POLICY MEASURES TO REBUILD CONFIDENCE IN FINANCIAL MARKETS AND TO IMPROVE GOVERNANCE OF AND BY INSTITUTIONAL INVESTORS

UNITED STATES

Recent Corporate Governance Developments

Part A

1. Major Challenges in Corporate Governance Arrangements or Practices Since the Issuance of the OECD Principles in 1999

a.) Challenges Regarding Business Practices

Towards the end of 2001 and the first part of 2002, the United States witnessed bankruptcies of broadly held public companies. Too often, an important component of these implosions was the significant failure of corporate governance. The U.S. Securities and Exchange Commission (SEC or “Commission”), the U.S. Department of Justice and other governmental bodies are continuing to investigate these corporate failures. However, these investigations, as well as complaints filed by prosecutors and news reports, suggest that these corporate governance lapses resulted from malfeasance by corporate management and the abdication of responsibility, or in some cases the complicity, of those charged with providing checks and balances to the governance system—senior executive officers, directors, audit committees, outside auditors, legal advisers and others. In one instance, a public company allegedly used affiliates to hold its poorly performing assets as means of moving these assets off its balance sheet. In some cases, public companies are alleged to have manipulated financial statements to show inflated profits.

As a result of these corporate collapses and perceived weaknesses in corporate governance, President Bush announced a “Ten Point Plan to Improve Corporate Responsibility and Protect America’s Shareholders” on March 7, 2002. The Plan called for a concerted response to the emerging news that some of the country’s largest corporations had not truthfully reported their earnings and that this would harm investors. The plan applied three core principles of effective governance: accuracy and accessibility of information, management accountability and auditor independence.

The President subsequently signed into law the Sarbanes-Oxley Act of 2002 on July 30, 2002 (“Act” or SOA). Among other things, the Act creates a new Public Company Accounting Oversight Board (PCAOB) for the public accounting profession, strengthens the oversight role of corporate audit committees, documents the responsibility of chief executive and chief financial officers for corporate

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1 This document was prepared by the staff of the U.S. Securities and Exchange Commission. It has not been reviewed or approved by the Commission and does not necessarily reflect the views of the Commission.
reporting, mandates new measures intended to promote auditor independence, authorizes the Commission to set minimum standards for attorneys appearing and practicing before it, adds new disclosure requirements for public companies, and enhances the criminal penalties for securities fraud.

b.) **Challenges Regarding the Legal and Regulatory Framework**

In the United States, corporate governance practices have traditionally been regulated by an issuer’s governing instruments, the corporate law and the court decisions of each issuer’s state of incorporation. For publicly owned companies whose securities are traded on a regulated market, the U.S. federal securities laws and rules of the market on which their securities are listed also affect corporate governance practices. Previously, the U.S. federal securities laws primarily affected corporate governance in the areas of disclosure and financial reporting, proxy voting, and the submission of shareholder proposals for consideration at shareholders’ meetings. As a result of concerns about the recent bankruptcies, the Sarbanes-Oxley Act was enacted, which greatly increased the range of corporate governance activities regulated by the U.S. federal securities laws. The Act addresses auditor independence, attorneys’ conduct and audit committee functions, as well as conflicts of interest of corporate executives and directors, among other things. See also the response to Question I.a. above.

II. **General Experience Concerning the Effectiveness of Voluntary Codes and “Self-Regulatory” Arrangements in Corporate Governance**

In the United States, voluntary codes and self-regulatory arrangements are generally viewed as useful means of obtaining acceptance of best practices by the private sector. Some recent examples of voluntary codes or guidance that have contributed to improvement of the corporate governance environment in the United States include:

- "Handbook for the Conduct of Shareholders' Meetings" and "Corporate Directors' Guidebook," 3rd ed., issued in 2000 2001, respectively by the Corporate Governance Committee of the American Bar Association’s Section of Business Law;
- "Principles of Corporate Governance," issued in May 2002 by the Business Roundtable; and

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2 In general, the Sarbanes-Oxley Act makes no distinction between U.S. and foreign issuers or U.S. and foreign accounting firms that are within the Act's coverage. However, many provisions of the Act are to be implemented by SEC or PCAOB rulemaking. The rules and regulations implementing the Act that have been adopted or proposed to date by the SEC include a number of provisions intended to accommodate or, in some cases, exempt foreign issuers and foreign accountants from certain of these rules and regulations to the extent that such accommodations and exemptions may be justified consistent with the provisions of the Act. Details regarding these accommodations and exemptions may be found in the individual releases for the rules and regulations cited in this response.
Self-regulatory organizations, such as the New York Stock Exchange (NYSE) and The Nasdaq Stock Market (Nasdaq), have also launched corporate governance initiatives. See the responses to Questions III.a. and III.e.

Self-regulation can be an effective means of developing best practices and codes of conduct that reflect and build on the experiences of market participants. In some instances, however, self-regulation may be inadequate or unevenly administered. For example, the recent corporate failures in the United States highlighted apparent deficiencies in the self-regulation of audit firms. As a result, the Sarbanes-Oxley Act established a PCAOB to oversee the audit of public companies that are subject to the securities laws. Under the Act, any public accounting firm that performs or participates in any audit report regarding such a company must register with the PCAOB. The PCAOB is required to conduct a continuing program of inspections of these registered public accounting firms, and may investigate and impose disciplinary or remedial sanctions when necessary. The SEC has general oversight over the PCAOB, which means that it has the power and duty to pre-approve Board rules, as well as to review disciplinary actions.

III. Recent, Ongoing and Planned Reform Initiatives in Corporate Governance Relating to the Five Areas Covered by the OECD Principles

a.) Rights of Shareholders

The SEC recently has made significant efforts to improve the ability of shareholders to obtain relevant information about reporting companies on a timely and regular basis, and has adopted rules to make chief executive officers and chief financial officers more accountable for the information contained in disclosures made by these reporting companies. Any company that has made a public offering of securities, listed its securities on a national securities exchange or other regulated market, and/or registered its securities with the SEC becomes a “reporting company,” and must file periodic reports and current reports of material developments with the Commission. In September 2002, the SEC adopted amendments to accelerate the due dates for the filing of periodic reports, such as the quarterly (Form 10-Q) and annual reports (Form 10-K), under the Securities Exchange Act of 1934 (“Exchange Act”) by U.S. reporting companies. These new filing rules apply to U.S. companies that have a public float of at least $75 million, that have been subject to the Exchange Act's reporting requirements for at least 12 calendar months and that previously have filed at least one annual report. The changes for these filers will be phased-in over three years. The annual report deadline will remain 90 days for year one, change from 90 days to 75 days for year two, and from 75 days to 60 days for year three and thereafter. The quarterly report deadline will remain 45 days for year one, change from 45 days to 40 days for year two, and from 40 days to 35 days for year three and thereafter. The phase-in period will begin for accelerated filers with fiscal years ending on or after December 15, 2002.

The SEC also adopted amendments, effective November 15, 2002, to require these accelerated filers to disclose in their annual reports where investors can obtain access to their filings, including whether
the company provides access to its Forms 10-K, 10-Q and 8-K current reports on its Internet website, free of charge, as soon as reasonably practicable after those reports are electronically filed with or furnished to the Commission. These amendments, as well as those dealing with the accelerated filing due dates for periodic reports, can be found at http://www.sec.gov/rules/final/33-8128.htm.

In addition to improving the timeliness with which periodic filings are made with the SEC, Section 408 of the Sarbanes-Oxley Act requires the SEC to review the disclosures made by listed companies at least once every three years. The disclosures reviewed would include the financial statements of these companies.

Section 302 of the Sarbanes-Oxley Act also requires the SEC to adopt rules requiring the chief executive officer and chief financial officer of reporting companies to certify each annual or quarterly report. Effective August 29, 2002, the Commission adopted Exchange Act Rules 13a-14 and 15d-14, which require an issuer's principal executive officer(s) and the principal financial officer(s), or persons performing similar functions, each to certify in each quarterly and annual report that: (i) he or she has reviewed the report; (ii) based on his or her knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the report; and (iii) based on his or her knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition, results of operations and cash flows of the issuer as of, and for, the periods presented in the report. In addition, these officers must certify that: they are responsible for establishing, maintaining and regularly evaluating the effectiveness of the issuer's disclosure controls and procedures; they have made certain disclosures to the issuer's auditors and the audit committee of the board of directors about the issuer's internal controls; and they have included information in the issuer's quarterly and annual reports about their evaluation and whether there have been significant changes in the issuer's internal controls or in other factors that could significantly affect internal controls subsequent to the evaluation.

The SEC also adopted rules requiring issuers to maintain, and regularly evaluate the effectiveness of, disclosure controls and procedures designed to ensure that the information required in reports filed under the Exchange Act is recorded, processed, summarized and reported on a timely basis. All of these new certification-related rules apply to both U.S. and foreign issuers, and can be found at http://www.sec.gov/rules/final/33-8124.htm.

In June 2002, the SEC also proposed to expand significantly the list of corporate events that would trigger the filing of a current report on Form 8-K. It proposed to add 11 new corporate events for disclosure on Form 8-K. It also proposed to shorten the filing deadline for Form 8-K to two business days after an event triggering the Form's disclosure requirements. Currently, the filing deadline is five business days or 15 calendar days after the triggering event, depending on the nature of the event. These amendments are intended to provide investors with better and faster disclosure of material corporate events, and can be found at http://www.sec.gov/rules/proposed/33-8106.htm.
The NYSE and Nasdaq have also submitted to the SEC rule proposals aimed at improving corporate governance standards. Currently, both the NYSE and Nasdaq only require shareholder approval of stock option or other arrangements in which officers or directors may acquire the stock of a company. In early October 2002, the SEC published for public comment proposals by the NYSE and Nasdaq that would require shareholder approval of all equity compensation plans. These proposals would also require shareholder approval of any material revisions to these plans, with limited exceptions for inducement awards (grants of options or shares as a material inducement to a person’s first becoming an employee of the issuer or any of its subsidiaries), plans related to mergers or acquisitions, and tax-qualified and parallel nonqualified plans. The NYSE’s proposals also prohibit brokers from voting customers’ shares on equity plans unless the beneficial owner of the shares has given voting instructions. The SEC’s publication of the NYSE’s rule proposals may be found at http://www.sec.gov/rules/sro/34-46620.htm, and the Nasdaq’s proposals may be found at http://www.sec.gov/rules/sro/34-46649.htm.

b.) Equitable Treatment of Shareholders

The Sarbanes-Oxley Act has several provisions that are aimed at ensuring the equitable treatment of all shareholders by preventing abusive self-dealing by insiders. For instance, Section 306 of the Act prohibits any director or executive officer of a reporting company from directly or indirectly purchasing, selling or otherwise acquiring or transferring any equity security of the issuer during a pension plan blackout period that temporarily prevents plan participants or beneficiaries from engaging in securities transactions in those equity securities through their plan accounts, if the director or executive officer acquired the equity security in connection with his or her service or employment as a director or executive officer. Any profits realized from such trades shall inure to and be recoverable by the company. The statute attempts to prevent the director or executive officer from obtaining an unfair advantage by engaging in a transaction involving an issuer’s equity securities at a time when participants or beneficiaries in the issuer’s pension plans cannot engage in similar transactions through their plan accounts. The SEC recently adopted rules to clarify the application of, as well as facilitate compliance with, Section 306. Section 306 and the SEC’s rules to implement Section 306 both became effective on January 26, 2003. The SEC’s rules can be found at http://www.sec.gov/rules/final/34-47225.htm.

Section 402 of the Sarbanes-Oxley Act also prohibits a reporting issuer from making personal loans to its directors or executive officers, other than loans made in the ordinary course of the consumer credit business of that issuer, such as certain home improvement, manufactured home and margin loans (with respect to registered broker-dealers). The terms of any such loans must be on terms that are no more favorable than those offered to the general public.

In addition, Section 403 of the Sarbanes-Oxley Act accelerates the filing deadline applicable to change of beneficial ownership reports that must be filed by officers, directors and principal shareholders under Section 16(a) of the Exchange Act. Section 16(a) requires any person who is the beneficial owner of more than 10% of any class of equity security that is registered under the Exchange Act, as well as the officers and directors of such company, to file a report with the SEC indicating the amount of all equity securities of that company owned by that person. Any changes in
that ownership, or the purchase or sale of a security-based swap agreement involving those equity
securities, must be reported to the Commission. Previously, any changes in that ownership had to be
reported within 10 days after the end of the calendar month in which the change occurred. The
Sarbanes-Oxley Act reduced the filing period for these reports to two business days after the
transaction was executed. Section 403 also requires these Section 16(a) reports to be filed
electronically within one year of the enactment of the Sarbanes-Oxley Act. The SEC adopted rule and
form amendments to implement these accelerated filing deadlines, which became effective on August
29, 2002. These amendments can be found at http://www.sec.gov/rules/final/34-46421.htm. In
December 2002, the SEC also proposed amendments to implement the electronic filing requirements
of Section 403 of the Act. These proposals may be found at http://www.sec.gov/rules/proposed/33-
8170.htm.

c.) Role of Stakeholders

As described above in the response to Question III.a., the Sarbanes-Oxley Act and the SEC’s recently
adopted rules improve the ability of shareholders and the public in general to obtain relevant
information about reporting companies on a timely and regular basis, and help make chief executive
officers and chief financial officers more accountable for the information contained in disclosures
made by these reporting companies. In addition, as described in the response to Question III.d. below,
the recent initiatives to improve disclosure and transparency benefit stakeholders and securityholders
alike by ensuring that companies disclose all material information. By having faster access to
relevant information and enhanced disclosure, stakeholders are better equipped to make meaningful
contributions when they participate in the corporate governance process. Moreover, as described in
the response to Question III.b., the Sarbanes-Oxley Act and SEC rules also help prevent abusive self-
dealing by insiders, which benefits not only securityholders but also stakeholders in general.

d.) Transparency and Disclosure

In December 2001, the SEC’s Division of Corporation Finance announced that it would monitor the
annual reports filed by all Fortune 500 companies with the SEC in 2002 as part of its process for
reviewing financial and non-financial disclosures made by public companies. The Division focused
on disclosure that appeared to be critical to an understanding of each company’s financial position and
results, but which seemed to conflict significantly with generally accepted accounting principles
(GAAP) or SEC rules, or to be materially deficient in explanation or clarity. The report summarizing
the results of this review was published on February 27, 2003, and may be found at

Many of the reforms initiated by the Sarbanes-Oxley Act have focused on improving the timeliness
and accuracy with which reporting companies disclose material information, including financial
information. For example, U.S. reporting companies will be required to file their periodic reports on
an expedited basis, phased in over a three-year period. The chief executive officer and chief financial
officer of all reporting companies are also required now to certify all periodic reports that are filed
with the SEC, and the SEC is required to review disclosures made by reporting companies at least
once every three years. (See the more detailed discussion of these initiatives in the response to Question III.a.) In addition, directors, officers and principal shareholders of U.S. companies with equity securities registered under the Exchange Act are also required now to report changes in their holdings of certain securities and security-based swap agreements within two business days after execution of the transaction. (See the response to Question III.b.)

In addition to these initiatives, the Sarbanes-Oxley Act also requires issuers to make certain disclosures. Section 401(a) of the Act directs the SEC to enact rules that would require issuers to disclose all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities or other persons that may have a material current or future effect on the issuer’s financial condition, changes in financial condition, results of operations, liquidity, capital expenditures or resources, or significant components of revenues or expenses of the issuer. The SEC adopted amendments requiring issuers to provide an explanation of their off-balance sheet arrangements in a separately captioned subsection of the "Management's Discussion and Analysis" (MD&A) section of its disclosure documents. Issuers are required to provide this disclosure in their registration statements, annual reports, and proxy or information statements that are required to include financial statements for their fiscal years ending on or after June 15, 2003, although they may provide such disclosure earlier on a voluntary basis. These amendments may be found at http://www.sec.gov/rules/final/33-8182.htm.

Section 404 of the Act also directs the SEC to promulgate rules that require issuers to include within their annual reports a statement of the management’s responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and containing an assessment of the effectiveness of their internal control structure and procedures for their most recently completed fiscal year. Section 404 also requires the issuer’s auditor to attest to, and report on, the assessment made by the issuer’s management. The SEC proposed rules to implement Section 404 on October 22, 2002, which may be found at http://www.sec.gov/rules/proposed/33-8138.htm.

Section 401(b) of the Sarbanes-Oxley Act also directs the SEC to promulgate rules providing that pro forma (also referred to as “non-GAAP”) financial information be presented in a manner that is not misleading, and that reconciles the information with the financial condition and results of operations of the issuer under GAAP. The SEC recently adopted new rules and amendments to implement Section 401(b), which will become effective on March 28, 2003. It adopted a new disclosure regulation, Regulation G, which will require public companies that disclose or release such non-GAAP financial measures to include, in that disclosure or news release, a presentation of the most directly comparable GAAP financial measure and a reconciliation of the disclosed non-GAAP financial measure to the most directly comparable GAAP financial measure. The SEC also adopted amendments to Item 10 of Regulation S-K and Item 10 of Regulation S-B to provide additional guidance to U.S. companies that include non-GAAP financial measures in their Commission filings. In addition, the SEC adopted similar amendments to Form 20-F, which is used by foreign private issuers to register a class of securities under the Exchange Act and to file annual reports.
The SEC also adopted amendments requiring U.S. issuers to furnish to the Commission, on Form 8-K, earnings releases or similar announcements. These amendments will bring earnings information within the SEC’s current reporting system by requiring reporting U.S. issuers to furnish to the Commission all releases or announcements disclosing material non-public financial information about completed annual or quarterly fiscal periods. Although these amendments do not require that companies issue earnings releases or similar announcements, the company’s publication of such releases or announcements will trigger the Form 8-K disclosure requirements. The SEC’s rules and amendments related to Section 401(b) of the Sarbanes-Oxley Act, as well as the amendments pertaining to earnings releases, can be found at http://www.sec.gov/rules/final/33-8176.htm.

The Sarbanes-Oxley Act also imposes certain requirements to help assure that the annual audit of public companies is conducted by an independent auditor. Section 201 of the Act specifies eight categories of services that an auditor may not provide to a reporting company at the same time that it is conducting an audit of that company. These services include: (i) bookkeeping or other services related to the accounting records or financial statements of the issuer; (ii) financial information systems design and implementation; (iii) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (iv) actuarial services; (v) internal audit outsourcing services; (vi) management functions or human resources; (vii) broker, dealer, investment adviser, or investment banking services; and (viii) legal services and expert services unrelated to the audit. The Act also specifies that the PCAOB may determine that any other non-audit service is prohibited, and may grant exemptions on a case-by-case basis to the extent necessary or appropriate in the public interest and consistent with the protection of investors, subject to Commission review.

In addition, the Sarbanes-Oxley Act imposes other requirements to help assure the independence of the auditor. Section 202 of the Sarbanes-Oxley Act requires the issuer’s audit committee to pre-approve the auditor’s provision of any services that are not expressly prohibited by the Act. The issuer must disclose the audit committee’s approval of such a non-audit service in its periodic reports. Section 203 of the Act requires rotation, on a five-year basis, of the lead or coordinating audit partner, and the audit partner responsible for reviewing the audit. Section 204 of the Act requires the audit firm to report to the issuer’s audit committee, on a timely basis, matters such as the critical accounting policies and practices to be used and any material written communications between the auditor and the issuer’s management. Section 206 of the Act prohibits an audit firm from performing any required audit services for an issuer if the issuer’s executive officers, such as the chief executive officer, controller, chief financial officer or chief accounting officer, were employed by that firm and participated in the audit of that issuer during the one-year period preceding the audit.

To implement these requirements of the Act, the SEC recently adopted amendments to its existing requirements regarding auditor independence. These amendments enhance the independence of accountants that audit and review financial statements and prepare attestation reports filed with the Commission. These amendments also will have an impact on foreign accounting firms that conduct audits of foreign subsidiaries and affiliates of U.S. issuers, as well as of foreign private issuers. In its release adopting these amendments, the Commission noted that foreign requirements designed to achieve auditor independence may overlap with the Commission’s new requirements, and that it has taken these foreign requirements into account by granting accommodations to foreign accounting firms in a manner and to the extent consistent with the spirit and intent of the Sarbanes-Oxley Act.
For example, as an accommodation to foreign accounting firms, additional time is being afforded to them with respect to compliance with auditor rotation requirements. These amendments go into effect on May 6, 2003, and can be found at http://www.sec.gov/rules/final/33-8183.htm.

The Sarbanes-Oxley Act also protects the integrity of the audit by making it illegal for an issuer’s officers or directors to fraudulently influence, coerce, manipulate or mislead accountants in performing any audit for the purpose of making the issuer’s financial statements materially misleading. (See Section 303 of the SOA.) On October 18, 2002, the SEC proposed rules to implement this provision of the Act. The proposed rules, in combination with the existing rules under Exchange Act Regulation 13B-2, are designed to ensure that management makes open and full disclosures to, and has honest discussions with, the auditor of the issuer's financial statements. If adopted, these rules would prohibit officers or directors of an issuer, or persons acting under their direction, from subverting the auditor's responsibilities to investors to conduct a diligent audit of the financial statements and to provide a true report of the auditor's findings. The Commission's proposed rules may be found at http://www.sec.gov/rules/proposed/34-46685.htm.

The Sarbanes-Oxley Act also requires the forfeiture of certain bonuses and profits by certain executive officers of an issuer if the issuer makes an accounting restatement. Under Section 304 of the Act, in the case of an accounting restatement that results from material non-compliance with financial reporting requirements under the securities laws as a result of misconduct, the chief executive officer and chief financial officer must reimburse the issuer for any bonuses and other incentive-based compensation and profits on stock sales within the past 12 months. The SEC may exempt any person from this requirement as it deems necessary and appropriate.

Finally, Section 407 of the Sarbanes-Oxley Act requires the SEC to promulgate rules requiring issuers to disclose whether their audit committees are composed of at least one member who is a financial expert, and if not, the reasons why. The SEC recently adopted such rules. The SEC’s rules and amendments will require companies to disclose in their annual reports whether they have at least one “audit committee financial expert” serving on their audit committee, and if so, the name of the expert and whether the expert is independent of management. A company that does not have an audit committee financial expert must disclose this fact and explain why it has no such expert. Companies, other than small business issuers, must comply with these rules in their annual reports for fiscal years ending on or after July 15, 2003. Small business issuers must comply with the audit committee financial expert disclosure requirements in their annual reports for fiscal years ending on or after December 15, 2003. The new rules and amendments can be found at http://www.sec.gov/rules/final/33-8177.htm.

Aside from these reforms, the Sarbanes-Oxley Act requires the SEC and the Comptroller General of the United States to conduct certain studies. Under Section 401(c)(1) of the Act, the SEC is directed to conduct a study of filings to ascertain the extent to which off-balance sheet transactions and special purpose entities are used, and whether generally accepted accounting rules result in transparent disclosure of the economics of off-balance sheet transactions. Under Section 108(d) of the Act, the SEC is directed to conduct a study on principles-based accounting, including the length of time required for the United States to change from a rules-based to a principles-based system. In
addition to these studies, under the Act the Comptroller General of the United States must study and review the potential effects of requiring the mandatory rotation of registered public accounting firms (Section 207 of the SOA) and the factors that led to, as well as problems resulting from, the consolidation of accounting firms (Section 701 of the SOA).

Prior to the enactment of the Sarbanes-Oxley Act, the SEC also proposed disclosure requirements that would enhance investors' understanding of the application of companies' critical accounting policies. These proposals would encompass disclosure in two areas: accounting estimates a company makes in applying its accounting policies and the initial adoption by a company of an accounting policy that has a material impact on its financial presentation. Under the first part of the proposals, a company would have to identify the accounting estimates reflected in its financial statements that required it to make assumptions about matters that were highly uncertain at the time of estimation. Disclosure about those estimates would then be required if different estimates that the company reasonably could have used in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, would have a material impact on the presentation of the company's financial condition, changes in financial condition or results of operations. Under the second part of the proposals, a company that has initially adopted an accounting policy with a material impact would have to disclose information that includes: what gave rise to the initial adoption; the impact of the adoption; the accounting principle adopted and method of applying it; and the choices it had among accounting principles. Companies would place all of the new disclosure in the MD&A section of their annual reports, registration statements and proxy and information statements. In addition, in the MD&A section of their quarterly reports, U.S. companies would have to update the information regarding their critical accounting estimates to disclose material changes. The proposed rules may be found at http://www.sec.gov/rules/proposed/33-8098.htm.

e.) The Responsibilities of the Board

Duties of corporate board members are generally established by state statute and a company’s articles of incorporation and bylaws. However, the Sarbanes-Oxley Act and the SEC rules implementing that Act now outline specific duties imposed on a company’s board of directors, primarily through the board’s audit committee. Under Section 301 of the Act, the SEC must promulgate rules directing the national securities exchanges and national securities associations to amend their listing rules as they relate to audit committees. Listing standards must require that: (i) the audit committee is responsible for the appointment, compensation and oversight of any audit firm registered with the PCAOB that is employed to perform audit services; (ii) all audit committee members are independent of the issuer; and (iii) all audit committees have complaint procedures, the authority to engage advisers, and the ability to determine appropriate funding for the audit. In February 2002, the SEC proposed a new rule to implement this section of the Act, which must be adopted and become effective by April 26, 2003 according to the requirements of the Act. Once the new rules become effective, the new requirements would need to be operative by the national securities exchanges and national securities associations no later than the first anniversary of the publication of the final rule in the Federal Register. The proposed rule may be found at http://www.sec.gov/rules/proposed/34-47137.htm#iii.

3 The listing requirements of self-regulatory organizations, such as the national securities exchanges, have also played a role, and those requirements are being revised, as discussed below.
As described in the response to Question III.d., Section 303 of the Sarbanes-Oxley Act also prohibits directors of an issuer from fraudulently influencing, coercing or otherwise misleading accountants in the performance of any audit for the objective of rendering the issuer’s financial statements materially misleading. The SEC has also recently adopted rules and amendments implementing Section 407 of the Act. These rules and amendments will require issuers to provide disclosure in their annual reports about whether they have at least one audit committee financial expert on their audit committees, and whether that expert is independent of management.

In addition to the SEC, the U.S. national securities exchanges and the Nasdaq have submitted to the SEC rule proposals to improve corporate governance. For example, on August 16, 2002, the NYSE submitted to the SEC for approval a broad set of corporate governance rules. (As discussed in the response to Question III.a., the SEC has published for comment some of these proposals.) These proposals resulted from then SEC Chairman Harvey Pitt’s request in February 2002 that the NYSE review its corporate governance listing standards. In response, the NYSE appointed a Corporate Accountability and Listing Standards Committee to review the Exchange’s current listing standards, and recent proposals for reform. On June 6, 2002, this Committee submitted its report and initial recommendations to the NYSE Board of Directors, which resulted in the NYSE’s rule proposals. Under these rule proposals, the majority of the board of directors of a listed company would have to be independent. In order for a director to be viewed as “independent,” the board of directors must determine that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company). Furthermore, the company must disclose in its proxy statement any basis for its determination that a relationship is not material. All listed companies would also be required to have an audit committee, nominating committee and compensation committee composed entirely of independent directors. The rule proposals contain an exemption from these requirements for “controlled companies,” companies of which more than 50% of the voting power is held by an individual, group or other company. However, these controlled companies still would be required to have an audit committee composed entirely of independent directors, and must disclose in their annual meeting proxy statements that they are controlled companies. The NYSE also proposed other corporate governance rules pertaining to audit committees and certifications by the chief executive officer of listed companies, all of which can be found at [http://www.nyse.com/pdfs/corp_gov_pro_a.pdf](http://www.nyse.com/pdfs/corp_gov_pro_a.pdf).

In October 2002, the Nasdaq also submitted to the SEC for approval corporate governance rule proposals that cover many of the same areas that are covered by the NYSE’s August proposals. The Nasdaq’s proposals would impose a new requirement that a majority of the board of directors of a Nasdaq company be independent. The rule proposals would strengthen the definition of independent directors by expanding the list of per se disqualifications from independence. These proposals may be found at [http://www.nasdaq.com/about/2002_141.pdf](http://www.nasdaq.com/about/2002_141.pdf).

As proposed the NYSE and Nasdaq proposals would not apply to foreign issuers; however, the NYSE proposal would require foreign private issuers to disclose any significant ways in which their corporate governance practices differ from those followed by domestic companies under NYSE listing standards. In light of the applicability of Section 301 of the Sarbanes-Oxley Act to both

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domestic and foreign listed issuers, it is anticipated that the NYSE and Nasdaq rule proposals will be revised to take into consideration the SEC’s adoption of final rules under Section 301, as discussed above.

The Commission expects to act on the NYSE and Nasdaq rule proposals in the near future.

IV. **Other Recent, Ongoing and Planned Reform Initiatives in Corporate Governance**

a.) **Surveillance and Enforcement**

The recent corporate collapses in the United States have resulted in efforts to improve oversight and surveillance of the activities of accounting firms that engage in the audit of public companies, as well as the effectiveness of enforcement actions generally. The Sarbanes-Oxley Act established a five-member Public Company Accounting Oversight Board (PCAOB) to oversee the audit of public companies subject to the securities laws. Under the Act, any public accounting firm that performs or participates in any audit report with respect to a reporting company must register with the PCAOB. The PCAOB is self-funded by fees assessed on reporting companies, and on registered public accounting firms. It is charged with establishing or adopting by rule standards relating to the preparation of audit reports for issuers, such as with respect to auditing, quality control, ethics, and independence. The PCAOB must also conduct a continuing program of inspections of registered public accounting firms.

Section 105 of the Sarbanes-Oxley Act empowers the PCAOB to investigate and impose disciplinary and remedial sanctions upon registered public accounting firms and their associated persons who violate the Act, the rules of the PCAOB, and the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants. The PCAOB has the power to compel testimony and documents from registered public accounting firms and their associated persons and to seek issuance of a subpoena from the SEC for the testimony and documents of other persons. The PCAOB is also authorized to sanction a registered public accounting firm or its supervisory personnel for failure to supervise when there is an underlying violation, and provides for the coordination and referral of investigations among the PCAOB, the SEC, and other federal and state regulators.

The SEC has general oversight over the PCAOB. This includes the power and duty to pre-approve the PCAOB’s rules, review disciplinary and other actions and, in specified circumstances, amend the PCAOB’s rules and censure or impose limitations on the PCAOB or a PCAOB member. The Act requires the SEC to determine, by April 26, 2003, that the PCAOB is organized and can carry out the purposes of the Sarbanes-Oxley Act.
The Sarbanes-Oxley Act also addresses corporate and criminal fraud accountability. Section 807 of the Act establishes additional criminal penalties for defrauding shareholders of publicly traded companies. Any person who knowingly executes, or attempts to execute, a scheme to defraud shareholders of publicly traded companies, or obtains by false or fraudulent means any money or property in connection with the purchase or sale of an issuer’s securities may be subject to a fine and imprisonment of not more than 25 years. Section 806 of the Act, which is administered by the U.S. Department of Labor, also provides whistleblower protection for employees of an issuer who assist in the investigation of prohibited conduct by federal regulators, Congress, or the employee’s supervisors. These employees may not be discharged by an issuer or otherwise discriminated against because they file or participate in a proceeding relating to fraud against shareholders. In addition, civil remedies may be available to these employees, such as reinstatement, back pay and compensatory damages.

Section 802 of the Act amends federal criminal law to prohibit knowingly altering, destroying, concealing, or falsifying records with the intent to impede, obstruct or influence an investigation in a matter within the jurisdiction of any department or agency of the United States, or in any case in bankruptcy. Auditors are also required to maintain for a five-year period all audit or review work papers. The SEC recently adopted rules requiring accounting firms to retain for seven years certain records relevant to their audits and reviews of issuers' financial statements. Records to be retained include an accounting firm's workpapers and certain other documents that contain conclusions, opinions, analyses, or financial data related to the audit or review. These rules can be found at http://www.sec.gov/rules/final/33-8180.htm. Compliance with these rules is required for audits and reviews completed on or after October 31, 2003.

The Act also modified the statute of limitations for private actions alleging securities fraud, and increased the amount of funds available for the relief of injured investors. Section 804 amends the federal judicial code to permit a private right of action for a federal securities fraud claim to be brought not later than the earlier of two years after the discovery of facts constituting the violation, or five years after the violation. Section 308 of the Act provides that if the SEC obtains both disgorgement and penalties from a defendant or respondent in an enforcement action, the amount of the civil penalty may be added to the disgorgement fund for the benefit of the injured investors.

The Sarbanes-Oxley Act also makes debts incurred as a result of securities fraud non-dischargeable in bankruptcy. Section 803 of the Act amends federal bankruptcy law to make non-dischargeable debts such as judgments and settlements that result from a violation of federal or state securities law, or common law fraud in connection with the purchase or sale of any security.

The Sarbanes-Oxley Act also enhances enforcement of white-collar crime. It creates a new, separate offense for criminal attempt or conspiracy to commit an offense under certain sections of the criminal code. (See Section 902 of the SOA.) It increases the maximum prison sentence for mail and wire fraud from five years to twenty years. (See Section 903 of the SOA.) Section 906 of the Act amends federal criminal law to require the chief executive officer and chief financial officer of a public company to provide written certifications in each of the issuer’s periodic reports that the report fully complies with Sections 13(a) and 15(d) of the Exchange Act, and that the information in the report
fairly presents the issuer’s financial condition and results of operation in all material respects. Any person who provides a certification knowing that the periodic report does not comply with the requirements of this section is subject to fines of up to $1 million and imprisonment of up to ten years. Any person who willfully certifies any statement knowing that the periodic report does not comply with the requirements of this section is subject to fines of up to $5 million and imprisonment for up to twenty years.

The Sarbanes-Oxley Act strengthens civil and criminal enforcement against corporate fraud generally. Section 1102 of the Act establishes criminal penalties of fines and/or imprisonment of up to 20 years for corruptly altering, destroying or concealing records, documents or other objects, or attempting to do so, with the intent of impairing the object’s integrity or availability for use in an official proceeding, or for obstructing, influencing or otherwise impeding any official proceeding or attempting to do so. The Act also provides the SEC with temporary freeze authority. Section 1103 of the Act amends Section 21C(c) of the Exchange Act to provide that during an investigation into federal securities laws violations by a public company or an officer, director or other affiliate of a public company, the SEC may seek a temporary order from a federal district court requiring the company to escrow extraordinary payments (compensation or other payments) likely to be made to such person for 45 to 90 days. If the person is charged with a violation of the securities laws before the expiration of the effective period of the temporary order, the SEC may seek to extend the effectiveness of the temporary order until the conclusion of the legal proceedings.

The Sarbanes-Oxley Act further amends Section 21C of the Exchange Act and Section 8A of the Securities Act of 1933 (“Securities Act”) to give the SEC additional authority to bar individuals from serving as officers and directors of public companies. Under Section 1105 of the Sarbanes-Oxley Act, the SEC is granted authority in administrative cease-and-desists proceedings to bar individuals from acting as an officer or director of a public company if the person’s conduct demonstrates unfitness to serve in such a capacity.

In addition, the Act increases the amount of criminal penalties under the Exchange Act and provides protection for informants. Section 1106 of the Act amends Section 32 of the Exchange Act to increase the maximum penalty for an individual to a fine of $5 million and imprisonment of not more than 20 years. The fine increases to $25 million for persons other than natural persons. Under Section 1107 of the Sarbanes-Oxley Act, anyone who takes any harmful action against any person knowingly, with the intent to retaliate, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any federal offense may be fined and imprisoned for up to 10 years. Harmful actions covered by this section would include interfering with the lawful employment or livelihood of any person.

Aside from these enforcement enhancements, the Sarbanes-Oxley Act also requires the SEC to conduct enforcement-related studies under Sections 308 and 704 of that Act. Under Section 308, the SEC is required to study the enforcement actions it has taken during the five years prior to the Act that have included proceedings to obtain civil penalties or disgorgement, and to identify areas where these proceedings may be used to provide restitution for injured investors effectively. The SEC is also
charged with reviewing other methods of providing restitution to injured investors that may be more efficient and effective, and to report its findings to Congress. The SEC submitted the report summarizing the results of its study to Congress in January 2003. The report may be found at http://www.sec.gov/news/studies/sox308creport.pdf. Under Section 704 of the Act, the SEC is also directed to study reporting violations and restatements made during the past five years to identify the areas most susceptible to fraud, inappropriate manipulation, or inappropriate earnings management. The results of this study were provided to Congress in January 2003, and may be found at http://www.sec.gov/news/studies/sox704report.pdf.

b.) Conflicts of Interest

Reforms have been initiated recently within the United States to address conflicts of interest involving auditors, corporate executives, and analysts. For instance, public accounting firms that are registered with the PCAOB are prohibited from performing audit services for a reporting company if the company’s senior management officials have been employed by that firm and participated in the audit of that company during the year preceding the audit. (See Section 206 of the SOA.) The Sarbanes-Oxley Act also requires rotation of the lead or coordinating audit partner on a five-year basis. (See Section 203 of the SOA.)

In addition to auditor conflicts of interest, the Act also addresses potential conflicts of interest by directors and executive officers of reporting companies. Section 402 of the Act prohibits a reporting company from making personal loans to any director or executive officer, other than certain home improvement, manufactured home and margin loans that are made in the ordinary course of the consumer credit business of the company. The terms of these loans may not be more favorable than those offered to the general public. As discussed more fully in the response to Question III.b., directors, officers and beneficial owners of more than 10 percent of any class of equity security of a U.S. issuer that is registered under Section 12 of the Exchange Act must also disclose any changes in their ownership of any equity securities of that issuer or security-based swap agreements involving the issuer’s equity securities within two business days of the transaction. (See Section 403 of the SOA.) The Sarbanes-Oxley Act also directs the SEC to issue rules requiring reporting issuers to disclose whether they have adopted a code of ethics, or disclose why they have not done so, which would apply to their principal financial officer, comptroller or principal accounting officer. (See Section 406 of the SOA.) The code of ethics must include standards that are reasonably necessary to promote honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships. The SEC recently adopted rules implementing this requirement of the Act, which can be found at http://www.sec.gov/rules/final/33-8177.htm. The SEC’s new rules extend this requirement to the principal executive officer, in addition to the senior financial officers. Issuers must comply with the code of ethics disclosure requirements in their annual reports for fiscal years ending on or after July 15, 2003. Under the new rules, U.S. reporting issuers must disclose any changes to, or waivers from, an issuer’s code of ethics immediately on current report Form 8-K. Because foreign private issuers do not file Form 8-K, they must disclose this information in the annual report that covers the fiscal year in which the change or waiver occurred, although the SEC strongly encourages them to disclose this information immediately on current report Form 6-K or on their websites if possible.
The SEC has also recently addressed conflicts of interest by analysts. On February 20, 2003, the SEC adopted Regulation Analyst Certification (Regulation AC) to promote the integrity of research reports, as well as investor confidence in those reports. Although Regulation AC was not mandated by the Act and was proposed before the Act was passed, it nonetheless supports the Act’s directives by requiring certifications and disclosures of conflicts of interest by research analysts. Regulation AC requires that brokers, dealers, and certain persons associated with a broker or dealer include in their research reports certifications by the research analyst that the views expressed in the report accurately reflect his or her personal views, and disclose whether or not the analyst received compensation or other payments in connection with his or her specific recommendations or views. Broker-dealers would also be required to obtain periodic certifications by research analysts in connection with the analyst’s public appearances. The Commission’s release adopting Regulation AC may be found at http://www.sec.gov/rules/final/33-8193.htm.

Section 501 of the Sarbanes-Oxley Act directs the SEC, or the self-regulatory organizations under the authorization and direction of the SEC, to adopt rules governing analyst conflicts within a year of the Act’s enactment, including rules: limiting the supervision and compensatory evaluation of securities analysts; defining periods in which brokers or dealers engaged in a public offering of a security as underwriters or dealers may not publish research on such security; and requiring securities analysts and brokers or dealers to disclose specified conflicts of interest. In addition, Section 501 requires rules that: restrict the prepublication clearance or approval of research reports by persons engaged in investment banking activities or not directly responsible for investment research; prohibit a broker or dealer and associates involved with investment banking activities from retaliating against a securities analyst as a result of an unfavorable research report that may adversely affect the investment banking relationship of the broker or dealer with the subjects of the research report; and establish safeguards to assure that securities analysts are separated within the investment firm from the review, pressure, or oversight of those whose involvement in investment banking activities may potentially bias their judgment or supervision.

c.) The External Audit Process

As discussed more fully in the responses to Questions III.d. and IV.a., reforms have been initiated through the Sarbanes-Oxley Act and SEC rulemakings to improve the external audit process in the United States. For example, the PCAOB has been established to oversee the audit of public companies, and the auditor independence rules have been strengthened. In addition, the Sarbanes-Oxley Act charges the SEC with developing rules to direct the exchanges to amend their listing rules to improve the effectiveness of audit committees. (See Sections 102 through 109, 201 through 207, 301 and 407 of the SOA.)

d.) Regulation of Corporate Service Providers Other Than External Auditors

As described more fully in the response to Question IV.b., the SEC’s recently promulgated Regulation AC and Section 501 of the Sarbanes-Oxley Act deal with analysts’ conflicts of interest. Section 604 of the Sarbanes-Oxley Act also amends the Exchange Act and the Investment Advisers Act of 1940 to
authorize the SEC to censure or restrict brokers, dealers, investment advisers or persons associated with them, who are subject to any final order of certain state regulatory entities that bar them from engaging in the business regulated by these state entities, or that constitutes a final order based on violations of any laws or regulations that prohibit fraudulent, manipulative or deceptive conduct.

In addition to these reform initiatives, the Sarbanes-Oxley Act also requires the SEC to set minimum standards of professional conduct for attorneys who appear and practice before the SEC to represent issuers. Under Section 307 of the Act, the SEC is directed to adopt a rule requiring these attorneys to report evidence of a material violation of the securities laws to the company’s chief legal officer or chief executive officer, and if these individuals fail to respond appropriately to this report, to the company’s audit committee. In January of 2003, the SEC adopted a rule prescribing minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers, which can be found at http://www.sec.gov/rules/final/33-8185.htm.

The Act and the SEC’s rules recognize that both inside and outside counsel are a vital part of any corporate governance regime. Independent directors must often rely on independent counsel in determining whether to undertake investigations of corporate conflicts, assess the results of such inquiries, deal with management conflicts of interest, and assess whether prompt disclosure of material corporate developments is necessary and appropriate. The “up-the-ladder” requirement of the Sarbanes-Oxley Act, which requires inside and outside attorneys to report evidence of violations of the federal securities laws to the chief legal officer and the chief executive officer, and if appropriate corrective action is not taken, to a committee of independent directors or the full board, makes this governance requirement a matter of federal law. The SEC is also considering a requirement that counsel “report out” to regulatory authorities if the issuer’s internal steps do not result in appropriate actions to stop the illegal conduct and/or make public disclosure. In addition, the Commission is considering a requirement that the issuer promptly notify the Commission if an attorney withdraws for “professional considerations.” These requirements recognize the corporate lawyer’s role as “gatekeeper” for his/her client – the corporation and its shareholders, rather than management.4

The Sarbanes-Oxley Act also requires the SEC and the Comptroller General of the United States to conduct studies on credit rating agencies, securities professionals and investment banks. Section 702 of the Act directs the SEC to conduct a study of the role and function of credit rating agencies in the operation of the securities markets and report the results to the President and Congress. The SEC completed this study, entitled “Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets,” in January 2003. This report addresses each of the points required by the Act, including: the role of credit rating agencies and their importance to the securities markets; any impediments faced by credit rating agencies in performing that role; measures to improve information flow to the market from rating agencies; barriers to entry in the credit rating agency business, and any conflicts of interest in the operation of credit rating agencies and measures to prevent such conflicts or ameliorate the consequences of such conflicts. The report required by the

4 State law requirements differ. Thirty-seven states permit “reporting out” and four other states require it. California, Delaware and the District of Columbia are among the jurisdictions that presently restrict disclosure.
Act coincided with a review of credit rating agencies already being conducted by the SEC, so that the final report also addresses other issues, such as allegations of anticompetitive or unfair practices, the level of diligence of credit rating agencies, and the extent and manner of SEC oversight. The report may be found at http://www.sec.gov/news/studies/credratingreport0103.pdf.

In addition to this report, the Sarbanes-Oxley Act requires the SEC to study and report on the number of securities professionals that violate, as well as aid and abet violations of, the federal securities laws. Section 703 of the Act directs the SEC to conduct the study based on information available for the period from January 1, 1998 to December 31, 2001. The securities professionals covered by the study include public accountants, public accounting firms, investment bankers, investment advisers, brokers, dealers, attorneys and other securities professionals practicing before the SEC. The SEC prepared a report that reviews the scope and methodology of the SEC’s study and summarizes the results, and submitted this report to Congress in January of 2003. This “Study and Report on Violations by Securities Professionals” may be found at http://www.sec.gov/news/studies/sox703report.pdf.

Finally, the Comptroller General of the United States is required by Section 705 of the Sarbanes-Oxley Act to conduct a study on whether investment banks and financial advisers assisted public companies in manipulating their earnings and hiding their true financial condition. In particular, the study will address the role of these investment banks and financial advisers in the collapse of Enron Corporation and Global Crossing. The report summarizing the results of this study is expected to be published soon and posted on the web at http://www.gao.gov/.

V. Primary Forces Behind Recent Changes in Corporate Governance Practices and Reform Initiatives

As indicated in the response to Question I.a., several bankruptcies in the United States during late 2001 and early 2002 highlighted the need for reforms in the corporate governance practices in the United States. Although the SEC had proposed several initiatives to address concerns about corporate governance and disclosure practices prior to the enactment of the Sarbanes-Oxley Act, such as with respect to certifications of periodic reports by chief executive officers and chief financial officers of reporting companies, the Act introduced a sweeping set of reforms as described in the responses above. The self-regulatory organizations, such as the national securities exchanges and Nasdaq, also proposed reforms, as described in the responses to Questions III.a. and III.e., as did private sector organizations, such as the Business Roundtable. See the Business Roundtable’s “Principles of Corporate Governance” at http://www.brtable.org/document.cfm/704.
VI. The Role of Large Shareholders in Listed Companies

Large shareholders, such as banks and families, do not have special privileges over other shareholders of a listed company within the U.S. regulatory framework. In many instances, they actually have more obligations under the federal securities laws because of their large share ownership. Any shareholder who owns more than 5% of any class of equity security that is registered under the Exchange Act must disclose his or her holdings to the company, and file a statement with the Commission. Beneficial owners of more than 10% of any class of equity security that is registered under the Exchange Act must file a report with the SEC indicating the amount of all equity securities of that company owned by that person. Changes in that ownership, or the purchase or sale of a security-based swap agreement involving those equity securities, must be reported to the SEC within two business days after completion of the transaction. Moreover, controlling shareholders of an issuer face additional burdens when they want to sell their holdings in that issuer. They generally are required to sell those securities through a registration statement that is reviewed and made effective by the SEC because they are viewed as affiliates of the issuer who are undertaking a distribution on behalf of the issuer. Non-controlling shareholders normally would not have this additional obligation in the sale of their holdings.

VII. Restrictions on Intermediary Shareholders

(i) Institutional Ownership of Individual Companies

As a general matter, a registered open- or closed-end investment company (a “fund”) is not prohibited from owning up to 100% of the equity securities of an individual company (a “portfolio company”). As a practical matter, however, most funds seek to comply with provisions of the Internal Revenue Code and the Investment Company Act of 1940 (“Company Act”) that restrict their ability to own substantial percentages of the equity securities of any single issuer. In addition, Section 12(d) of the Company Act restricts fund ownership of certain companies in the securities and insurance industries. Section 20(c) of the Company Act prohibits a fund from purchasing shares of a portfolio company if cross or circular ownership exists or would exist. As explained below, those restrictions can limit some funds’ ownership of a large percentage of the shares of a portfolio company. In addition, if a fund owns 5% or more of the shares of a portfolio company, the Company Act generally prohibits certain transactions between the fund and the portfolio company.

Fund Diversification Limitations

Most funds choose to comply with the provisions of Section 851 of Subchapter M to obtain pass-through tax treatment for the funds’ income, so that only shareholders, and not the funds, are subject to taxation. Under Section 851 of Subchapter M, with respect to 50% of a fund’s assets, the fund may not own more than 10% of the outstanding voting securities of any one issuer, and the securities of any one issuer (other than government securities or other funds’ securities) may not represent more than 5% of the fund’s total assets. In addition, a fund may not invest more than 25% of its assets in the securities of one issuer (other than government securities or other funds’ securities).
Funds that hold themselves out to the public as "diversified" must comply with Section 5(b) of the Company Act, which provides that, with respect to 75% of the fund’s assets (the “75% basket”), the fund may not own more than 10% of the outstanding voting securities of any one issuer, and the securities of any one issuer (other than government securities or other funds’ securities) may not represent more than 5% of the fund's total assets.

Under Section 5(b) of the Company Act, a diversified fund may invest up to 25% of its assets in the securities of one issuer (the “25% basket”). A fund may not exceed the 25% limit by aggregating a holding of up to 5% in the 75% basket with a holding of up to 25% in the 25% basket. A fund that holds itself out to the public as diversified may not become non-diversified without the approval of its shareholders. Funds that hold themselves out as non-diversified are not subject to the requirements of Section 5(b) of the Company Act.

A small number of funds elect not to meet the requirements of Section 851 of Subchapter M. These funds may not be diversified and could own up to 100% of the equity securities of various portfolio companies.

**Securities-Related Portfolio Company Restrictions**

Section 12(d)(2) of the Company Act generally restricts any fund, and any company it controls, which do not already own at least 25% of the total outstanding voting stock of an insurance company, from acquiring in the aggregate more than 10% of the total outstanding voting stock of an insurance company. Section 12(d)(3) of the Company Act generally prohibits any fund, and any company it controls, from acquiring securities or any other interest in the business of a broker, dealer, underwriter, an investment adviser to an investment company or an investment adviser registered under the Investment Advisers Act of 1940 (“securities-related entity”), unless the securities-related entity meets certain conditions, or the fund can comply with an exemption available in rule 12d3-1 under the Company Act.

**Cross and Circular Ownership**

Section 20(c) of the Company Act prohibits a fund from purchasing the voting securities of a portfolio company if cross or circular ownership exists or would exist between the fund and the portfolio company. Cross ownership exists when two companies beneficially own more than 3% of the voting securities of the other. Circular ownership, in its most basic form, exists when one company holds 3% of the voting securities of a second company, which holds 3% of the voting securities of a third company, which in turn holds 3% of the voting securities of the first company, thus completing a “circle” of ownership.

**Affiliated Transaction Limitation**

Section 17 of the Company Act prohibits certain transactions between a fund and affiliated persons of the fund (“affiliated transactions prohibitions”). If a fund owns 5% or more of the voting securities of a portfolio company, it is deemed to be “affiliated” with the portfolio company.

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5 See Section 2(a)(3) of the Company Act (defining affiliated person) and Section 17 (prohibiting certain transactions between and among funds and, among others, their affiliated persons and the affiliated persons of those persons). In addition, Section 10(f) generally prohibits a fund from purchasing or otherwise acquiring securities during an underwriting or selling syndicate when a principal underwriter of the security is affiliated with the fund.
Pension Plans

There are two limitations on the portion of shares which corporate pension plans may hold in an individual company. Under section 407(a)(2) of the Employee Retirement Income Security Act of 1974 (ERISA), a defined benefit pension plan generally may not invest more than ten percent of its assets in employer securities. ERISA also contains a general prudence and diversification rule, which requires plans to diversify investments so as to minimize the risk of large losses. This does not place a percentage limit on investments in securities of any one company, but is a practical limitation, based on the facts and circumstances. There is an exception from the diversification requirement and the prudence requirement to the extent that it requires diversification for investment by individual account plans in eligible account securities of their sponsoring employer. Certain plans, such as employee stock ownership plans, invest as much as 100% of their assets in shares of their sponsoring employer.

(ii) Ability to Exercise Their Ownership Functions

Open- and Closed-End Funds

In general, there are no restrictions on a fund’s ability to exercise its ownership functions with regard to its portfolio companies. Typically, a fund’s board of directors delegates to the fund’s investment adviser the responsibility for exercising the fund’s rights as a shareholder in portfolio companies. A fund’s investment adviser has a fiduciary duty to exercise the fund’s shareholder rights in a manner that is consistent with the best interests of the fund, and generally is prohibited from exercising the fund’s shareholder rights to further its own interest at the expense of the fund.

In general, a fund “official,” such as a fund’s director, may serve as a director of a portfolio company. In that event, the fund should take into account the special circumstances presented by that director’s role. In addition, any “independent director” of a fund who serves as a director of a portfolio company could lose his or her status as an “independent” director depending on the amount of the securities of the portfolio company owned by the fund. A person who is affiliated with the fund (for a

6 Section 204A of the Investment Advisers Act of 1940, for example, requires a fund’s investment adviser to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material, nonpublic information by the adviser or any person associated with the adviser. A fund director, in some circumstances, may be a person associated with an investment adviser. In that event, the investment adviser’s written policies and procedures would need to address the possibility that the fund official, as a director of the portfolio company, may have access to material, nonpublic information about the purchase and sale of the portfolio company’s securities. The fund would be prohibited from trading on the basis of that information.

7 The Company Act requires that at least 40% of a fund’s board of directors be persons who are not “interested persons” of the fund or its investment adviser (“independent directors”) as defined in Section 2(a)(19) of the Company Act. In addition, as a practical matter, most funds rely on several rules that exempt them from certain requirements of the Company Act; those rules require that independent directors must constitute a majority of the fund’s board of directors. Thus, as a result, independent directors constitute a majority of most funds’ boards of directors.
reason other than serving as director) would not qualify as an independent director. That is, a person who serves as the director of a portfolio company would not qualify as an independent director of a fund that owns 5% or more of the outstanding voting securities of the portfolio company.\(^8\)

In addition, an arrangement whereby a fund “official” serves as a director of a portfolio company also could lead to conflicts of interest between the official and the fund in connection with any transaction between the fund and the portfolio company. For instance, a portfolio company could so highly compensate a director that the director’s interest in the compensation would be greater than his or her interest in protecting the fund’s shareholders. Such transactions also could implicate the affiliated transactions prohibitions of the Company Act.

Pension Plans

Not only are corporate pension plans not restricted from exercising their ownership functions of voting, corporate pension plan trustees would be considered imprudent if they did not vote their shares. Corporate pension plan trustees rarely sit on the boards of companies in which their plans own shares (except in some situations, on the boards of their sponsoring employer), although there is no legal prohibition against sitting on such boards.

(iii) Ability to Communicate with Each Other

Open- and Closed-End Funds

We assume that you refer to communications between a fund and its portfolio company. There generally are no limitations on a fund’s ability to communicate with its portfolio companies. As discussed above, however, the written policies and procedures of a fund’s investment adviser may impact the ability of a fund director to communicate material, non-public information. In addition, as discussed above, a fund’s ability to engage in certain transactions with affiliated portfolio companies may be limited by the Company Act and the rules thereunder.

Pension Plans

ERISA contains no such restrictions, although the securities laws contain some limitations on such communications. Regulations under ERISA make it clear that managers of corporate pension plans have a duty to vote plan shares on matters which may affect the value of the shares, and to keep a record of such votes so as to enable trustees of such plans to fulfill their duty to monitor such votes to assure that the managers have prudently fulfilled their voting obligations. The SEC has recently adopted a new rule and rule amendments under the Investment Advisers Act of 1940 that require investment managers that have voting discretion to adopt policies and procedures reasonably designed to ensure that the adviser votes proxies in the best interest of clients, to disclose to clients information about those policies and procedures, and to disclose to clients how they may obtain information on how the adviser voted their proxies. The

\(^8\) See Sections 2(a)(3) and 2(a)(19) of the Company Act.
new rule and amendments apply to investment managers for corporate pension plans, and may be found at http://www.sec.gov/rules/final/ia-2106.htm.

**Formal Requirements in Terms of Exercising Ownership**

Generally, a fund is not required to exercise its ownership function by voting, but the decision whether or not to exercise that function is subject to the fiduciary duties of the fund’s adviser and directors. The Commission recently adopted Rule 30b1-4 under the Company Act, which requires an open-end fund to disclose in its registration statement and a closed-end fund to disclose on Form N-CSR, the policies and procedures that the fund uses to determine how to vote proxies relating to its portfolio securities. In addition, a fund must disclose how it voted proxies related to its portfolio securities by filing Form N-PX with the Commission and making that information available to its shareholders, either on its website or upon request. A fund must disclose in its annual and semi-annual reports to shareholders and in its registration statement the methods by which shareholders may obtain information about the fund’s proxy voting. There are no specific provisions requiring funds to communicate with their shareholders on corporate governance matters relating to portfolio companies.

**VIII. Systems in Place Consistent with IOSCO’s Recent Statements**

In October 2002, IOSCO published three statements of principles on transparency and disclosure, independence of external auditors and public oversight of the audit function. The United States has systems in place that implement all of the principles set forth in these three statements. The U.S. regulatory regime for ongoing disclosure of material developments implements all of these principles. All companies that wish to list their securities on a U.S. national stock exchange or other regulated market, such as Nasdaq, must register their securities with the SEC and file periodic reports, as well as current reports to disclose material information in the intervening period between the filing of periodic reports (Principle 1). All listed companies must file both periodic and current reports on a timely basis, as prescribed by the SEC’s regulations (Principle 2). Listed companies are also required to disclose any material information to the U.S. markets that they disclose to a foreign market (Principle 3). Both U.S. and foreign companies must make their periodic and current report filings on the SEC’s Electronic Data Gathering, Analysis and Retrieval System (EDGAR), the SEC’s electronic filing system. This means that any filing made with the SEC is available to the public as soon as it is filed with the SEC (Principle 4). The antifraud provisions of the federal securities laws prohibit issuers from making any material misstatements or omitting material information with respect to offers and sales of securities, the registration and sale of securities in the secondary market, or the solicitation of proxies (Principle 5). With respect to Principle 6, the SEC adopted Regulation FD in 2000 to address the selective disclosure by issuers of material, nonpublic information. Finally, listed issuers provide certifications in their periodic and current reports that they have duly authorized the person(s) who have signed the report to do so on their behalf, and thus assume liability for any material misstatements or omissions in their filings. In addition, chief executive and chief financial officers of public companies are now required to provide certifications in the periodic reports of these

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companies indicating that, based on their knowledge, the report does not contain any untrue statement of material fact or omit to state a material fact (Principle 7).

The IOSCO Principles on Auditor Oversight observe that there should be a body responsible for overseeing the audit profession that acts in the public interest. They set forth six principles for establishing effective oversight generally. The provisions of the Sarbanes-Oxley Act that call for the establishment of a private sector board to oversee the accountants who perform independent audits of public companies conform with the IOSCO Principles of Auditor Oversight. The PCAOB will be subject to SEC oversight and will be responsible for registering public accounting firms that prepare audit reports for issuers (Principle I). Subject to SEC oversight, the PCAOB will be responsible for promulgating standards governing auditing, attestation quality control, ethics and independence (Principles II and III). The PCAOB will be responsible for conducting inspections of registered public accounting firms on an ongoing and regular basis, and will be subject to SEC oversight (Principle IV). The PCAOB will be responsible for conducting investigations, bringing disciplinary proceedings and imposing sanctions against registered public accounting firms and individuals for violations related to the preparation of audit reports, including the failure to supervise other members of the engagement team. As part of its investigative powers, the PCAOB will have the ability to obtain testimony, to require access to audit work papers and to cooperate with foreign counterparts (Principles III, IV, V and VI).

The IOSCO Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor’s Independence set forth 32 principles that should govern the independence of auditors of financial statements of listed entities. The SEC adopted rules on January 22, 2003 to implement the auditor independence requirements contained in Title II of the Sarbanes-Oxley Act. These rules build on the SEC’s prior efforts to modernize and strengthen its independence standards, which are contained in its November 2000 independence release. On January 8, 2003, the SEC also proposed rules to implement Section 301 of the Act. These proposed rules would prohibit self-regulatory organizations from listing any security of an issuer that is not in compliance with requirements regarding the structure, composition and authority of the audit committee. The Act requires the SEC to adopt final rules by April 26, 2003. In addition to the SEC’s rules, the American Institute of Certified Public Accountants and the Independence Standards Board have promulgated a large, complementary body of regulations and required professional practices relating to independence. As a result of all of these regulations and practices, the United States complies with all of the principles set forth in the IOSCO Principles of Auditor Independence.
Part B

1. Appointment of the External Auditor

The external auditor is appointed by the audit committee, which is a committee of the company’s board of directors. Section 301 of the Sarbanes-Oxley Act requires the SEC to direct the U.S. securities exchanges and Nasdaq to amend their listing rules to make the audit committee of a listed company directly responsible for the appointment, compensation and oversight of the external auditor of that company.

2. Reporting by the External Auditor

The external auditor reports to the audit committee. Section 204 of the Sarbanes-Oxley Act requires the auditor to report to the audit committee on matters such as the critical accounting policies and practices to be used, all alternative treatments of financial information within GAAP that have been discussed with the company’s management officials, the ramifications of the use of these alternative treatments, and the treatment preferred by the auditor.

3. Rotation of Auditors

Under Section 203 of the Sarbanes-Oxley Act, the lead (or coordinating) audit partner with primary responsibility for the audit, as well as the audit partner responsible for reviewing the audit, must be rotated on a five-year basis. Section 207 of the Act requires the Comptroller General of the United States to conduct a study and review of the potential effects of requiring mandatory rotation of audit firms. The report of the results of this study must be submitted to Congress by July 30, 2003.

4. Provision of Consulting Services by External Auditors

Section 201 of the Sarbanes-Oxley Act prohibits an external auditor of a reporting company from providing eight types of non-audit services at the same time that it is auditing that company. The prohibited services are: (i) bookkeeping or other services related to the accounting records or financial statements of the audit client; (ii) financial information systems design and implementation; (iii) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (iv) actuarial services; (v) internal audit outsourcing services; (vi) management functions or human resources; (vii) broker or dealer, investment adviser, or investment banking services; and (viii) legal services and expert services unrelated to the audit. The PCAOB may determine that other non-audit services are prohibited, and may grant exemptions from any of these prohibitions on a case-by-case basis to
5. **Conflicts of Interest**

State statutes and case law address interested party transactions involving the board and executive officers. Most state statutes permit transactions involving interested directors and officers provided that certain conditions are met. For example, Section 144 of the Delaware General Corporation Law (DGCL), which is similar to other state statutes, permits interested party transactions if: (i) the material facts of the relationship or interest are disclosed to the board, and the transaction is approved by a majority of the disinterested directors; (ii) the material facts of the relationship or interest are disclosed to the shareholders, and the transaction is approved by shareholders’ vote; or (iii) the transaction is fair to the corporation at the time that it is approved by the board or shareholders. While directors and executives are not prohibited from self-dealing, they may not act in a manner that violates their fiduciary duty of loyalty to the corporation. Directors and officers may not take advantage of the corporation through unfair or fraudulent transactions, and may not usurp for themselves a corporate opportunity that is available to the corporation.

Directors and executive officers have a fiduciary duty to disclose to the board any material interest that they may have in a transaction or other matter affecting the company. They may also have to disclose material interests to shareholders, as described above. Companies subject to the disclosure requirements of the U.S. federal securities laws must disclose these material interests in filings with the SEC.

Under some state statutes, directors who have an interest in a transaction are permitted to participate in the decision making with respect to those transactions, as long as the majority of disinterested directors votes in favor of the transaction. However, as a matter of practice, many boards appoint a committee of disinterested directors as a means of avoiding potential shareholder suits where a demand is first required to be made on the board of directors to remedy the matter in dispute.

Section 402 of the Sarbanes-Oxley Act prohibits reporting companies from making personal loans to their directors or executive officers, other than certain home improvement, manufactured home, and margin loans made in the ordinary course of the consumer credit business of that company. The terms of any such loan must be on terms that are no more favorable than those offered to the general public.

6. **Senior Executive Compensation**

The general shareholders’ meeting does not have to approve senior executive compensation. However, compensation arrangements for these executives must be disclosed. U.S. companies are required to disclose the compensation paid to each of their directors, their chief executive officer, and their next four highly compensated executive officers in their registration statements, annual reports, and proxy or information statements filed with the SEC. A foreign company must disclose the amount of compensation paid to its directors and members of its administrative, supervisory or management bodies in the registration statements and annual reports that it files with the SEC.
Disclosure is required on an individual basis unless individual disclosure is not required in the company’s home country and is not otherwise publicly disclosed by the company.

7. **Independent Directors**

State law generally does not contain any requirements that boards have independent directors. However, public companies that list their securities on the U.S. securities exchanges or Nasdaq must comply with the independent directors requirements of those markets’ listing standards. As discussed more fully in the response to Question III.e., the NYSE and Nasdaq have proposed rule changes that would require the majority of a listed company’s board of directors to be independent, and that would strengthen the definition of “independence.” Under the NYSE’s proposed rules, a director would be viewed as “independent” if the board of directors determined that a director had no material relationship with the listed company. Listed companies would be required to disclose these determinations. The rules also set forth certain parameters for determining that a director was not independent. For example, no director who was an employee of the listed company could be independent until five years after his/her employment ended. Also, no director who was affiliated with or employed by a present or former auditor of the company or one of its affiliates could be independent until five years after the end of the affiliation or the auditing relationship.

Under the Nasdaq’s current rules, an “independent director” is defined as “a person other than an officer or employee of the company or its subsidiaries or any other individual having a relationship, which, in the opinion of the company’s board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.” The Nasdaq’s rule proposals, which were submitted to the SEC for approval in October 2002, would increase the list of per se disqualifications from independent status. For example, a director would not be viewed as independent if a non-employee family member accepts any payments from the company or its affiliates in excess of $60,000 during the current year or any of the past three fiscal years, or if any family member of the director is, or in the past three years was, employed as an executive officer by the company or any parent or subsidiary of the company.

8. **Duties and Responsibilities of the Board of Directors**

The actual responsibilities of each board may differ according to the applicable state statute and the articles of incorporation and bylaws for each company. However, boards in the United States are subject to duties of care and loyalty and are expected to manage the business of the company, and perform essentially all of the functions described in Principle V.D. of the *OECD Principles of Corporate Governance* (such as review and guide corporate strategy, select and replace key executives, etc.).

With respect to the financial reporting process, boards typically delegate their oversight function to an audit committee. The Sarbanes-Oxley Act requires the SEC to adopt rules directing the U.S. securities exchanges and Nasdaq to amend their listing rules with respect to audit committees. The listing standards must now require the audit committee to be directly responsible for the appointment, compensation and oversight of any registered public accounting firm employed to perform audit services; that all audit committee members be independent of the issuer; and that all audit

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10 The Company Act also contains independence requirements for companies that are registered as investment companies. Many SEC rules that provide exemptive relief from restrictions of the Company Act specifically rely on the approval and oversight of fund independent directors. See discussion at footnote 7.
committees have complaint procedures. The responses to Questions III.d. and e. more fully describe recent changes to the responsibilities of audit committees.

The chief executive officers and chief financial officers of reporting companies are also now explicitly responsible for financial reporting disclosures made by the companies. As a result of the Sarbanes-Oxley Act and the SEC’s new rules, they are now required to certify the periodic (annual and quarterly) reports made by their companies. Their responsibilities are more fully described in the response to Question III.a.

9. **Dual Board Structure**

Dual board structures are not commonly used in companies incorporated in the United States.

10. **Boards of Auditors**

Please see the response to Question 11 below. Audit committees, rather than boards of auditors, are the norm in the United States.

11. **Audit Committees**

Many state statutes permit some or all of the board’s powers to be delegated to designated committees of the board, including the audit committee. In addition, as discussed above in the response to Question 8, the audit committee of listed companies is now required by Section 301 of the Sarbanes-Oxley Act to be directly responsible for appointing, compensating and overseeing the external auditor.

12. **Common Shares with Different Voting Rights**

State statutes generally permit the creation of different classes of voting capital stock. The company’s articles of incorporation describe the classes of voting capital stock that can be created and the voting rights applicable to each class. The articles and relevant state statutes also may prescribe the types of matters on which each class of shares may vote. For instance, it would be possible to have two classes of common stock that are equal in all respects except that Class A shares would be entitled to ten votes per share on some or all matters, while Class B shares would only be permitted to one vote per share, with both classes voting as one class except on matters that would affect the rights of a specific class.