NYSE listing standards.
- **Establishing new control and enforcement mechanisms**.
  - Each listed company's CEO must certify annually that the company has established and complied with procedures for verifying the accuracy and completeness of information provided to investors and that he or she has no reasonable cause to believe that the information provided to investors is not

accurate and complete. The CEO must further certify that he or she has reviewed with the board those procedures and the company's compliance with them.

– CEOs must certify annually that they are not aware of any company violations of NYSE listing standards.

– Upon finding a violation of an NYSE listing standard, the NYSE may issue a public reprimand letter to any listed company and ultimately suspend or de-list an offending company.

Recommended New Listing Standards:

1. **Empower non-management directors to serve as a more effective check on management.**

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

   - The independent directors must designate, and publicly disclose the name of, the director who will preside at the executive sessions.

2. **Require listed companies to have a nominating/corporate governance committee composed entirely of independent directors.** Current standards do not require either such committee.

   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 to select, or to 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; and committee reporting to the board.

3. **Require listed companies to have a compensation committee composed entirely of independent directors.** Current standards do not require a compensation committee.

   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 to 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.

  – 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; and committee reporting to the board.

4. Add additional requirements for audit committee membership:

- Director's fees are the only compensation an audit committee member may receive from the company.

- A director who meets the definition of "independence" mandated for all audit committee members, 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.

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

- If a director serves on more 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.

5. 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: (a) 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 (b)

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).
  - at least annually, obtain and review a report by the independent auditor describing: the firm's internal quality-control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of the 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 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.
  - 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.
  - as appropriate, obtain advice and assistance from outside legal, accounting or other advisors.
  - discuss policies with respect to risk assessment and risk management.
  - meet separately, at least quarterly, 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.
  - set clear hiring policies for employees or former employees of the independent auditors.
  - report regularly to the board of directors.
- an annual performance evaluation of the audit committee.

6. Increase shareholder control over equity-compensation plans.

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

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

7. **Require listed companies to adopt and disclose their corporate governance guidelines, which should include the following subjects and be available on the Company's website.**

   - 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.

8. **Require listed companies 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).
   - Reporting of any illegal or unethical behavior.

9. **Require listed foreign private issuers to disclose any significant ways in which their corporate governance practices differ from those followed by domestic companies under NYSE listing standards.**

10. **Require the CEO of any listed company to certify to the NYSE each year:**

   - that the company has established procedures for verifying the accuracy and completeness of the information provided to investors; that those procedures have

been carried out; and that, based upon the CEO's assessment of the adequacy of those procedures and of the diligence of those carrying them out, the CEO has no reasonable cause to believe that the information provided to investors is not accurate and complete in all material respects. The CEO must further certify that he or she has reviewed with the board those procedures and the company's compliance with them; and

- that he or she is not aware of any violation by the company of NYSE listing standards.

See discussion below concerning the June 12, 2002 SEC proposals.

11. Enable the NYSE to issue a public reprimand letter to any listed company that violates an NYSE listing standard.

Recommendations to the SEC:

1. The SEC should require CEOs to certify to shareholders that, to the best of their knowledge and belief, their companies' financial statements and disclosures fairly present the information that reasonable investors should have to make informed investment decisions.

On June 12, 2002, the SEC proposed rule changes that would require the principal executive officer and the principal accounting officer of domestic reporting companies to certify with respect to their 10-K and 10-Q reports that:

- they have read the report;
- to their knowledge, the information is true in all important respects; and
- the report contains all information about the company of which they are aware that they believe is important to a reasonable investor.

The proposed rule changes would also require domestic reporting companies to maintain procedures to provide reasonable assurances that the company is able to collect, process and disclose information required in SEC periodic and current reports and to periodically review and evaluate these procedures. The principal executive officer and the principal financial officer would be required to certify in the annual report that they have reviewed the results of the evaluation.

2. The SEC should require public accountants to be regulated by a new private-sector organization governed and funded independently of the accounting industry.

- A private, independent body would review the quality controls of accounting firms and discipline auditors for incompetent or unethical conduct.
- The SEC should oversee the organization's membership, rules and activities to ensure that it is independent of the accounting industry.

3. **The SEC should require companies, in all public or shareholder communications, to report complete GAAP-based financial information before any reference to "pro forma" or "adjusted" financial information. Any pro forma information should be reconciled to the GAAP information.**

4. **The SEC should prohibit relationships between independent auditors and audit clients that may impair the effectiveness of audits.**

   - Pursue its review of its basic guidelines for permitted and prohibited relationships between auditors and audit clients.

5. **The SEC should exercise more active oversight of the FASB to improve the quality of GAAP and the speed of FASB actions.**

   - The SEC should focus on improving the overall quality of GAAP (to reduce "check the box" accounting) and on ensuring that the FASB promptly responds to investor needs.

6. **The SEC should improve Management's Discussion and Analysis (MD&A) disclosure through adoption of the proposed rules on accounting estimates resulting from the application of critical accounting policies and the initial adoption of accounting policies.** (See Paul Weiss memo – May 2002)

7. **The SEC should, as proposed, require prompt disclosure of insider transactions (amendments to Form 8-K rules).** (See Paul Weiss memo – April 2002)

8. **The SEC should evaluate the impact of the selective disclosure rules (Regulation FD) on corporate behavior and disclosure practices.**

Recommendations to Congress:

1. **Congress should allocate additional resources to the SEC as necessary to enable it to increase its monitoring and enforcement activities.**

2. **Congress should give the SEC the authority to bar officers and directors of public companies from holding these positions after they have failed to fulfill their responsibilities.**

   - Administrative process advocated rather than lengthy judicial process currently required.

3. **Congress should create a public/private panel to review stock concentration in 401(k) plans.**

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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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