

## NYSE Standards Committee Proposes Changes to Current Listing Standards

By Michael L. Zuppone & John J. UyHam

On June 6, 2002, the Corporate Accountability and Listing Standards Committee of the New York Stock Exchange issued a report to the NYSE's board of directors which contained recommendations proposing significant changes to the NYSE's current listing standards. The recommendations propose changes to listing standards governing:

- board composition;
- board committees;
- shareholder approval of equity compensation plans;
- corporate governance and ethics; and
- disclosure requirements.

The recommended rule changes are intended to enhance the accountability, integrity and transparency of NYSE listed companies. We expect the board of directors of the NYSE to approve the recommendations in generally their current form at its August 1, 2002 meeting. Following such approval, the staff of the NYSE will prepare and submit one or more formal rule-making applications to the Securities and Exchange Commission for approval. The proposed rule changes will then be subjected to the SEC's notice and comment procedures which provide for a period of public comment on the proposed rule changes.

The full text of the committee's report is available at [www.nyse.com/pdfs/corp\\_govreport.pdf](http://www.nyse.com/pdfs/corp_govreport.pdf).

### Board of Directors

*Independent Directors.* The Committee recommended that the board of a listed company have a majority of independent directors. This is a significant proposal as the existing listing standards require only that the audit committee be comprised of independent directors. Under the proposed listing standards, a director is independent if:

- during the prior five years, the director has not been employed by the company or employed by another company on whose board an executive officer of the listed company serves;
- the director has not been employed by a present or former auditor of the company, unless five years have passed since either the end of the individual's employment or the end of the auditor's relationship with the company;
- each person in the director's immediate family satisfies the above criteria; and
- the board of the listed company affirmatively determines that the director has no material relationship with the company.

The "no material relationship" test represents a change from the existing definition of independence which only requires that a director's relationship with the company does not interfere with the exercise of the director's independence from management and the company. In determining

whether a relationship is material, the Committee recommended that boards of directors broadly consider all relevant facts and circumstances, including the director's affiliation with companies, firms, organizations and persons that have a relationship with the company. Ownership of less than a controlling amount of the company's stock alone is not a definitive bar to finding a director independent. Further guidance as to how to apply the "no material relationship" test may be contained in the related formal rule-making application submitted to the SEC. The Committee also proposed that the basis for a determination that a relationship is not material should be disclosed in the company's annual meeting proxy statement.

In order to promote communication among the independent directors, the report also recommended that independent directors meet regularly in executive session without management participation. The meetings are regularly scheduled to prevent any negative inference from the fact that an executive session is held at a particular time. The independent directors must designate and publicly identify in the company's annual meeting proxy statement, a director, who may be a non-executive chairman of the board, to preside at the executive sessions.

### Board Committees

Several new rules regarding board committees were proposed. These new rules would require each listed

company to have audit, compensation and nominating/corporate governance committees, each composed entirely of independent directors and each with a charter describing the purposes and responsibilities of the committee. The existing listing standards do not require listed companies to have compensation and nominating/corporate governance committees.

*Audit Committee.* Several rule changes proposed by the Committee relate to the audit committee. First, the only allowable payments to audit committee members as compensation for their service are director's fees, though they could still receive a pension or other deferred compensation for past service. Second, a director who meets the independence requirements for audit committee members but who also directly or indirectly holds more than 20% of the company's stock may not chair or be a voting member of the audit committee. Third, the chair of the audit committee must have accounting or related financial management experience. In contrast, the current rule requires that one member of the audit committee have such experience, but does not mandate that it be the chair. Finally, if a director is permitted by a board to simultaneously serve on the audit committee of more than three public companies, the board must determine that the director can effectively serve on its audit committee and publicly disclose this determination in the company's annual meeting proxy statement.

The Committee stated that the audit committee charter must specify that the audit committee's purpose, at a minimum, is to:

- assist the board in overseeing:
  - the integrity of the company's financial statements

- the company's compliance with legal and regulatory requirements
- the qualifications and independence of the company's independent auditors, and
- the performance of the company's internal audit function and independent auditors; and
- prepare the audit committee report required by the SEC to be included in the company's annual meeting proxy statement.

The Committee also proposed the following minimum duties and responsibilities for the audit committee:

- retain and terminate, in the audit committee's sole discretion, the company's independent auditors;
- obtain an annual report from the company's independent auditors describing auditor quality-control issues, governmental or professional investigations during the last five years into other audits carried out by the auditors and all relationships between the auditors and the company;
- discuss the company's annual and quarterly financial statements with management and the independent auditors;
- discuss earnings press releases and financial information and earnings guidance provided to analysts and rating agencies;
- if appropriate, obtain legal advice from outside legal counsel or other advisors, whom the audit committee must be able to retain without the approval of the full board;
- discuss policies on risk assessment and risk management;
- hold separate meetings at least quarterly with management and the company's internal and independent auditors;

- review with the independent auditors any audit problems or difficulties and management's response;
- set clear hiring policies for employees or former employees of the independent auditors;
- review major issues regarding accounting principals and financial statement presentations, the effect of regulatory and accounting initiatives and off-balance sheet transactions on the financial statements and analyses prepared by management and/or the independent auditors on significant financial reporting issues and judgments;
- report regularly to the full board of directors regarding any issues that arise relating to, among other things, financial reporting and compliance; and
- undertake an annual performance evaluation of the audit committee.

*Compensation Committee.* Under the proposed rules, the compensation committee charter must specify that the committee's purpose, at a minimum, is to:

- discharge the board's responsibilities relating to the compensation of the company's executives; and
- prepare the annual report on compensation to be included in the company's annual meeting proxy statement.

The Committee also proposed that the charter specify the compensation committee's duties and responsibilities which, at a minimum, must be to:

- review and approve corporate goals and objectives relevant to CEO compensation and in light of such goals and objectives evaluate CEO performance and set CEO compensation; and
- make recommendations to the full board on incentive compensation plans and equity-based plans.

The compensation committee must also undertake an annual performance evaluation of the committee. If a company engages a compensation consultant, the compensation committee must have the sole authority to retain and terminate the consultant as well as authority to approve the fees charged by the consultant and other retention terms.

*Nominating/Corporate Governance Committee.* Under the proposed rules, the nominating/corporate governance committee charter must specify that the committee's purpose, at a minimum, is to:

- identify individuals qualified to become board members;
- select, or to recommend that the board select, the director nominees for the next annual meeting of shareholders; and
- recommend to the board a set of corporate governance principles applicable to the company.

The Committee also proposed that the charter specify the nomination/corporate governance committee's duties and responsibilities which, at a minimum, must reflect the board's criteria for selecting new directors, and oversight of the evaluation of the board and management. The nominating/corporate governance committee must also have the sole authority to engage any search firm used to identify director candidates. The nominating/corporate governance committee must also undertake an annual performance evaluation of the committee.

### **Shareholder Approval of Equity Compensation Plans**

The proposed rules significantly change the existing standards regarding shareholder approval of equity compensation plans. The Committee proposed that all equity-compensation plans and any material revisions to

the plans (including repricings) be subject to shareholder approval. The proposal would delete the current exemptions from the shareholder approval requirement (relating to, among other things, broad-based plans).

In addition, the Committee's recommendations would prohibit a broker from voting a customer's shares on matters involving equity compensation plans unless specific voting instructions had been given to the broker by the customer.

### **Corporate Governance Guidelines**

The Committee recommended new rules requiring listed companies to adopt corporate governance guidelines, which must address, at a minimum:

- director qualification standards;
- director responsibilities;
- director access to management and independent advisors;
- director compensation;
- director orientation and continuing education;
- management succession; and
- annual performance evaluations of the board.

The corporate governance guidelines must be disclosed on the company's website, along with the charters for the audit, compensation and nominating/governance committees and the company's code of business conduct and ethics.

### **Code of Business Conduct**

The proposals require adoption of a code of business conduct and ethics for directors, officers and employees. The code must at least set out company policy on:

- conflicts of interest;

- use of corporate opportunities for personal gain;
- confidentiality of company information;
- fair dealing with customers, suppliers, competitors and employees;
- protection and proper use of company assets;
- compliance with laws, rules and regulations; and
- encouragement of reporting of illegal or unethical behavior to the company.

A waiver of the code requires the approval of the board or a board committee and prompt public disclosure to shareholders.

### **CEO Certification**

The proposed rules require the CEO of a listed company to make an annual certification to the NYSE. The CEO must certify 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 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 the procedures and the company's compliance have been reviewed with the board. Finally, the CEO must certify that he or she is not aware of any violation by the company of the listing standards.

The SEC has proposed similar rules which requires that within the 12 month period prior to the filing of the Form 10-K Annual Report, the company must conduct an evaluation under the supervision of management of the effectiveness of the design and operation of procedures that must be maintained to provide reasonable assurances that the company is able to collect, process and disclose the infor-

mation required to be disclosed in its periodic and current reports filed with the SEC. See, SEC Release No. 34-46079 (June 14, 2002).

### Reprimand Letter

The Committee proposed as an additional enforcement mechanism the issuance of public reprimand letters to companies that violate listing standards. Suspension and delisting would still be available options; however, the Committee reasoned that a lesser penalty would give the NYSE more flexibility in enforcing its rules.

### Disclosure Requirements

The Committee also recommended several new public disclosure obligations for listed companies related to the proposed rules. Listed companies would be required to disclose in their annual meeting proxy statement:

- the basis for a board determination that a relationship between a purportedly independent director and the company is not material;
- the name of the director who will preside at the executive sessions of the independent directors; and
- the basis for a determination that simultaneous service by a director on the audit committee of more than three public companies does not impair the director's ability to serve on the audit committee of the listed company.

The Committee recommended that waivers of the code of business conduct and ethics be promptly disclosed to shareholders, presumably through the filing of a Form 8-K Current Report or in another form filed with the SEC. In addition, each listed company's website must include the company's corporate governance guidelines, the charters of its most important committees (including at least the audit, compensation and nominating/corporate governance committees) and

the company's code of business conduct and ethics. The company's annual report must state that this information is available on the website and that it is available in print to any shareholder who requests it.

Existing listing standards permit foreign private issuers to follow home-country practices with respect to certain corporate governance matters, an approach the Committee recommended be continued. However, the Committee also recommended that listed foreign private issuers make their U.S. investors aware of the significant ways in which their home-country practices differ from those followed by domestic companies under the listing standards.

### Recommendations to Other Institutions

The Committee also proposed recommendations to both the SEC and Congress. The recommendations to the SEC were to:

- require oversight of public accountants by an independent private-sector organization;
- require CEO certification to shareholders that to the knowledge of the CEO, the company's financial statements and disclosures fairly present the information that reasonable investors should have to make an informed investment decision;
- require reporting of GAAP-based financial information before referring to any pro forma or adjusted financial information in any public or shareholder communication;
- review the SEC's guidelines regarding permitted relationships between auditors and audit clients;
- exercise more active oversight of the FASB;
- improve MD&A disclosure;
- accelerate disclosure of insider transactions; and

- evaluate the impact of Regulation F-D on the full and fair disclosure in earnings guidance.

The SEC has proposed rules that would require CEOs and CFOs certify in Form 10-K Annual Reports and Form 10-Q Quarterly Reports that:

- he or she has read the report;
- to his or her knowledge, the information in the report is true in all important respects as of the end of the period covered by the report; and
- the report contains all information about the company of which he or she is aware that he or she believes is important to a reasonable investor as of the end of the period covered by the report.

The Committee proposed that Congress should allocate additional resources to the SEC and create a public/private panel to review stock concentration in 401(k) plans. In addition, the Committee recommended that Congress give the SEC administrative authority to bar officers and directors of public companies from serving as an officer or director of a public company if they have violated their duties to stockholders. This recommendation is apparently directed at expanding the SEC's power to sanction insiders who violate anti-fraud or insider trading rules.

### Conclusion

Once the new standards are adopted, there will likely be some transition time for listed companies to comply. In fact, the Committee has already recommended that companies have 24 months from the date of the rule's enactment to comply with the requirements regarding the number of independent directors. We believe, however, that listed companies should begin to conduct internal policy reviews to gauge compliance with the proposed rules. In particular, companies should:

- create or update a director's questionnaire to reflect the new independence standards;
- circulate the revised questionnaire at least annually and require directors to provide prompt updates if the information changes;
- review the current composition of the audit, compensation and nominating/corporate governance committee to comply with independence requirements, and, in the case of the chair of the audit committee, expertise requirements;
- determine whether any compensation being paid to a member of the audit committee would violate the new compensation rules;
- review or create policies relating to conflicts of interests with independent auditors, including policies regarding the hiring of the auditor's employees; and

- create or update a code of business conduct.

Overall the proposed rules should prompt a board of directors to closely evaluate the effectiveness of its oversight and assess all procedures through which the board operates.

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