

NYSE Corporate Governance Requirements Finalized

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On November 4, 2003, the U.S. Securities and Exchange Commission approved new corporate governance rules for companies with securities listed on the New York Stock Exchange. These rules have their genesis in the June 2002 recommendations of the NYSE's Corporate Accountability and Listing Standards Committee, and were subsequently refined to comply with the Sarbanes-Oxley Act of 2002 (S-Ox) and to generally harmonize them with Nasdaq's corporate governance requirements. This article summarizes the final NYSE rules.

Definition of Independence. To qualify as an independent director, the NYSE requires the board to affirmatively determine and disclose that the director has no material relationship with the company either directly or through another organization that has a relationship with the company. Boards are expressly required to broadly consider all relevant facts and circumstances and to assess materiality from the viewpoint of the director and the persons and organizations with which the director is affiliated. Material relationships may include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships. The commentary to the rules states that the concern is independence from management. Therefore, ownership of even a significant amount of stock, by itself, is not a bar to a finding of independence.

A number of relationships will preclude a finding of independence. A director will not be independent in any of the following situations:

- The director is an employee of (or has an immediate family member who is an executive officer of) the company, until three years after the end of the employment relationship. Employment as an interim chair or CEO does not disqualify a director from being independent following that employment.
- The director receives (or has an immediate family member who receives) more than \$100,000 per year in direct compensation from the company, until three years after he or she ceases to receive more than \$100,000 of compensation. The following fees need not be considered in determining independence under this test: (a) director or committee fees; (b) pension and other forms of deferred compensation for prior service where such compensation is not contingent on continued service; (c) in the case of the director, compensation for serving as an interim chair or CEO; and (d) in the case of immediate family members, compensation received for service as a non-executive employee of the company.
- The director is affiliated with or employed by (or has an immediate family member who is affiliated with or employed in a professional capacity by) a present or former internal or external auditor of the company, until three years after the end of the affiliation, employment or auditing relationship.
- The director is (or has an immediate family member who is) employed as an executive officer of another company whose compensation committee includes a present executive officer of the company, until three years after the end of the service or employment relationship.
- The director is currently an executive officer or employee of (or has an immediate family member who is currently an executive officer of) another company that makes payments to, or receives payments from, the company for property or services in any fiscal year in excess of the greater of \$1 million and 2 percent of the other company's consolidated

gross revenues, until three years after falling below this threshold. Charitable organizations are not considered companies for this purpose, but if contributions to the charity exceed the greater of \$1 million and 2 percent of the charity's consolidated gross revenues, the company must disclose the amount of the contributions.

"Immediate family member" includes a person's spouse, parents, children, siblings, fathers- and mothers-in-law, sons- and daughters-in-law, brothers- and sisters-in-law and anyone (other than a domestic employee) who lives in the person's home. In applying the three-year look-back provision, consideration need not be given to those who are no longer immediate family members due to legal separation or divorce, or to those who have died or become incapacitated. "Company" means not only the listed company; it includes all the companies in a consolidated group.

To ease the transition to the new rules, a one-year look-back will apply until November 3, 2004. Beginning November 4, 2004, however, the three-year look-back will apply.

Board of Directors Generally. A majority of the directors on the board must be independent. To empower non-management directors to serve as a more effective check on management, the non-management directors must meet at regularly scheduled sessions without management, and the independent directors must meet separately at least once a year. If a single director is chosen to preside at these sessions, his or her name must be disclosed. If there is no single presiding director, the company must disclose the procedure by which a presiding director is chosen for each meeting. The company must also disclose how interested parties can communicate directly with the presiding director or the non-management directors as a group.

Nominating/Corporate Governance Committee. Companies must have a nominating/corporate governance committee composed solely of independent directors. The committee must have a written charter that governs the membership and functioning of the committee, prescribes the purposes and responsibilities of the committee and requires an annual performance evaluation. The purposes and responsibilities of the committee must, at a minimum, include (a) identifying individuals qualified to become board members (consistent with criteria approved by the board); (b) selecting (or recommending that the board select) the director nominees; (c) developing and recommending to the board a set of corporate governance principles; and (d) overseeing the evaluation of the board and management. The committee should also have the sole authority to retain and terminate any search firm hired to identify director candidates and to approve the search firm's fees and other terms of retention.

Compensation Committee. Companies must have a compensation committee composed solely of independent directors. In addition to providing for the internal workings of the committee, the compensation committee's written charter must prescribe the purposes and responsibilities of the committee and require an annual performance evaluation of the committee. The purposes and responsibilities of the committee must, at a minimum, include having direct responsibility for (a) reviewing and approving corporate goals and objectives relevant to CEO compensation; (b) evaluating the CEO's performance in light of those goals and objectives; (c) determining and approving (either as a committee or with the other independent directors) the CEO's compensation level on the basis of this evaluation; (d) making recommendations to the board with respect to non-CEO compensation, incentive-compensation plans and equity-based plans; and (e) producing the report on

executive compensation required to be included in the proxy statement. The compensation committee must have the sole authority to retain, terminate and compensate a consulting firm to assist in evaluating director, CEO or senior executive compensation.

Audit Committee. The NYSE rules supplement the S-Ox-mandated audit committee requirements and deal with both the composition and the duties of the audit committee. Every company must have an audit committee composed of at least three directors, all of whom must be independent and either be financially literate (as this qualification is interpreted by the board) or become financially literate within a reasonable period of time. In addition, one member must have accounting or related financial management expertise (as interpreted by the board). A person who qualifies as an "audit committee financial expert" under S-Ox is presumed to have this expertise. If an audit committee member serves on the audit committees of more than two other public companies, the board must determine that the simultaneous service on three or more audit committees will not impair the member's ability to be effective and must disclose this determination. In addition to meeting the NYSE independence standards, each member must meet the enhanced independence requirements under S-Ox. That is, he or she (a) must not be an "affiliate" of the company; and (b) must not receive any compensation from the company other than director and committee fees and pension and other deferred compensation that is not contingent on continued service.

The audit committee must have a written charter that governs its purposes and responsibilities and provides for an annual performance evaluation of the committee. The NYSE rules specify that the purpose of the committee must, at a minimum, be to (a) assist the board in its oversight of the integrity of the company's financial statements, the company's compliance with legal and regulatory requirements, the independent auditor's qualifications and independence, and the performance of the internal and independent audit functions; and (b) prepare the audit committee report that is required by the SEC.

To accomplish these purposes, the NYSE has assigned the following duties and responsibilities to the audit committee: (a) assessing the qualifications, performance and independence of the independent auditor; (b) discussing the annual audited financial statements and quarterly financial statements and MD&A (including major issues regarding accounting principles and financial statement presentation, significant financial reporting issues and judgments made, the effect of regulatory and accounting initiatives, and off-balance-sheet structures); (c) discussing earnings press releases, earnings guidance and other financial information provided to analysts and rating agencies (the committee need not discuss each release in advance; it is sufficient to discuss the types of information to be disclosed — paying particular attention to *pro forma* and other non-GAAP information — and the type of presentation to be made); (d) discussing policies on risk assessment and risk management; (e) keeping direct channels of communication open with management, the internal auditors and the independent auditor; (f) reviewing with the independent auditor any audit problems or difficulties and obtaining management's response; (g) setting clear hiring policies for employees and former employees of the independent auditors; and (h) reporting regularly to the board.

These duties are in addition to those imposed by S-Ox. Under S-Ox, the audit committee must (a) be directly responsible for the appointment, compensation, retention and oversight of the independent auditor; (b)

establish procedures for the treatment of complaints regarding accounting, internal accounting controls and auditing matters; (c) preapprove non-audit services to be provided by the independent auditor; and (d) have the authority to engage and compensate independent counsel and other advisors.

Internal Audit Function. Companies must have an internal audit function to provide management and the audit committee with ongoing assessments of the company's risk-management processes and internal controls.

Corporate Governance Guidelines. Companies must adopt corporate governance guidelines and post these guidelines on their websites, together with the charters of their most important committees (including, at least, the nominating/corporate governance, compensation and audit committees). The guidelines must cover: (a) director qualification standards; (b) director responsibilities; (c) director access to management and independent advisors; (d) director compensation; (e) director orientation and continuing education; (f) management succession; and (g) the annual performance evaluation of the board.

Codes of Conduct. Companies must adopt a code of business conduct and ethics that applies to directors, officers and employees, and must disclose the code on their websites. Any waivers granted to executive officers or directors must be approved by the board or a board committee and be promptly disclosed to the shareholders. The code must deal with the following issues: (a) conflicts of interest; (b) corporate opportunities; (c) confidentiality; (d) fair dealing; (e) protection and proper use of company assets; (f) compliance with laws (including insider trading laws); and (g) encouragement of the reporting of illegal or unethical behavior.

Compliance with NYSE Listing Standards. Each company's CEO must certify to the NYSE each year that he or she is not aware of any violation of the NYSE corporate governance listing standards. In addition, the CEO must promptly notify the NYSE when any executive officer becomes aware of any material non-compliance with any of the applicable corporate governance listing standards. The NYSE may publicly reprimand any listed company that violates an NYSE listing standard.

Application of Rules and Exemptions Available. The governance rules apply to virtually all companies listed on the NYSE, although companies that fall into the following categories qualify for some exemptions from these rules: foreign private issuers, controlled companies, limited partnerships and companies in bankruptcy, closed-end and open-end funds, passive business organizations, companies with no listed common equity securities.

Effective Dates and Transitional Rules. Companies must comply with the new rules by the earlier of their first annual shareholders' meeting after January 15, 2004 and October 31, 2004. Companies with staggered boards will have until the second annual shareholders' meeting after January 15, 2004 (or December 31, 2005 at the latest) to replace directors who are not scheduled to stand for election in 2004, although they are still required to have an independent audit committee by the earlier deadline. Foreign private issuers will have until July 31, 2005 to comply with the S-Ox-mandated audit committee requirements.

The existing audit committee listing standards will continue to apply to companies during the transition period.

Companies that are listing in conjunction with their initial public offering, transferring from other markets that lack similar requirements, or emerging from bankruptcy proceedings will have additional time to meet certain requirements.

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