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## Rethinking Corporate Governance Policies and Procedures

As a response to the various accounting and corporate governance frauds, scandals and improprieties dominating the news, various legislation and regulations have been passed or proposed and are being debated with a goal to better protect investors. While it may be weeks or months before all of these laws and rules fully shake out into their final forms, companies should be focusing on their internal affairs in the meantime and reevaluating the way they manage themselves. In particular, the Sarbanes-Oxley Act of 2002 (the “Act”) and new New York Stock Exchange, Nasdaq and Securities and Exchange Commission proposals emphasize the need for a variety of new and/or improved corporate policies and documents.<sup>1</sup>

### ***Board Committee Charters***

Under proposed NYSE listing standards, all Boards of listed companies would be required to have not only audit committees, but also standing compensation and nominating committees. While many companies already have these committees, the proposals would also require these committees to be comprised solely of independent directors and to have charters, as is now required for audit committees under revised standards that took effect for most companies in 2001. The Nasdaq proposals would require independent (with limited exceptions) committee or Board approval of director nominations and CEO compensation. The NYSE and Nasdaq proposals also require the Board to have a majority of independent directors and tighten definitions of “independence” for directors. In addition, to further promote independence, most loans to directors (and officers) are now prohibited under the Act.

The committee charters would state each committee’s purpose and spell out the general goals and responsibilities of the committee and require annual performance evaluations of the committee. The compensation committee’s purposes would include discharging the Board’s responsibilities relating to the compensation of the company’s executives. Note that for many companies this would shift the ultimate responsibility for executive compensation (other than certain plan-based compensation) from the Board to the compensation committee. Committee charters would have to be posted on company websites.

The NYSE has also proposed expanding the detail required to be in audit committee charters, calling for them to spell out more specific purposes and a lengthy list of responsibilities. The Act and the NYSE and Nasdaq proposals also specify that the audit committee must retain and terminate the company’s independent auditors and approve all audit engagement fees and terms and significant non-audit engagements. This shifts sole responsibility to the audit committee, rather than allowing companies the option of the ultimate authority lying with the full Board. The Act requires the rotation of the lead and reviewing audit partners at least every 5 years. The audit committee should monitor this rotation and also consider setting strict hiring policies for employees or former employees of outside auditors to help assure independence. The Act specifically requires a one-year “cooling off” period before employees of independent auditors can assume senior management and financial positions with the issuers whom they audited, while Nasdaq and NYSE proposals contain longer cooling off periods for such persons to be considered independent directors. The Act and the NYSE proposals indicate that consideration should be given by the audit committee to periodic rotation of the auditing firm. Although the conclusion may be that the benefits of continuity prevail, these considerations promote important dialogue previously not given as much attention. Nasdaq

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<sup>1</sup> Nasdaq revised listing proposals contain many, but not all, of the same requirements, as the NYSE proposals. Nasdaq has indicated that additional corporate governance proposals are being considered. In addition, Nasdaq is under pressure from the SEC to more closely parallel the NYSE proposals to avoid arbitrary distinctions between the two organizations.

proposed rules would require audit committees to review and approve in advance all related party transactions, while the Act will require audit committees to review and approve any permitted consulting services (the scope of which has been substantially reduced under the Act) to be performed by the independent auditors of the company. Under the Act, accounting firms will be specifically required to report to audit committees on a variety of topics, including critical accounting policies and alternatives thereto.

Companies should be reviewing their existing audit committee charters to make sure they would still be workable under the new proposals and laws. For example, the NYSE proposals would require that the chair of the audit committee have accounting or related financial management expertise. Current rules require only that one member, not necessarily the chairman, have such expertise. In addition, the Act requires that to be independent, a member of the audit committee cannot be an affiliated person. This is stricter than current NYSE and Nasdaq standards and does not contain exceptions. The Act and new NYSE independence rules will also limit audit committee members' compensation from the company to only director's fees (including committee fees) and the NYSE proposals would prohibit certain large stockholders or their officers from voting on audit committees. As all of these requirements are important procedures in fulfilling the committee's goals, companies should not necessarily wait until specific listing standards or legislation require these practices.

### ***Internal Audits and Compliance***

The Act contains provisions requiring certifications of annual and quarterly reports by CEOs and CFOs. The SEC has indicated in rule proposals that as part of this certification process, it will specifically require companies to maintain procedures for gathering, analyzing and disclosing all of the information that is required to be included in their periodic and current reports. Company procedures would need to provide "reasonable assurance" that the company is able to collect, process and disclose both financial and non-financial information in its reports. Companies will need annually to evaluate the effectiveness of the design and operation of these procedures under the supervision of management and ensure that the results of the evaluation are communicated to the company's principal executive and financial officers and Board. The procedures should ensure timely collection and evaluation of information potentially subject to disclosure under securities law requirements and capture information that is relevant to an assessment of the need to disclose developments and risks that pertain to the company's business. In addition, under the Act, companies will need to disclose annually information regarding the effectiveness of management's internal control structure and procedures for financial reporting.

Companies therefore need to formulate internal procedures to protect themselves and their investors. Such procedures can also help identify deficiencies in internal operations and promote more accuracy and integrity across company financial and other information. The SEC has given little guidance as to what procedures would provide reasonable assurance. They recommended, however, that companies create a committee with responsibility for considering the materiality of information and determining disclosure obligations on a timely basis. This committee would report to senior management and/or the Board and would consist of at least the principal accounting officer or controller, the general counsel or other senior legal official with responsibility for disclosure matters, the principal risk management officer, the chief investor relations officers and other relevant officers or employees, such as managers of different business units. In light of the SEC's proposed additions to the list of items that must be reported quickly on a Form 8-K and also required real-time disclosure under the Act of material changes to companies' financial condition or operations, such a committee will likely be useful, even if not formally required. The company's procedures and controls must be routinely monitored for adequacy and updating by this committee. CEOs and CFOs should also meet regularly with lower level officers to discuss with those officers relevant disclosure items in greater detail. A consistent, complete set of questions should be asked at each meeting to ensure responsiveness. CEOs and CFOs should document their procedures before each filing on a regular basis and should consider having other officers with whom they have met do the same.

### ***Codes of Governance and Ethics***

Under proposed NYSE listing standards, companies would be required to adopt corporate governance guidelines and a code of business conduct and ethics. These corporate governance guidelines and codes of business conduct and ethics, in addition to committee charters, would have to be publicly disclosed by listed companies on their websites. The nominating committee would be responsible for development and recommendation to the Board of the relevant principles underlying the governance

guidelines. The corporate governance guidelines should address director qualifications and responsibilities, director access to management and independent advisors, responsibilities of key board committees, director compensation and director orientation and continuing education. Corporate governance guidelines should cover planning for management succession and policies and principles for performance review for CEOs and perhaps other officers, as well as annual performance reviews of the directors through self-evaluations to determine whether the Board and its committees are functioning effectively.

The Act will require issuers to state whether they have adopted a code of ethics for senior financial officers. A code of business conduct and ethics for these individuals, as well as directors, other officers and employees (required under both the NYSE and Nasdaq proposals), should focus on key areas of ethical risk, provide guidance to personnel to help them recognize and deal with ethical issues, provide mechanisms to report unethical conduct, and help to foster a culture of honesty and accountability. The NYSE would require that the code contain compliance standards and procedures that will facilitate the effective operation of the code and ensure prompt and consistent action against violations of the code. Generally, these codes would cover corporate policies regarding conflicts of interest, opportunities arising from the use of corporate property, information or position, confidentiality, fair dealing with customers, suppliers, competitors and employees, protection and proper use of company assets, compliance with laws, rules and regulations, and reporting of illegal or unethical behavior to appropriate personnel.

### ***Reviewing Insider Trading Policies***

The SEC has proposed additional items that will be required to be reported promptly by public companies on Current Reports on Form 8-K, in many instances in as short a period as two days. Among the proposed new items to be reported are the adoption and modification or termination by directors and executive officers of trading plans, contracts and arrangements for the purchase or sale of company equity securities (so-called “10b5-1 plans”). In addition, under the Act, insiders will need to report most of their transactions in company securities (including option grants and exercises) within two business days, which often involves the assistance of company personnel or counsel. Companies may therefore have increased responsibilities with respect to these trades and 10b5-1 plans even though they are currently the responsibility of the individuals. As a practical matter, companies will need to institute procedures and systems to make sure they are aware of these activities by insiders before they occur or, the latest, simultaneously, and continually remind insiders of their responsibilities. Further, the Act contains prohibitions on executives trading during benefit plan blackout periods and requires companies to notify those executives in advance of such blackout periods. Many company anti-insider trading policies already contain pre-clearance procedures for trading by insiders and blackout periods, but these may no longer be broad enough to cover all transactions or reflect the new law and rules, and probably do not require pre-clearance of 10b5-1 plans or specifically address benefit plan blackouts.

### ***Need for Workable Policies and Charters***

While some of the foregoing is in the proposal stages and not yet required, many of the proposals are nonetheless good corporate governance policies. Nevertheless, policies and charters that cannot be followed or are not enforced may do more harm than good. One size does not fit all. It is important to carefully tailor each policy, charter or other document to the needs of each individual company and set up realistic expectations. In addition, policies, charters and procedures should be periodically evaluated to ensure that they continue to reflect reality and can be followed and enforced.

Directors, officers and employees need to be made aware of the existence of relevant charters, policies and procedures and understand their importance and the reasons behind them. Continuing internal education and dissemination will be necessary. The NYSE has recommended, and Nasdaq proposals would require, that directors be trained regarding their duties, company plans, significant financial and accounting issues and other matters, depending on the characteristics of the particular company. In addition, audit committees need to continue to converse regularly and openly with outside auditors and each needs to be aware of the other’s duties and responsibilities.

Internal compliance committees or review committees must also be workable. Committees that are too small may not produce enough diverse input and ideas, while committees that are too large may be ineffective at reaching consensus or conclusions. In addition, these committees and other internal risk management procedures should be considered adaptable to change, but must be balanced with enough continuity to build confidence within the company and a productive knowledge base.

## ***Conclusion***

The summary above covers a few of the underlying policies and procedures that companies should consider. Companies that already have these in place should take a fresh look in light of the Act and the current climate of investor (and regulator) unrest. For a more comprehensive discussion of the topics covered in this Client Advisory or for assistance in developing any of the foregoing policies or charters, please contact the lawyer at ZAG/S&W LLP with whom you regularly consult, or the undersigned.

Howard E. Berkenblit  
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