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SEC APPROVES NYSE CORPORATE GOVERNANCE RULES

By Richard P. Wolfe and Andrew D. Pilant

In our October 2003 E*Zine, we reviewed the New York Stock Exchange's second amendment to its proposed corporate governance rules; a link to that E*Zine is provided below. On November 4, 2003, the SEC approved the NYSE's revised corporate governance rules. *(Click here to link to the SEC's release approving the NYSE's revised rules.)*

We have summarized below the principal requirements of the comprehensive revised NYSE corporate governance rules. *(Click here to link to the complete text of the final NYSE corporate rules.)*

Director Independence

Majority Independent Directors. A majority of the board of directors must consist of independent directors.

Definition of Independent Director. No director qualifies as "independent" until the board affirmatively determines that the director has no material relationship with the company. This determination must be disclosed in the company's annual proxy statement. The following relationships disqualify a director from being deemed "independent":

- a director employed by (or whose immediate family member is an executive officer of) the company is not independent until three years following the termination of the relevant employment;
- a director who receives (or whose immediate family member receives) more than $100,000 per year in direct compensation from the company is not independent until three years after the relevant person ceases to receive more than $100,000 per year;
- a director who is (or whose immediate family member is) affiliated with or employed in a professional capacity by a present or former internal or external auditor of the company is not independent until three years after the end of the affiliate, employment, or auditing relationship;

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- a director who is (or whose immediate family member is) employed as an executive officer of another company where any of the listed company's present executives serve on that company's compensation committee is not independent until three years after the end of such service or the employment relationship; and

- where a director is an executive officer or employee (or has an immediate family member who is an executive officer) of another company, and payments received from, or paid to, the listed company by the other company exceed the greater of $1 million or 2% of the other company's consolidated gross revenues, the director is not independent until three years after such payments fall below such threshold.

Immediate Family Member. This term includes a person's spouse, parents, children, siblings, mothers- and fathers-in-law, sons- and daughters-in-law, brothers- and sisters-in-law, and anyone who shares such person's home.

"Look-back" Periods. The new rules impose a "look-back" period of three years for the five tests of a director's independence listed above. For transition purposes, each independence disqualification has a one-year look-back until November 4, 2004, at which time the full three-year look-back period becomes effective.

Additional information regarding the NYSE's director independence requirements is contained in our October 2003 E*Zine discussing the NYSE's second amendment to its proposed corporate governance rules. *(Click here to link to our E*Zine discussing the NYSE's second rules amendment.)*

Executive Sessions for Non-Management Directors

Non-management directors must meet in regularly scheduled executive sessions without management. The NYSE recommends that, to the extent any non-management directors are not independent, listed companies should at least once a year schedule an executive session involving only independent directors. In addition, companies must disclose a method for interested parties to communicate directly with either the director presiding over executive sessions or with the non-management directors as a group.

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Independent Board Committees

The three board committees listed below must be comprised solely of independent directors. Each must have a written charter that addresses, among other items, the committee's purposes and responsibilities, and an annual performance evaluation of the committee. The principal responsibilities of each committee are as follows:

Nominating/Corporate Governance Committee. This committee will be required to identify individuals qualified to become board members (consistent with criteria approved by the board), nominate directors for election, and oversee an evaluation of the board and management.

Compensation Committee. The compensation committee determines the compensation of the company's chief executive officer, although the new rules clarify that *all independent directors* may be involved in approving the CEO's compensation. The entire board, however, is not precluded from *discussing* CEO compensation.

Audit Committee. The audit committee charter must include the requirements imposed by the Sarbanes-Oxley Act (relating to independence standards and certain committee responsibilities) as well as several NYSE-mandated responsibilities, such as discussing the company's financial statements with management and the independent auditors, establishing clear hiring policies for employees or former employees of the independent auditors, and reviewing with the independent auditors any audit problems or difficulties with management's response.

At least one member of the audit committee must have "accounting or related financial management expertise" or become financially literate within a reasonable period of time after his or her appointment to the committee. The board may presume that a person has such expertise if that person satisfies the definition of "audit committee financial expert" in Item 401(h) of SEC Regulation S-K.

Other Corporate Governance Provisions

Internal Audit Function. Each company must have an internal audit function.

Corporate Governance Guidelines; Code of Business Conduct and Ethics. Each company must adopt (i) corporate governance guidelines and (ii) a code of business conduct and ethics for directors, officers and

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employees, each of which must be posted on the company's website along with its "most important" board committee charters, including at a minimum the audit, compensation, and nominating/corporate governance committee charters. The availability of this information must be disclosed in the company's annual report on Form 10-K. In addition, any waivers of the code of business conduct and ethics for directors or executive officers must be promptly disclosed to shareholders.

CEO Certification. The CEO of each listed company must certify to the NYSE each year that he or she is not aware of any violation by the company of the NYSE's corporate governance rules. In addition, a CEO must promptly notify the NYSE after any executive officer of the company becomes aware of any material non-compliance with any applicable provision of the corporate governance rules.

Public Reprimand Letter. The NYSE may issue a public reprimand letter to any listed company that violates a NYSE listing standard, including a corporate governance rule.

Exemptions from the NYSE Corporate Governance Rules

The NYSE rules exempt "controlled companies," limited partnerships and companies in bankruptcy from the requirements that their boards have a majority of independent directors, and that the nominating/corporate governance and compensation committees be composed entirely of independent directors.

Effective Dates

General Transition Period. Listed companies are required to be in compliance with the new NYSE corporate governance rules by the earlier of (i) a company's first annual meeting after January 15, 2004, or (ii) October 31, 2004. Generally, companies with classified boards have an additional year (but no later than December 31, 2005) to replace a director not scheduled to stand for election in 2004.

Initial Public Offerings (IPOs). A company listing in conjunction with its IPO will be required to phase in its independent nomination/corporate governance and compensation committees on the same schedule mandated by the SEC for audit committees:

- one independent member at the time of listing;

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- a majority of independent members within 90 days; and
- fully independent committees within one year.

These companies will also be required to have majority independent boards within 12 months after listing on the NYSE. The same compliance schedule will also apply to companies emerging from bankruptcy or that have ceased to be controlled companies.

Transfers. Companies transferring to the NYSE from markets or exchanges that do not impose the same requirements will have 12 months to come into full compliance with the NYSE's corporate governance rules.

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SEC SETTLES REGULATION FD CHARGES AGAINST SCHERING-PLOUGH AND FORMER CEO

By Amos J. Oelking, III

On September 9, 2003, the SEC filed two enforcement proceedings against Schering-Plough Corporation and its former CEO and chairman Richard J. Kogan, alleging violations of the disclosure requirements of Regulation FD.

Schering and Kogan agreed to pay $1 million and $50,000 civil penalties, respectively, in settlement of the proceedings, and further agreed to cease and desist from any future violations of Regulation FD. The penalty against Schering, which was approved by the court on September 27, 2003, is the largest penalty the SEC has obtained to-date for a Regulation FD violation. The penalty against Kogan is the first penalty the SEC has obtained against an individual in a Regulation FD proceeding. *(Click here to link to the full text of the SEC's release regarding the Schering/Kogan proceedings.)*

The proceedings arose out of private meetings during the week of September 30, 2002 between Kogan and Schering's senior vice president of investor relations and four institutional investors (Wellington, Massachusetts Financial, Fidelity and Putnam), three of which were among Schering's largest stockholders.

According to the SEC, at these meetings Kogan, through a combination of "spoken language, tone, emphasis, and demeanor," disclosed negative and material nonpublic information regarding Schering's earnings prospects for 2002 and earnings outlook for 2003. Specifically, Kogan disclosed that analysts' estimates for Schering's 2002 third quarter were too high and that earnings would decline significantly in 2003.

Immediately after the meetings, analysts at Fidelity and Putnam downgraded their ratings of Schering's stock, and portfolio managers at these two firms and Wellington sold large blocks of Schering stock. During the three-day period following the meetings, the price of Schering's stock declined more than 17% on heavy trading volume, with the sales by Fidelity and Putnam accounting for more than 30 percent of such volume.

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Moreover, the SEC found that during this sell-off, Kogan held a private meeting with analysts and portfolio managers at which Kogan stated, among other things, that 2003 would be "real tough" for Schering and that Schering's 2003 earnings would be "terrible." According to the SEC, these and the other statements made by Kogan during the meeting went materially beyond Schering's prior public disclosures. Later that day, Schering issued a press release providing earnings projections for 2002 and 2003 that were materially below analysts' estimates and, with regard to 2002, materially below Schering's own prior earnings projections.

The SEC found that Schering violated Regulation FD, and that Kogan caused such violations, by providing material nonpublic earnings guidance during the private meetings and failing to make public disclosure of the information as required by Regulation FD. While acknowledging that Kogan may not have purposefully suggested that the institutional investors sell Schering stock, the SEC found that Kogan's conduct violated Regulation FD because his "statements, demeanor and general expressions of concern for Schering's prospects during [the] private meetings amounted to selective disclosure and prompted a significant sell-off in Schering stock."

Please remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues you may contact the head of our Corporate and Securities practice group:

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