

## Corporate Responsibility Redefined

July 2002  
Part 1 of a series from the  
Corporate Group

The turmoil in the financial markets sparked by the various financial scandals, probably beginning with Enron-Andersen and most recently WorldCom and Xerox, has produced a public and professional demand for change. Multiple proposals have been presented and the process for adoption commenced. Others are in draft form. Still others are merely described in clamorous recitals by legislators, regulators and members of the media. This Advisory is the first in a series we have prepared for our clients and friends to help them sort through the many proposals to understand their content and to prepare for the changes that are surely coming. Each Advisory focuses on a specific subject. Our aim is to provide you information that is to the point and includes all proposals relevant to a particular topic, in a communication that is short enough to be readily digested and understood.

While there may be specific changes that have not yet been proposed, we believe that the scope and nature of the principal proposed changes to the structure and operations of public companies and to their disclosure and reporting responsibilities can now be outlined. They fall generally into three categories: corporate governance, financial reporting and review, and periodic reporting. We expect many of these changes - especially those in corporate governance - also to impact private companies because state legislatures import them into state corporation statutes or because the judiciary adopts them as standards.

There are some proactive measures we recommend companies undertake now - actions that will better prepare them to install changes when change is mandated. These are detailed below under [Actions Companies Can Take Now](#).

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### ADDITIONAL INFO

Some of you may wish to review in their entirety the proposals of a number of parties who have concerned themselves with these issues. In the case of the NYSE and Nasdaq proposals you may wish to forward comments directly to them.

### IN THIS ADVISORY

1. [The Process of Change](#)
2. [Current Status of Proposed Changes](#)
3. [The Nature of the Proposed Changes](#)
4. [Actions Companies can take Now](#)

### THE PROCESS OF CHANGE

The process of change in the standards of public company conduct is itself confusing. In fact, this change occurs only in one of two ways - either the Securities and Exchange Commission ("SEC") installs change through its rulemaking process or Congress passes legislation that the President signs.

### SEC Rulemaking

The first changes have already been effected by the SEC, using its rulemaking authority. Most likely, the next changes will also occur the same way. There are two routes available. The first begins with the two principal exchanges - the New York Stock Exchange ("NYSE") and the Nasdaq Stock Market, Inc. ("Nasdaq") - as well as changes with respect to the regulation of investment bankers and brokers initiated through the National Association of Securities Dealers ("NASD"). The second route is direct rulemaking by the SEC itself.

Since the securities statutes do not directly deal with issues of corporate governance, the principal vehicle for change in corporate governance will be the recently proposed changes to the NYSE and

To obtain the proposals, or to forward comments, we refer you to the following websites:

NYSE - [www.nyse.com](http://www.nyse.com)  
Nasdaq - [www.Nasdaq.com](http://www.Nasdaq.com)  
Council of Institutional Investors - [www.cii.org](http://www.cii.org)  
Business Roundtable - [www.brtable.org/index.cfm](http://www.brtable.org/index.cfm)

## ABOUT US

McKenna Long & Aldridge is a full-service law firm of nearly 400 lawyers and public policy advisors with offices in Atlanta, Denver, Los Angeles, Philadelphia, San Diego, San Francisco, Washington, DC, and Brussels. Formed June 1, 2002 through the merger of Long Aldridge & Norman LLP and McKenna & Cuneo L.L.P., the firm provides business solutions in the areas of corporate law, government contracts, intellectual property and technology, complex litigation, public policy and regulatory affairs, real estate, environmental law and finance.

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Nasdaq listing requirements. Once approved by their respective Boards of Directors, these proposals are submitted to the SEC for approval. (Similarly, the NASD approves changes with respect to broker-dealers and submits them to the SEC for approval; one such change - that dealing with analysts' conflicts of interest - has already been submitted and approved; that action will be the subject of a later Advisory.)

The direct rulemaking process is a process that involves the publication of proposed rules followed by a comment period, at the end of which the SEC will review the comments and incorporate its responses to the comments in a final rule. Occasionally, the SEC moves directly, without proposal or comment, under its investigative authority. It invoked this procedure with its order of June 28, 2002 concerning certification of periodic reports.

## Legislation

The legislative process is one with which we are all more familiar. It begins with bills proposed in either House of Congress, reviewed by a committee in that House, reported out and adopted by that body, after which it is sent to the other legislative body; following the adoption by the second body of its version of the bill, a conference version is completed and adopted by both bodies, after which it is executed by the President.

## CURRENT STATUS OF PROPOSED CHANGES

At the present time, nearly all changes are in proposed form. Some are further along in the process of adoption than others. They are as follows:

1. Nasdaq Board of Directors has approved (on May 22, 2002) certain proposed changes and forwarded them to the SEC for consideration. Another group of changes was considered by Nasdaq at a meeting of its Listing and Hearing Review Council from June 26-28, 2002. Proposed changes will be prepared, presented to its Board and when adopted forwarded to the SEC for approval. If approved, these will change corporate governance for Nasdaq-listed companies.
2. On February 13, 2002, the NASD, and on February 27, 2002, NYSE, filed with the SEC proposed rule changes regarding analysts' conflicts of interest. The SEC approved these proposals on May 10, 2002. These changes principally affect disclosure of analysts' compensation and their relationships with their employers and companies whose securities are covered; they also place limits on the relationships of analysts to the companies they cover.
3. On June 28, 2002, the SEC ordered certification by the CEO and CFO of the most recent 10-K and all later-filed 8-K's and 10-Q's (including the June 30 quarter) for companies with revenues greater than \$1.2 billion. These certifications must be made by August 14, 2002. The effect is to require these separate officers to reconfirm to the investing public the reliability of the companies' present market information.
4. The SEC has released for comment several proposed rule changes, specifically those affecting disclosure and reporting times; as to some of these proposed changes the comment period has closed; none has presently been adopted. The result, if these rule changes are adopted, will be to increase the amount of disclosure and require it more quickly.

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5. The House of Representatives, on April 24, 2002, passed a bill known as CAARTA, which addresses many of the issues referenced above and, in particular, accounting oversight.
6. On June 25, 2002, the Senate Banking Committee reported out the Accounting Industry Reform Bill, frequently referred to as the "Sarbanes Bill." It is generally considered topically similar to the House bill, but more exacting.
7. On June 26, 2002, the SEC issued proposed rules relating to accounting oversight, specifically calling for oversight through the formation of Public Accountability Boards in the private sector.

Each of items 6, 7 and 8 is broad-ranging and will affect many aspects of corporate governance, reporting and, especially, financial reporting and review.

## **NATURE OF PROPOSED CHANGES**

The proposed changes can be classified in three groups:

- Corporate governance
- Financial reporting and review
- Periodic reporting

## **Corporate Governance**

The corporate governance proposals themselves break into three particular groups concerning:

- Board of Directors
- Management
- Board interaction with Management

The proposals concerning boards have to do not only with the composition of the board and its method of selection of directors, but also with the operation of the board.

The proposals regarding composition emphasize the need for at least a bare majority of directors who are independent of management or other close relationships with the company. The definition of independence is more stringent than the present definition. The proposals suggest the use of a nominating committee of the board for the selection of director candidates.

All proposals mandate a Board committee structure including at least three committees:

- Audit committee
- Compensation committee
- Governance/nominating committee (note that the proposals would not require a change from the present practice of some companies of having separate nominating and governance committees)

The proposals emphasize having a separate charter for each committee and insist that each committee be comprised either entirely or principally of independent directors.

Other topics in the corporate governance proposals include:

- Extended review of executive compensation (including shareholder review in some cases)
- Adoption of a code of conduct
- Regular sessions of training and orientation for directors
- Adoption of corporate governance guidelines
- Establishment of stated risk management practices
- Implementation of a formal compliance program

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## **Changes in Financial Reporting and Methods of Review**

The landscape of proposed changes to financial reporting and methods of review is not as clear as that regarding corporate governance. It is not clear whether accounting principles will themselves be changed. While it seems clear that change in oversight of the accounting profession will occur, it is not clear how this change may affect public companies.

It is clear that the method of review of financial statements will change and that the audit committee will be the principal agent of change. The NYSE and Nasdaq have each proposed enhancing the role of the audit committee. In addition, the June 28 SEC rule concerning the certification of periodic reports by certain companies' CEOs and CFOs entails significant review. Certification of this kind is also included in an earlier proposal of the SEC to what may be a different universe of public companies.

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## **Changes in Periodic Reporting and Disclosure Requirements**

A number of proposals have been released from the SEC for comment. In some cases the comment period has closed. These proposals include:

- Changes in 8-K reporting including changes in filing deadlines as well as the addition of 11 new items that would require disclosure.
- Changes in 10-K annual and 10-Q quarterly reporting including acceleration of filing deadlines and certification by CEOs and CFOs.
- Website posting of periodic reports and other information.
- Changes to the method of reporting of transactions by officers and directors:
  - Changes to Forms 3, 4 and 5
  - New item in 8-K for the company to report such transactions

Finally, there are the proposed changes in oversight of accounting firms reflected in:

- The accounting reform bills adopted by the House of Representatives (CAARTA) and reported out of committee in the Senate (the Sarbanes Bill); and
- The new rules proposed by the SEC on June 26, 2002 to establish a new accounting oversight body.

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## **ACTIONS COMPANIES CAN TAKE NOW**

Although the exact nature of the changes remains in proposal form, we suggest there are a number of actions companies can undertake at this time to prepare them for change. We believe these proactive reviews will make it possible for companies to implement mandated change more quickly and with less disruption.

1. Review of the existing board structure, including independence and standards of independence, nominating and orientation procedures. Companies may assign this task to the governance committee or appoint a special committee in the absence of a governance committee.
2. Review by audit committee of procedures for the preparation and disclosure of financial statements and of significant accounting policies. This review should undoubtedly include dialog with both financial management and existing auditors.
3. Review separately the charters of each standing committee of the board and in addition, the procedures and guidelines adopted by those committees for the execution of their tasks. If there are currently no guidelines or procedures, consider the contents such procedures and guidelines might have.
4. Review internal reporting processes for transactions of officers and directors with the company and with respect to securities of the company.
5. Review the procedures for preparation, review and finalization of reports such as 8-K, 10-Q, 10-K and press releases, both internally and with external advisors.
6. Consider the process necessary to evaluate board performance if such a process is not currently in place; or review the existing process for adequacy.
7. Review your company's current document retention policy.
8. Review your company's relevant insurance policies, including directors and officers coverage.

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## **CONCLUSION**

Calls for change reported in the media have come from many quarters. Given the process for change, the SEC, NYSE, Nasdaq and the Houses of Congress and the President's own 10-point plan (the subject matter of which is included within the proposals presently outstanding), are of course the most significant. But in our view, two other groups have also played a significant role in the formulation of the proposals - the Business Roundtable and the Council of Institutional Investors, and we believe their views are relevant to understanding many changes. Even if not adopted, their views may well become "best practices" (practices considered important guidelines for legislatures and judges to consider) and they may well become the source of future shareholder proposals. They may also become a reference point for disclosure required by the SEC. If, for example, codes of conduct are not imposed by the exchanges, while the SEC cannot impose the

adoption of such codes, the SEC could require public companies to disclose whether they have codes of conduct and the contents of such codes.

**In the next few days you will receive two separate Advisories** - the first deals specifically with the question of proposals concerning the composition and committee structure of boards of directors and the second deals with audit committees. In each we will compare the Nasdaq and NYSE proposals in their current form, since it is through changes to their respective listing requirements that governance changes will actually be mandated. We have also included relevant comments from each of the Business Roundtable and the Council of Institutional Investors. You can expect to receive Advisories on the following topics over the next several weeks:

- Composition and structure of boards of directors
- Audit committees
- Compensation committees and executive compensation
- Governance and nominating committees
- Changes in 8-K reporting
- Changes in 10-K and 10-Q reporting
- Changes in reporting requirements for transactions of officers and directors
- Impact of the Andersen decision on document retention policies
- Changes to rules regarding conduct of analysts
- Changes to accounting oversight
- Changes to management's discussion and analysis

If current events dictate, we may well change the order of delivery of these Advisories or deliver a newer one sooner.

This **Information Advisory** is for informational purposes only and does not constitute specific legal advice or opinions. Such advice and opinion are provided by the firm only upon engagement with respect to specific factual situations.