108:Annual SEC Update

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Faculty Biographies

Michael D. Cahn

Michael D. Cahn is senior associate general counsel-securities at Textron Inc. in Providence, Rhode Island. He is Textron's principal securities lawyer, advising Textron on issuances of securities, disclosure issues, SEC reporting, and corporate governance issues. He also advises Textron on corporate development and other legal matters.

Prior to joining Textron, Mr. Cahn was an associate at Cahill Gordon & Reindel in New York City.

Mr. Cahn is a member of ACC's Board of Directors and serves as vice chair of ACC's Council of Committees. He was previously chair of ACC's Corporate and Securities Law Committee and secretary of ACC's Council of Committees. He also has served on the advisory board of the *ACC Docket* and is a frequent lecturer and panelist at corporate and securities law seminars.

Mr. Cahn received a BA from Michigan State University and his JD from Harvard Law School.

Paula Dubberly

Paula Dubberly is associate director (legal) of the Division of Corporation Finance at the U.S. Securities and Exchange Commission in Washington, DC. Ms. Dubberly oversees the Office of the Chief Counsel, the Office of Rule Making and the Office of Enforcement Liaison. Ms. Dubberly was chief counsel of the division from 2000 to 2003. Prior to becoming chief counsel, Ms. Dubberly was an assistant director. Registrants in her office included asset-backed issuers, investment banks, real estate investment trusts and Internet companies.

Prior to joining the Commission, Ms. Dubberly was an associate at Jones, Day, Reavis and Pogue.

Jim L. Kaput

Jim L. Kaput is senior vice president and general counsel at The ServiceMaster Company in Downers Grove, Illinois. In addition to serving as the chief legal officer of a $3.6 billion residential and consumer services company, he oversees ServiceMaster's government affairs, risk management operations, corporate secretary, and corporate compliance functions.

Prior to joining ServiceMaster he was a partner in the Chicago office of Sidley & Austin (now Sidley Austin Brown & Wood), specializing in corporate and securities law matters.

Mr. Kaput serves on the board of directors of the Illinois & Michigan Canal Corridor Association, which manages the development of the I&M Canal national heritage corridor.

Mr. Kaput received his BS from the University of Pennsylvania, Wharton School of Business and his law degree from Cornell University Law School.

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Ronald O. Mueller

Ronald O. Mueller is a partner in the Washington, DC office of Gibson, Dunn & Crutcher. Mr. Mueller works in the corporate/securities area with an emphasis on proxy and disclosure issues, corporate governance, executive compensation (including Section 16 and Rule 144), and corporate transactions.

Previously, Mr. Mueller separated from the firm to work as legal counsel to Commissioner Edward H. Fleischman at the United States Securities & Exchange Commission. While at the SEC, Mr. Mueller worked on many of the matters before the Commission, including enforcement matters and regulatory initiatives.

Mr. Mueller is a member of the District of Columbia Bar Association and the ABA. He is a member of the subcommittee on employee benefits and executive compensation of the Committee on Federal Regulation of Securities and a member of the American Society of Corporate Secretaries. Mr. Mueller has written articles and spoken at seminars about a variety of securities law issues, including the use of electronic communications under the federal securities laws, trends and developments in proxy disclosures and proxy contests, and the SEC's Management Discussion and Analysis disclosure requirements, Section 16 rules, and executive compensation disclosure rules. Mr. Mueller has also coauthored a number of legal articles.

Mr. Mueller received his BA, magna cum laude, from Vanderbilt University and his JD from Columbia Law School, where he was both a Harlan Fisk Stone Scholar and a James Kent Scholar.

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Complying with the Revised Form 8-K

By Michael D. Cahn*

On August 23, 2004, major revisions to the SEC's Current Report on Form 8-K became effective. These revisions added eight new items, expanded two existing Form 8-K items and transferred to the Form 8-K two items that previously were reportable on Form 10-K or Form 10-Q. The SEC also accelerated the filing deadline of Form 8-K to four business days from the date of the event, although for certain items issuers will not incur certain penalties if the information is included in the next Form 10-K or 10-Q covering the period in which the reportable event occurred.

Companies need to have procedures in place to ensure that the attorneys and others responsible for filing the Form 8-K are notified of all reportable events in time to draft and file the report. These procedures will be more difficult to establish than procedures for Forms 10-K and 10-Q, which are filed on a regular schedule and can be the subject of quarterly inquiries. This paper will discuss the items required in the revised Form 8-K and suggest possible sources of the required information, and will review the new filing deadlines.

Form 8-K Items

The revised Form 8-K is divided into nine sections, although Section 6 is reserved.

Section 1 – Registrant's Business and Operations

1.01 Entry into a Material Definitive Agreement

Possible Sources: Company Counsel, Human Resources, Treasurer's Department, Corporate Secretary

This is a new item that requires companies to describe new and amended agreements that are material, definitive and not in the ordinary course of business. Material amendments to such agreements must be described even if the original agreement preceded the effective date of the revised form.

To be considered definitive, the agreement must be legally binding and enforceable. The SEC's adopting release states that non-binding letters of intent would not be definitive, while an enforceable agreement subject to stated conditions, such as customary closing conditions, would be definitive.

While most routine agreements would be considered to be in the ordinary course and not reportable, certain types of agreements are always considered to be outside the ordinary course, such as (a) compensatory plans and agreements with directors or executive officers other than plans available to employees generally, and (b) compensatory plans involving equity securities in which any employee can participate unless the plan has been approved by shareholders or is immaterial in amount or significance.

The text of the agreements need not be filed with the Form 8-K, but must be filed as an exhibit to the next periodic report (on Form 10-K or 10-Q) or registration statement. The Commission is encouraging companies to file the exhibit with the Form 8-K when feasible.

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Item 1.02 Termination of a Material Definitive Agreement

Possible Sources: Company Counsel, Human Resources, Treasurer's Department, Corporate Secretary

This new item requires disclosure of the termination of any agreement of the type reportable under Item 1.01.

Item 1.03 Bankruptcy or Receivership

Possible Sources: Attorneys working on the bankruptcy proceeding

This item is basically unchanged from former Item 3 of Form 8-K. Obtaining information on such an extraordinary event should not be an issue.

Section 2 – Financial Information

Item 2.01 Completion of Acquisition or Disposition of Assets

Possible Sources: Company Counsel, Controller's Department

This item is basically the same as former Item 2. It requires disclosure of information concerning completed acquisitions and dispositions of assets amounting to more than 10 percent of the company's consolidated total assets or which are "significant" as defined in Regulation S-X. A report under this item will result in the filing of financial statements of the business acquired (if an acquisition) and pro forma financial information under Item 9.01.

Item 2.02 Results of Operations and Financial Condition

Possible Sources: Investor Relations, Corporate Communications, Controller's Department

This is substantively the same as former Item 12, and requires that companies report public announcements of previously non-public information regarding results of operations or financial condition for completed financial periods. Information filed under this Item is "furnished" and not "filed," so that the information is not incorporated into other SEC filings unless the company elects to do so.

Item 2.03 Creation of a Direct Financial Obligation or an Obligation under an Off-Balance Sheet Arrangement of a Registrant

Possible Sources: Company Counsel, Treasurer's Department, Controller's Department

This new item requires companies to disclose information regarding new material direct financial obligations such as long-term debt obligations, capital lease obligations, operating lease obligations and short-term debt obligations that arise outside the ordinary course of business. Companies also must report if they become directly or contingently liable for a material obligation arising out of an "off-balance sheet arrangement," which is defined as it currently is for the MD&A.

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Item 2.04 Triggering Events That Accelerate or Increase a Direct Financial Obligation or an Obligation under an Off-Balance Sheet Arrangement

Possible Sources: Company Counsel, Controller's Department

This new item requires companies to report any event of default or acceleration under material direct financial obligations and off-balance sheet arrangements.

Item 2.05 Costs Associated with Exit or Disposal Activities

Possible Source: Controller's Department

If a company commits to an exit or disposal plan, or otherwise disposes of a long-lived asset or terminates employees under a plan of termination described in FASB Statement No. 146, under which it will incur material charges, the company must provide certain information under this new item.

Item 2.06 Material Impairments

Possible Source: Controller's Department

If a company concludes that a material charge for impairment to its assets, including securities or good will is required, it must provide information under this new item.

Section 3 – Securities and Trading Markets

Item 3.01 Notice of Delisting or Failure to Satisfy a Continued Listing Rule or Standard; Transfer of Listing

Possible Source: Company Counsel, Corporate Secretary

This new item would be triggered in the event of material noncompliance with a stock exchange rule or listing standard or if the company takes action to withdraw from listing.

Item 3.02 Unregistered Sales of Equity Securities

Possible Sources: Company counsel, Corporate Secretary, Treasurer's Department

This item has been partially transferred from the 10-K and 10-Q, which requires reporting of sales of unregistered equity securities. Such sales must be reported on Form 8-K if unregistered sales since the last report amount to one percent or more of the total shares outstanding. Sales of less than that amount will continue to be reported in the 10-K or 10-Q.

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Item 3.03 Material Modification to Rights of Security Holders

Possible Source: Corporate Secretary

This item has been moved from Form 10-Q.

Section 4 – Matters Related to Accountants and Financial Statements

Item 4.01 Changes in Registrant's Certifying Accountant

Possible Sources: Chief Financial Officer, Controller's Department

This is substantively the same as former Item 4.

Item 4.02 Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review

Possible Sources: Chief Financial Officer, Controller's Department

This new item requires a report if the company concludes that previously issued financial statements should no longer be relied upon because of an error or the company receives a notice from its independent accountant that it should take steps to prevent future reliance on a previously issued audit report or completed interim review. This item only requires reporting when there is a problem with the financial statements and is not triggered by restatements created by corporate events such as stock splits and dispositions.

Section 5 – Corporate Governance and Management

Item 5.01 Changes in Control of Registrant

Possible Source: Company Counsel

The is the same as former Item 1, although the language has been streamlined. It requires information on any person who acquires control of the company.

Item 5.02 Departure of Directors or Principal Officers; Election of Directors; Appointment of Principal Officers

Possible Sources: Corporate Secretary, Human Resources Department

Previously, companies only had to report resignations of directors who furnished a letter describing a disagreement with the company, and didn't have to report resignations of officers. Under the revised form, companies must report the following:

- A director's resignation or refusal to stand for reelection because of a disagreement known to any executive officer, in which event the company must describe the disagreement even if the director does not send the company a letter describing it

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- A director's retirement, resignation, removal or refusal to stand for reelection under circumstances not involving a known disagreement
- The retirement, resignation or termination of the CEO, president, CFO, principal accounting officer or principal operating officer
- The appointment of a new CEO, president, CFO, principal accounting officer or principal operating officer

Item 5.03 Amendments to Articles of Incorporation or Bylaws; Change in Fiscal Year

Possible Source: Corporate Secretary

In the past, when a company changed its articles and by-laws, it only had to file the has to describe the changes and file the revised documents with the Form 8-K.

Item 5.04 Temporary Suspension of Trading Under Registrant's Employee Benefit Plans

Possible Source: Human Resources Department

This item is the same as former Item 11. It requires that the company report any suspension of trading in its benefit plans that under SEC rules would require a temporary freeze in trading in company securities by directors and executive officers.

Item 5.05 Amendments to the Registrant's Code of Ethics, or Waiver of a Provision of the Code of Ethics

Possible Sources: Corporate Secretary; Company counsel

Under the previous Form 8-K, changes and waivers under the company's code of ethics could either be reported on Form 8-K or on the company website. Under the new Form 8-K, the requirement is the same, but if website posting is elected it will have to be posted within four business days.

Section 6 - [Reserved]

Section 7 – Regulation FD

Item 7.01 Regulation FD Disclosure

Possible Sources: Investor Relations, Corporate Communications

This item is the same as former Item 9, and is a voluntary method of complying with the fair disclosure provisions of Regulation FD. Information filed under this Item is "furnished" and not "filed," so that the information is not incorporated into other SEC filings unless the Company elects to do so.

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Section 8 – Other Events

Item 8.01 Other Events

This item is the same as former Item 5, and is a voluntary method of disclosing information and incorporating such information into other filings, such as registration statements.

Section 9 – Financial Statements and Exhibits

Item 9.01 Financial Statements and Exhibits

Possible Sources: Financial Statements **--** Controller's Department; Exhibits – As required by the related Form 8-K item.

This item is the same as former Item 7. It requires that the company list what it are filing with the Form 8-K in the way of (a) financial statements of businesses acquired, (b) pro forma financial information with respect to transactions reportable under Item 2.01, and (c) exhibits.

Filing Deadlines

The revised Form 8-K is required to be filed within four business days after the occurrence of the event. Generally, if a company fails to timely file an 8-K, 10-Q or 10-K, the company may be subject to liability under Rule 10b-5 and for one year is prohibited from using short-form registration statements Form S-2 and S-3, and the company's security holders are barred from selling company securities under Rule 144 until the information is filed. However, the SEC has adopted a limited safe harbor from public and private claims for the following seven items:

1.01 Entry into a Material Definitive Agreement
1.02 Termination of a Material Definitive Agreement
2.03 Creation of a Direct Financial Obligation or an Obligation under an Off-Balance Sheet Arrangement of a Registrant
2.04 Triggering Events that Accelerate or Increase a Direct Financial Obligation under an Off-Balance Sheet Arrangement
2.05 Costs Associated with Exit or Disposal Activities
2.06 Material Impairments
4.02(a) Non-Reliance of Previously Issued Financial Statements

For these seven items, a failure to file the Form 8-K on time will not, by itself, (i) be deemed to be a violation of Section 10(b) of the Securities Exchange Act of 1934 or Rule 10b-5, (ii) subject the company to the one-year ban on using Form S-2 and S-3 registration statements or (iii) affect a security holder's ability to rely on Rule 144. However, the information required by the seven items still must be filed in the 10-Q or 10-K covering the period in which the event occurred, and Forms S-2 and S-3 will not be available until the information is filed. Furthermore, the safe harbor from Section 10(b) and Rule 10b-5 only applies to a failure to file a report on Form 8-K and does not excuse material misstatements or omissions in the Form 8-K.

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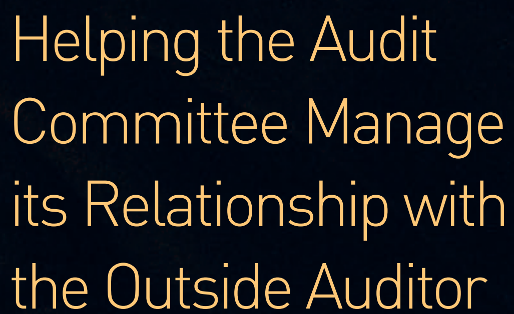

Helping the Audit Committee Manage its Relationship with the Outside Auditor

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By Michael D. Cahn
and Michael J. Scanlon

Tools You Can Use

IT SEEMS INNOCENT ENOUGH—one of your company's subsidiaries in Indonesia has been outsourcing its bookkeeping for the past few years. No problem, right? But then you learn that the same firm that has been providing these bookkeeping services is an affiliate of your outside auditor. The antennae start to go up. You wonder: Is this an auditor independence problem? Does the outside auditor know about this potential conflict? Should the audit committee get involved in this situation? Assuming there is an independence concern, what are the consequences and how can you remedy the situation?

Michael D. Cahn and Michael J. Scanlon, "Tools You Can Use", *ACC Docket* 22, no. 5 (May 2004); xx-xx. Copyright © 2004 Michael D. Cahn and Michael J. Scanlon, and the Association of Corporate Counsel. All rights reserved.

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Resolving questions concerning the outside auditor's independence has always been an important part of the audit process, but until recently it might have been seen as somewhat routine. However, developments over the past few years—in particular, the passage of the Sarbanes-Oxley Act of 2002—have made the issue of auditor independence a primary concern for audit committees and company management. Because the Act makes the audit committee "directly responsible" for the appointment, compensation and oversight of the outside auditor, the audit committee must play a more active role than ever in overseeing a company's relationship with its outside auditor.[1]

In-house counsel can also play a crucial role in assisting the audit committee in this task. As a starting point, you should ensure that the audit committee understands the auditor independence rules, including the requirements for audit committee pre-approval of services to be provided by the auditor. Imparting this understanding is no easy task given the complexity of the auditor independence rules as applied in today's complex business environment. But this may not be enough. It also is imperative that you help ensure that the individuals who will have frequent interaction with the auditor—such as your chief financial officer and controller—also fully understand the auditor independence rules and the consequences that will result if the auditor's independence is deemed impaired. Achieving that level of understanding is a daunting task, but one for which you can provide significant assistance.

AUDITOR INDEPENDENCE BEFORE AND AFTER SARBANES-OXLEY

Many people share the common misperception that the auditor independence rules came of age with the passage of the Sarbanes-Oxley Act. While Sarbanes-Oxley affected some important changes to these rules, the guidelines governing an auditor's relationship with its client evolved well before the Act's passage. For decades, the Securities and Exchange Commission (SEC) has required that all audited financial statements included in annual reports or registration statements filed by public companies be audited by independent auditors. The criteria for determining the independence of auditors developed over the years in informal fashion, with the SEC staff issuing non-binding guidance from time to time in the form of no-action letters or interpretive releases. However, in 2000, after a sometimes contentious rulemaking process, the SEC issued a comprehensive set of rules governing auditor independence. These rules were modified and expanded in 2003 with a further round of SEC rulemaking that was mandated by Sarbanes-Oxley; as a result, the independence rules that are in effect today are largely a combination of the 2000 and 2003 rules.[2]

The SEC's current rules governing auditor independence include both general and specific criteria for assessing an auditor's independence. Starting with the general standard, an auditor will not be recognized as independent "if the accountant is not, or a reasonable investor knowing all the relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the auditor's engagement."[3] This general standard dictates that the auditor must be independent in fact and appearance, and lays the foundation for the specific categories of relationships that are further proscribed by the rules. The general standard also applies in circumstances that are not expressly covered by any of the rules addressing the specific categories of relationships. Consequently, even though the rules may not appear to cover your particular situation, you must consider how the general standard might apply before concluding that your auditor's independence will not be deemed impaired.[4]

Prior to 2000, the SEC's auditor independence rules were uniquely focused on this general standard. While one could turn to various resources in the pre-2000 era to analyze the manner in which the SEC would apply the general set of criteria in any given situation, the analysis of such issues was based more on lore than law. To infuse this critical analysis with a greater level of certainty, the SEC formally identified specific categories of prohibited relationships as part of the 2000 and 2003 auditor independence rulemaking process.[5] These specific standards govern the following types of relationships between the outside auditor and the audit client: (1) financial relationships, (2) employment relationships, (3) business relationships, and (4) the provision of non-audit services by the outside auditor to the audit client.

THE RULES ON FINANCIAL RELATIONSHIPS IMPOSE LIMITATIONS ON DIRECT AND MATERIALLY INDIRECT INVESTMENTS, INVESTMENTS IN COMMON WITH AUDIT CLIENTS, BROKER-DEALER RELATIONSHIPS, DEBTOR-CREDITOR RELATIONSHIPS, AND INSURANCE PRODUCTS ISSUED BY CLIENTS.

The rules also identify numerous sub-categories of relationships within each of the broader categories that may be deemed to impair independence. In considering the relationships identified in these subcategories, you always should bear in mind that the rule's use of the term "audit client" includes all affiliates of the audit client, which generally means any entity that controls, is controlled by, or is under common control with, your company.[6] Thus, when evaluating whether the rules apply to a particular situation, you should consider the relationships between your company and the auditor, as well as the relationships between your auditor and subsidiaries, equity investments (including joint ventures), and other controlled entities. Similarly, the definition of "audit firm" in the SEC's rules includes not just the firm that is actually auditing your company but also associated entities of that firm, which might operate under different names in various countries.[7]

Financial Relationships

The rules on financial relationships impose limitations on direct and materially indirect investments, investments in common with audit clients, broker-dealer relationships, debtor-creditor relationships, and insurance products issued by clients.[8] For example, under the SEC's auditor independence rules, your audit firm and its accountants clearly cannot hold direct investments—stocks, bonds, notes, options, or other securities—in your company during the period of the audit engagement. Your auditor's independence may also be deemed to be impaired if the audit firm makes an investment in your company through an intermediary under its control.

Employment Relationships

The rules also prohibit employment of current professional personnel of an outside auditor from being employed by the audit client or serving on the audit client's board of directors. This prohibition may seem obvious enough, but situations may inadvertently arise that implicate this rule. For example, let's say that a senior financial officer at one of your subsidiaries in Malaysia resigns during a critical financial reporting period, and local management of your subsidiary asks a senior accountant from your auditor's affiliate in Kuala Lumpur to temporarily perform the manager's duties until the press of work subsides. This may sound innocent enough, but you now have a significant auditor independence situation on your hands.

Similarly, the auditor's independence could be deemed impaired if a close family member of a partner or a professional employee of the auditor serves in an accounting role or financial reporting oversight role (a position where he or she has influence over the content of your accounting records).[9] In addition, as part of Sarbanes-Oxley, Congress expanded the conflict of interest principles governing employment by former audit firm personnel, providing that independence will be impaired unless there is a one-year cooling off period before a member of the audit engagement team can begin working with the client in certain key financial positions.[10] The "one-year" cooling-off period is somewhat of a misnomer, however, because the rules adopted by the SEC to implement this provision can extend the cooling-off period to up to 23 months, depending on when

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the individual left the audit firm and whether he or she was working at the firm at the time the firm commenced its audit procedures for your current audit.[11]

Business Relationships

The auditor independence rules also severely restrict the extent to which your company is permitted to enter into business relationships with its auditor. Specifically, an auditor's independence will be deemed impaired when the auditor has a direct or material indirect business relationship with an audit client.[12] This aspect of the rules is sometimes difficult to apply in practice given the rule's subjective construction of what constitutes a material indirect business relationship. As a general matter, however, you should be alert to the potential for an independence violation when you see that your company is being asked to provide a product or service to your auditor that you know to be material either to the auditor or to your company.

Joint business ventures and prime/subcontractor relationships between an auditor and your company also are off limits under this provision of the auditor independence rule. Despite the apparent breadth of its prohibitions, the rule is not intended to limit ordinary course transactions.[13] For example, if your company is selling off-the-shelf software to numerous customers, you would be permitted to sell the same product to your auditor—unless the auditor is materially reliant on the software, in which case further consideration would need to be given to whether the sale would present an independence problem.

Non-Audit Services

The portion of the auditor independence rules that has received the most attention since the passage of Sarbanes-Oxley pertains to restrictions on an auditor's ability to provide non-audit services to its client. Most of these scope of service restrictions, however, had already been implemented by the SEC as part of its 2000 rulemaking. The provisions include restrictions on the several types of non-audit services (*see* "Don't Go There," this page, for a complete list). Congress affirmed the restrictions on these services when it passed the Sarbanes-Oxley Act, and merely added expert services to the list of prohibited engagements.[13] In addition, Congress authorized the Public Company Accounting Oversight Board (PCAOB) to supplement the proscriptions on non-audit services.[14] Importantly, Sarbanes-Oxley clarified that audit firms may continue to provide tax services to their clients, although some qualifications to this principle that have been articulated by the SEC. (See "A Tax Service by Any Other Name . . . ," next page, for a discussion of these limitations.)

Don't Go There

RESTRICTIONS ON NON-AUDIT SERVICES

The SEC's auditor independence rules set forth 10 particular non-audit services that will be deemed to impair the auditor's independence. Although the rules governing these restricted services are not absolute in all cases (for example, some of the restrictions include an exception if it is reasonable to conclude that the results of these services will not be subject to audit procedures during a financial statement audit), the circumstances where these types of services can be provided by your outside auditor are very limited. Thus, your company should refrain from engaging the independent auditor to perform the following services, unless it is clear that the circumstances would permit such an engagement:

- Bookkeeping or other services related to your accounting records or financial statements,
- Financial information systems design and implementation,
- Appraisal or valuation services, fairness opinions or contribution-in-kind reports,
- Actuarial services,
- Internal audit outsourcing services,
- Management functions, including acting (temporarily or permanently) as a director, officer or employee of your company or performing any decision-making, supervisory or ongoing monitoring function for a company,
- Human resources functions,
- Broker-dealer, investment adviser or investment banking services,
- Legal services, *i.e.*, services that could be provided only by someone qualified to practice law in the jurisdiction in which the service is provided, and
- Expert services unrelated to the audit, including the provision of an expert opinion or other expert service. (In legal proceedings, however, the independent accountant is permitted to provide factual accounts of work performed and can explain positions taken during the performance of any services provided for your company.)

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When formulating rules implementing the auditor independence provisions of Sarbanes-Oxley, in 2003, the SEC modified some of the exceptions to the scope of service restrictions. For example, the rules eliminated an exception that allowed bookkeeping services if the services were provided in an emergency situation. On the other hand, the SEC's rules now allow an auditor to provide bookkeeping, appraisal or valuation services, actuarial services, and internal audit services, when "it is reasonable to conclude that the results of these services will not be subject to audit procedures" during a financial statement audit.[15] In these situations, the SEC has indicated that it is comfortable with the auditor providing the otherwise prohibited service because the auditor will not be auditing its own work.[16]

Another important exception set forth in the rules allows audit firms to evaluate the internal control systems of their audit clients for purposes of recommending changes to these systems and processes. This is a significant development because under Section 404 of Sarbanes-Oxley, your auditor must attest to management's evaluation of your company's internal control over financial reporting. By allowing the auditor to evaluate these internal controls in advance of the attestation and recommend changes where appropriate, this exception should minimize the number of instances in which a company is surprised by an adverse attestation report from the auditor. Your auditor, however, still cannot design or implement your internal accounting systems or risk management controls because these services would be deemed to impair independence.

A Tax Service by any Other Name . . .

The Sarbanes-Oxley Act provides that an accounting firm does not impair its independence by providing tax services that are pre-approved by the audit committee. In its release adopting auditor independence rules under Sarbanes-Oxley, the SEC reiterated its own position that an accounting firm can continue to provide tax services such as tax compliance, tax planning, and tax advice to audit clients without impairing its independence. However, the release warns that merely labeling a service as a "tax service" will not necessarily eliminate its potential to impair independence. In particular, the release notes that an accountant's independence could be deemed to be impaired if the accountant is retained to structure a transaction initially recommended by the accountant—the sole purpose of which is tax avoidance and the tax treatment may not be supported by the Internal Revenue Code and related regulations.

TACKLING AN EXPANDED PRE-APPROVAL ROLE

The Sarbanes-Oxley Act's most important modification to the auditor independence regime is the enhancement of the audit committee's role in overseeing and monitoring the auditor's independence. Prior to Sarbanes-Oxley, the audit committee was responsible for evaluating the outside auditor's independence in view of the services provided by the auditor.[17] With the passage of Sarbanes-Oxley, Congress considerably expanded this responsibility by making the audit committee "directly responsible" for the appointment, compensation, and oversight of the outside auditor. Congress also made one element of this oversight responsibility more concrete by requiring that the audit committee pre-approve the audit and all non-audit services provided by the outside auditor.[18]

Obviously, understanding the scope of the auditor independence rules is critical for all persons involved in the audit process. As in-house counsel, you can assist the audit committee in this task by imparting your understanding of the applicable regulations when an auditor independence issue arises. A firm grasp of the auditor independence rules also ensures a smooth execution of the pre-approval process, and will enable you actively to assist your audit committee in developing a sensible and practical pre-approval strategy for the committee.

Before engaging the auditor to perform audit or non-audit services, the audit committee now must pre-approve the provision of those services. Previously, no such affirmative oversight steps were required.[19] This rule means exactly what it says—the approval must be obtained *before* the auditor is engaged for the service; subsequent ratification is not sufficient.[20] The audit committee can

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implement a pre-approval process in one of two ways: by expressly pre-approving the specific engagement at an in-person or telephone meeting of the committee, or by establishing pre-approval policies and procedures that set forth the manner in which specific services are approved and in some instances, the manner in which certain categories of services are pre-approved. Many large corporations favor the latter option because it affords the audit committee greater flexibility in pre-approving outside auditor services.

CRAFTING AN ACCEPTABLE PRE-APPROVAL POLICY FOR YOUR AUDIT COMMITTEE IS NOT AS SIMPLE A TASK AS YOU MIGHT EXPECT. NOT ONLY MUST A POLICY ADDRESS THE SEC'S PRE-APPROVAL RULES, BUT IT MUST ALSO COMPORT WITH INFORMAL GUIDANCE ISSUED BY THE SEC STAFF.

The Pre-Approval Three-Step

Crafting an acceptable pre-approval policy for your audit committee is not as simple a task as you might expect. Not only must a policy address the SEC's pre-approval rules, but it must also comport with informal guidance issued by the SEC staff.

Fundamentally, a pre-approval policy must satisfy three basic requirements: (1) the policy must be detailed as to the particular services to be provided by the outside auditor; (2) the policy must evidence that the audit committee is informed of each service that is being pre-approved, and; (3) the policy cannot delegate the audit committee's responsibilities to management.[21]

Detailing the Service

When crafting a pre-approval policy, you should describe the services that are being pre-approved under the policy with as much detail as possible. One fairly common practice that audit committees already employ to satisfy this requirement is to attach an appendix to the policy specifying the services that are being pre-approved. In the appendix, services should be broken into categories—audit, audit-related, tax, and other services—and should be accompanied by a specific description of the services that the auditor will provide. For example, if the audit committee is seeking pre-approval for a service that falls under the audit-related category, such as audits of your company's employee benefit plans, it is helpful to specify the actual plans that will be audited. Similarly, if the appendix includes a category for tax compliance services, you should consider including as much detail as possible regarding the type of tax compliance services—*e.g.*, state tax filing services, expatriate tax services, or VAT tax services—rather than simply including it as a line item designated as "tax compliance" services. These recommendations are based on indications from the SEC staff that a pre-approval policy will not be viewed as acceptable if the policy provides for what the SEC views as broad, categorical approvals, such as "tax compliance" services.[22]

As a means of providing the appropriate level of detail in the policy and demonstrating effective oversight of the outside auditor, many audit committees are drafting pre-approval policies that include the terms of engagement and the fee thresholds for the various types of services for which pre-approval is being sought. While the fee threshold cannot be the only basis used to pre-approve services, it is acceptable and useful to have fee thresholds that correspond to the different services. In addition, to avoid perpetual pre-approval, most policies provide that the pre-approval granted under the policy will extend for a period of one year, unless otherwise indicated. While it is not always easy to draft a policy that is sufficiently detailed, there is a simple rule of thumb: Read the description of the service in the policy, and ask yourself whether management would need to make a judgment call regarding whether an engagement falls within the pre-approved category. If this judgment call has to be made, then—according to the SEC staff—the policy may not be sufficiently detailed as to the particular services provided.[23] In such a case, the audit committee would need to pre-approve the specific engagement.

Keeping the Audit Committee Informed

By including a sufficient level of detail regarding a particular service, you will also help to ensure that the policy satisfies the second pre-approval policy requirement—keeping the audit committee

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informed about the particular services to be provided by the auditor. The SEC staff has stated that when seeking pre-approval of services that are listed in a policy, it is appropriate to provide the audit committee with detailed back-up documentation regarding the specific services that are to be provided.[24] It is not exactly clear what the SEC staff has in mind when it refers to such documentation, but it might, for instance, include a detailed description of the particular work to be done, supplemented by materials such as draft engagement letters and existing summaries or outlines for the planned projects. To keep the audit committee informed, the policy can also include a provision that the audit committee will be presented with materials at its regularly scheduled meetings that provide an update on the status of pre-approved services and fees charged for those services.

IF YOUR COMPANY HAS NUMEROUS SUBSIDIARIES AND/OR JOINT VENTURES, YOU SHOULD BE THINKING ABOUT WHETHER OR NOT THE PROVISION OF SERVICES TO THESE AFFILIATES BY THE AUDITOR WOULD IMPLICATE THE PRE-APPROVAL REQUIREMENTS.

Restriction on Delegation to Management

The third pre-approval policy requirement is that the policy not delegate responsibilities to management. To satisfy this requirement, many audit committees draft pre-approval policies that contain a specific disclaimer that the audit committee is not delegating any of this pre-approval responsibility to management. The audit committee also may wish to provide that all engagements of the auditor be subject to formal engagement letters and that, in instances where the audit committee has pre-approved the service but has not itself executed the engagement letter, only certain company officers, such as the CFO or Controller, will have the authority to execute such engagement letters. This limited delegation of authority to your CFO or Controller should provide that all proposed engagements of the auditor will be approved by one of those officers or some other gatekeeper designated by the audit committee to execute such letters. Upon receiving a request for a specific engagement, this designated officer should determine if the engagement already has been pre-approved by the audit committee. If it has not, then the officer must seek pre-approval from the audit committee before the auditor can be engaged. Because the audit committee cannot delegate its pre-approval authority to management, this officer must present the engagement to the audit committee if there is any question as to whether the engagement is authorized.

Going Beyond Pre-Approval Basics

In addition to incorporating the SEC's three basic requirements into the audit committee's pre-approval policy, there are several other steps that you should consider. For example, if you want to build additional flexibility into the policy, include a provision that allows the audit committee to delegate specific pre-approval authority to one or more members of the audit committee. Under the SEC rules, if this delegation option is elected, the member or members approving the specific engagement must then report on this action at the next audit committee meeting.

Similarly, if your company has numerous subsidiaries and/or joint ventures, you should be thinking about whether or not the provision of services to these affiliates by the auditor would implicate the pre-approval requirements, and, if so, how the services that are intended to be provided to these affiliates should be pre-approved. In other words, what do you know about the services to be provided? And, what should the audit committee know about these services? Your knowledge of the auditor independence rules will be particularly helpful in these situations as you learn about the services and consider whether there are or may be any issues surrounding the services that could implicate the auditor independence rules.

Additionally, consider whether your pre-approval policy should cover audit services provided to an affiliate by an audit firm that is not associated with your principal outside auditor. Pre-approval for such services is not required under the auditor independence rules, but section 301 of Sarbanes-Oxley does mandate that the audit committee is

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responsible for the "appointment, compensation, and oversight of the work of any *registered public accounting firm* employed by the issuer . . . for the purpose of preparing or issuing an audit report or related work."[25] Thus, for example, as expressed in recent guidance from the SEC staff, if a subsidiary of your company in another country uses an audit firm that is not affiliated with your principal outside auditor to provide statutory audit services, and that firm is registered with the Public Company According Oversight Board (PCAOB), your audit committee should be approving the appointment of that firm to provide audit services to the subsidiary.[26] As noted by the SEC staff, however, failure of the audit committee to pre-approve audit services provided by another audit firm will not affect the independence of the principal auditor.[27]

IN THE EVENT AN AUDITOR INDEPENDENCE SITUATION ARISES, YOU SHOULD BE PREPARED TO PLAY A CRITICAL ROLE IN MANAGING THE SITUATION. THE MOST IMPORTANT STEP IN THIS PROCESS IS TO ESTABLISH AND MAINTAIN COMMUNICATION.

You also can aid the audit committee in its oversight of the outside auditor by communicating with the outside auditor before final adoption of the preapproval policy. Any concerns voiced by the auditor regarding the policy can be discussed with the audit committee at that time and any changes, if merited, can be made. Once the audit committee is satisfied with the policy, the audit committee must formally adopt it; separate board approval of the policy is not required.

It is important to note that your work is not done when the policy is adopted. You should pay particular attention to the manner in which the policy is being implemented over the next few years in order to identify ways to improve and enhance the policy, both from the perspective of the audit committee and management. In addition to monitoring whether the policy is providing a useful and efficient oversight tool, you also should work with the audit committee, management, and the outside auditor to monitor adherence to the standards set forth in the policy.

NAVIGATING INDEPENDENCE CONCERNS

Some events are just beyond your control. No matter how clear your understanding of the auditor independence rules and how effective the audit committee's oversight of the relationship with the outside auditor has been (including through application of the pre-approval policy), you may still have to confront a potential auditor independence issue. This is particularly true given the complexity of both the auditor independence rules and today's business environments. In addition, it is not inconceivable that auditor independence issues could arise as a result of the PCAOB audit firm inspection process, as this supervisory body examines the manner in which firms are providing non-audit services to audit clients.

In the event an auditor independence situation arises, you should be prepared to play a critical role in managing the situation. The most important step in this process is to establish and maintain communication—with your audit committee, with management, and with the auditor—to achieve a satisfactory outcome.

When an auditor independence issue first arises, you must develop the facts quickly. The best way to do this is to work closely with your CFO, Controller and their staffs to mitigate any existing problems and to head off similar issues that might be unfolding. You also should ask the outside auditor to develop its analysis regarding the situation as quickly as possible. When communicating this request to the auditor, you should advise the auditor that it might be asked to present its analysis to the audit committee. If, after gathering the facts, you determine that the issue appears of significant magnitude, you may want to engage outside counsel to investigate the situation or suggest that the audit committee do so.

If an interpretive issue regarding application of the rules remains outstanding once you have ascertained all the facts, it is worth bearing in mind that the SEC staff has indicated that it is willing to consult on auditor independence issues.[28] Thus, it

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- ACC's committees, such as the Corporate and Securities Law, are excellent knowledge networks and have email lists to join and other benefits. Contact information for ACC committee chairs appears in each issue of the *ACC Docket*, or you can contact Staff Attorney and Committees Manager Jacqueline Windley at 202.293.4103, ext. 314, or windley@acca.com, or visit ACCA Online℠ at www.acca.com/networks/ecommerce.php.

- *The Rise and Fall of Enron: Principles for Director Focus,* available at ACCA Online℠ at http://www.acca.com/legres/enron/NACDENRON.pdf.

- *Summary and Analysis of Sarbanes-Oxley Act,* available at ACCA Online℠ at http://www.acca.com/legres/enron/sarbanes_oxley_act.pdf.

- John K. Villa. "How Will Recent Changes in Corporate Governance, Public Auditing, and the Role of In-house Counsel Affect You?" *ACCA Docket* 20, no. 9 (October 2002), available at ACCA Online℠ at http://www.acca.com/protected/pubs/docket/on02/ethics2.php.

- Bart R. Schwartz and Jonathan L. Freedman, "Audit Committees of Boards of Directors: How Much Responsibility Do They Have? How Much Responsibility Should They Have?", *ACCA Docket* 20, no. 5 (May 2002) available at ACCA Online℠ at http://www.acca.com/protected/pubs/docket/mj02/audit1.php.

- Broc Romanek, Linda L. Griggs and Sandra Leung, "New Compliance Challenges Under The Sarbanes-Oxley Act of 2002," *ACCA Docket* 20, no. 10 (November/December 2002), available at http://www.acca.com/protected/pubs/docket/nd02/sarbanes2.php.

- *Report of the American Bar Association Task Force on Corporate Responsibility*, available at ACCA Online℠ at http://www.acca.com/public/policy/corpresp/aba.pdf.

- John K. Villa, Jeffrey M. Smith and Michaela Allbee, "Recent Proposals for Changes in Corporate Governance, Securities Disclosure, Public Auditing and the Role of Corporate Counsel: A Snapshot as of July 22, 2002", available at ACCA Online℠ at http://www.acca.com/public/reference/enron/villa.pdf.

- *After Enron: Issues for Boards and Audit Committes to Consider,* available at ACCA Online℠ at http://www.acca.com/public/article/enron/After_enron.pdf.

- Mischa Buford, "Corporate Compliance Considerations," available in the Virtual Library℠ on ACCA Online℠ at http://www.acca.com/protected/article/compliance/corporate.pdf.

- *Congress' Conference Report on Sarbanes-Oxley*, at www.senate.gov/~banking/docs/reports/reports.htm.

- Sarbanes-Oxley Act of 2002, available at http://news.findlaw.com/hdocs/docs/gwbush/sarbanesoxley072302.pdf.

- U.S. Securities & Exchange Commission ("SEC") page about its Sarbanes-Oxley rulemaking, at www.sec.gov/news/press/2002-128.htm.

- Marian Exall and John D. Capers, Jr., "Audit Committees Under the Sarbanes-Oxley Act: Establishing the New Complaint Procedures," *ACC Docket* 21, no. 1 (January 2003), available at ACCA Online℠ at http://www.acca.com/protected/pubs/docket/ja03/audit.pdf.

- Peter Loughran, James Scoville and Erin Callahan, "Corporate Governance and Directors' Duties: United States, GLOBAL COUNSEL CORPORATE GOVERNANCE HANDBOOK, 2003," available on PLC Law Department at www.practicallaw.com/A27021.

ON PAPER:

- JOHN K. VILLA, CORPORATE COUNSEL GUIDELINES (ACCA and West 1999, with annual updates).

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may be appropriate to have your outside counsel or your outside auditor approach the SEC staff on a "no-names" basis regarding the relevant matter to obtain a preliminary opinion on the issue at hand. Regardless of how you proceed, all involved need to work quickly and in a coordinated fashion to determine whether you, the auditor, or most importantly, the audit committee believes that an auditor independence issue exists. Efficient coordination and communication among you, the audit committee, the auditor, and the respective counsel are at a premium in these situations.

Delivering The News

In addition, when faced with an independence issue, you must be prepared to apprise your audit committee of the potential penalties and implications in the event that an auditor independence violation is found. The consequences of such a violation can be extraordinarily serious. The independent auditor's opinion on your company's financial statements, or consent to use such opinion, must be included in your annual report on Form 10-K and in any registration statement, and the independent auditor also must review all unaudited financial statements included in your interim reports filed on Form 10-Q. Thus, if your current auditor's independence is deemed to be impaired under the SEC's rules, you must move very quickly, and at considerable expense, either to resolve the independence issue with the SEC or to retain a new audit firm. This may cause the filing of your periodic reports or registrations statements to be delayed. Even more troubling is the potential that your past SEC filings could be in jeopardy if it turns out that your auditor was not independent at the time of those filings. This unfortunate turn of events could result in a series of tribulations, including potential SEC enforcement action. In view of the potentially severe consequences that could flow from an auditor independence violation, the value in taking the preventive steps and identifying a strategy for addressing a genuine auditor independence issue is of the utmost importance.

Some audit committees may feel overwhelmed by the scope and depth of their additional responsibilities, including those associated with the regulation of auditor independence issues. In-house counsel can take important steps to assist audit committees in managing their burdens in relation to the auditor independence rules and in managing their relationship with the outside auditor. These steps include explaining the auditor independence rules to the audit committee, assisting the audit committee in establishing effective compliance procedures, and being prepared in advance with a strategy in the event an auditor independence issue arises. ■

NOTES

1. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §301; Exchange Act Rule 10A-3(b)(2). While the SEC's auditor independence rules apply to public companies and the application of these rules are most relevant to in-house counsel at public companies, there is a movement afoot in several states to adopt state-specific "Sarbanes-Oxley"-like legislation, which could very well impact the manner in which private companies are forced to view the auditor independence rules.
2. The auditor independence rules as modified in 2000 and 2003 are codified in Rule 2-01 of Regulation S-X.
3. 17 C.F.R. § 210.2-01(b).
4. There is also a preliminary note to the SEC's auditor independence rules to be aware of. The note sets forth four principles the SEC suggests you should consider when evaluating auditor independence issues. There is a popular misconception that these principles are part of the rules; for example, it is often stated that the auditor cannot perform "advocacy services" for the audit client. But, while there is a restriction on legal services, there is no express prohibition on "advocacy" services per se. Taking these four principles to their logical conclusions, however, it would be difficult to see when an audit firm could provide services to a client in any given situation. Partially in view of concerns about the overbreadth of the principles in application, the SEC elected not to codify them in the rules. While the principles may provide useful guidance in some situations, they are difficult to apply in practice.
5. 17 C.F.R. § 210.2-01(c).
6. 17 C.F.R. § 210.2-01(f)(4).
7. 17 C.F.R. § 210.2-01(f)(1).
8. 17 C.F.R. § 210.2-01(c)(1).
9. 17 C.F.R. §§ 210.2-01(c)(2) and 2-01(f)(3) (defining "accounting role or financial reporting oversight role").
10. *See* Sarbanes-Oxley Act of 2002, § 206.
11. 17 C.F.R. § 210.2-01(c)(2)(B)(iii).
12. 17 C.F.R. § 210.2-01(c)(4).
13. *See* 65 Fed. Reg. 76008, 76043 (Dec. 5, 2003).
14. *See* Sarbanes-Oxley Act of 2002, § 201.
15. *See* Sarbanes-Oxley Act of 2002, § 201(a). Any additional limitation on non-audit services proposed by the PCAOB will be subject to notice and comment rulemaking and approval by the SEC.
16. *See* 17 C.F.R. §§ 210.2-01(c)(4) (i), (iii), (iv) and (v).
17. *See* 68 Fed. Reg. 6006, 6012 (Feb. 5, 2003).

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18. *See* Item 9(e)(4) of Schedule 14A (superceded) (previously requiring the audit committee to state in its report whether it has considered if the provision of non-audit services provided by the outside auditor is compatible with maintaining the auditor's independence).
19. *See* Sarbanes-Oxley Act of 2002, §§ 201, 202.
20. *Id.*
21. The pre-approval requirement includes a narrow exception, providing that a waiver from the pre-approval requirement is permissible where the services: (1) do not in the aggregate account for more than five percent of total revenues paid by the audit client to the auditor in the fiscal year in which the services were performed; (2) were not recognized as non-audit services at the time of the engagement; and (3) are promptly brought to the attention of the audit committee and approved prior to completion of the audit by the audit committee. *See* 17 C.F.R. § 210.2-01(c)(7)(i)(C).
22. 17 C.F.R. § 210.2-01 (c)(7)(i)(B).
23. *See* U.S. Securities and Exchange Commission, Office of Chief Accountant: *Application of the January 2003 Rules on Auditor Independence, Frequently Asked Questions* (Office of Chief Accountant FAQ) (August 13, 2003).
24. *Id.*
25. *Id.* at FAQ 24.
26. Sarbanes-Oxley Act of 2002, § 301 (emphasis added).
27. *See* Office of Chief Accountant FAQs, at FAQ 21.28. Because the audit committee's obligation to oversee the hiring of registered public accounting firms arises under Section 301 of Sarbanes-Oxley, which mandates the national exchanges to adopt listing standards that comply the requirements of this provision, it is conceivable that the failure of the audit committee to pre-approve audit services provided by another registered public accounting firm could affect your company's compliance with applicable listing standards. Currently, however, neither the NYSE or NASDAQ listing standards provide any guidance indicating that this would be the case.
29. *See* 68 Fed. Reg. at 6015 (encouraging, in the context of the legal services prohibition, that accounting firms consult with the staff where certain independence issues arise). The SEC rules also include an exemption from independence violations where the parties did not know of the circumstances giving rise to the lack of independence; the independence impairing event was corrected as promptly as possible after the firm became aware of it; and the firm has a quality control system in place that satisfies certain criteria. *See* 17 C.F.R. § 210.2-01(d).

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THE SERVICEMASTER COMPANY

Documents in Response to the Sarbanes-Oxley Act of 2002 and New York Stock Exchange Listing Standards

A. Corporate Governance Principles
B. Committee Charters
  1. Audit and Finance Committee Charter
  2. Compensation and Leadership Development Committee Charter
  3. Governance and Nominating Committee Charter
C. Committee Duties and Responsibilities Charts
  1. Audit and Finance Committee
  2. Compensation and Leadership Development Committee
  3. Governance and Nominating Committee
D. Board and Committee Evaluation Materials
  1. Board Performance Questionnaire
  2. Director Self-Assessment Questionnaire
  3. Audit and Finance Committee Performance Questionnaire
  4. Compensation and Leadership Development Committee Performance Questionnaire
  5. Governance and Nominating Committee Performance Questionnaire
E. Governance and Nominating Committee Report (available in 2004 proxy statement)
F. NYSE Compliance Chart
G. CEO/CFO Certification Materials
  1. 302 CEO Certification
  2. 906 CEO Certification
  3. General Counsel Certification Letter
  4. Controller Certification Letter
  5. Internal Audit Certification Letter
  6. Business Unit General Counsel Certification Letter
H. Disclosure Committee Charter
I. Audit Committee Financial Expert Questionnaire
J. Public Accounting Firm Policy
K. Regulation G – Procedures Relating to Earnings Releases and Associated Earnings Conference Calls, SEC Filings, Investor Conferences and Discussions with Potential and Existing Stakeholders
L. Financial Code of Ethics
M. Code of Conduct (available on www.svm.com under "Corporate Governance")
N. Compliance Helpline Policy
O. Legal Ethics Policy for Practicing Attorneys
P. Form of Internal Control Report

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CORPORATE GOVERNANCE PRINCIPLES

The ServiceMaster Company
(adopted by the Board of Directors October 4, 1996, amended March 8, 2002
and amended and restated January 30, 2004)

The Board of Directors of the Company has adopted the following Corporate Governance Principles to assist the Board in the exercise of its responsibilities to the Company and its shareholders. The Board will continue to assess the appropriateness of these Principles and implement such changes and adopt such additions as may be necessary or desirable to promote the effective governance of the Company.

Purpose

The purpose of these Principles is to describe the manner in which the Company will be managed by or under the direction of its Board within the framework of its corporate objectives To Honor God In All We Do, To Help People Develop, To Pursue Excellence, and To Grow Profitably and for the benefit of its shareholders.

These principles are intended as a guide. They do not supersede or replace the Company's Amended and Restated Certificate of Incorporation or Bylaws, nor are they intended to govern or limit the enforceability or validity of any action taken by the Company, its Board, or any committee of the Board. These principles do not impose or impute a higher duty or standard of care for the Board or any individual director than would otherwise be required by law.

Director Qualifications

1. Number of Members of the Board. The Board shall have at least three members in accordance with Article 7.1 of the Company's Amended and Restated Certificate of Incorporation. The Board shall have the objective of having ten to twelve members with no more than two members from management. Additional members may be appropriate from time to time in order to accommodate the availability of one or more outstanding candidates.

2. Selection of Members of the Board. The Governance and Nominating Committee is responsible for reviewing the qualifications of, and recommending to the Board, nominees for membership on the Board. The Governance and Nominating Committee shall recommend to the Board guidelines and criteria to determine the qualifications to serve and continue to serve as a director. The Board shall strive to have a diversity of gender, ethnicity, culture and race. Members should in general have skills, experience or expertise in one or more of the following areas: finance, accounting, information technology, senior management of a major company, federal or state government agencies or contracting practices, marketing, strategic planning, human resources, ethical training, and regulatory and compliance.

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3. Independence Requirements. The majority of the Board shall satisfy the independence requirements of Article 7.5 of the Company's Amended and Restated Certificate of Incorporation. Unless otherwise determined by the Board, each member of the Board other than a member who is an officer of the Company shall, at a minimum, satisfy the independence requirements under the New York Stock Exchange listing standards. To be considered independent under the New York Stock Exchange listing standards, no director may:

a. have a material relationship with the Company (as affirmatively determined by the Board), either directly or indirectly as a partner, shareholder or officer of an organization that has a relationship with the Company; provided, that a director will not be considered to have a material relationship with the Company if (i) the director is a partner, principal, counsel or advisor to, shareholder, director or officer of another company that does business with the Company and the annual sales to, or purchases from, the Company are less than 1% of the annual revenues of the other company and the director does not receive any compensation (paid, deferred or otherwise) as a direct result of such business with the Company and (ii) the director is an officer, director or trustee of a charitable organization, and the Company's discretionary charitable contributions to the organization are less than 1% (and no more than $50,000) of that organization's total annual charitable receipts (the Company's automatic matching of employee charitable contributions will not be included in the amount of the Company's contributions for this purpose); provided, further, that a director will be considered to have a material relationship with the Company if the director is an officer of another company that is not a charitable organization and any of the Company's present executives serves on that other company's board of directors;

b. be an employee, or have an immediate family member who is an executive officer, of the Company;

c. receive, or have an immediate family member who receives, more than $100,000 per year in direct compensation from the Company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service);

d. be affiliated with or employed by, or have an immediate family member who is affiliated with or employed in a professional capacity by, a present or former internal or external auditor of the Company;

e. be employed, or have an immediate family member who is employed, as an executive officer of another company where any of the Company's present executives serve on that other company's compensation committee; or

f. be an executive officer or an employee, or have an immediate family member who is an executive officer, of a company that makes payments to, or receives payments from, the Company for property or services in an amount which, in any single fiscal year, exceeds the greater of $1 million, or 2% of such other company's consolidated gross revenues.

An immediate family member includes a director's spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law and anyone (other than domestic employees) who shares the director's home.

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No director will be considered independent until a period of three years (or any shorter period provided under the New York Stock Exchange listing standards) has elapsed from the end of the relationships described in subsections (b)-(f) above.

The Company will disclose in its proxy statement the Board's determinations regarding the independence of each director.

4. Committee Independence Requirements. Each member of the Audit and Finance Committee, Compensation and Leadership Development Committee and Governance and Nominating Committee shall satisfy the independence requirements and membership criteria set forth in its respective charter.

5. Ethics and Conflicts of Interest. The Board expects all directors, officers and employees to act ethically and adhere to the Company's Code of Conduct. The Board will not permit any waiver of any ethics policy for any director, executive officer or other member of the Company's senior management. If an actual or potential conflict of interest arises for a director, the director shall promptly inform the Chief Executive Officer and the presiding director.

6. Retirement Age, Term Limits and Evaluation of Director Performance. Each director must be younger than the age of 70 at the date he or she is elected to the Board. Subject to the Company's Bylaws, the Board shall have the authority to make exceptions to this policy under circumstances to be determined by the Board. The Board does not believe it should establish term limits. The Governance and Nominating Committee shall regularly and timely evaluate the performance of individual directors.

7. Significant Change in Status. If a director has a significant change in professional or personal circumstances, such as through a change of employer, retirement, a change in job responsibilities or health, the director should tender his or her resignation to the Board. The Board shall then determine whether such change in status makes accepting the resignation desirable.

8. Service on Other Public Company Boards. A director who also serves as an officer of the Company shall not serve on more than two other boards of public companies and other directors should not serve on more than four other boards of public companies. No member of the Audit and Finance Committee may serve on the audit committee of more than two other public companies. A director should advise the Chairman of the Board and the Chairman of the Governance and Nominating Committee prior to accepting an invitation to serve on the board of another public company.

Director Responsibilities

1. Duties. In meeting its responsibilities, the Board shall act as a whole or through a committee. The basic responsibility of the directors is to exercise their business judgment in good faith to act in what they reasonably believe to be the best interests of the Company and its shareholders. Each director is expected to be familiar with the Company's business, to review in advance of meetings the materials distributed and to attend and participate in meetings of the Board and meetings of any committee of which such director is a member. The specific duties and responsibilities of the Board include, among other things, fostering a continued understanding and implementation of the Company's corporate objectives; representing the interests of the Company's shareholders in

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maintaining and enhancing the success of the Company's business; overseeing and interacting with senior management with respect to key aspects of the business including strategic planning, succession planning and management development, operating performance, shareholder returns and budgets and adhering to the Company's Code of Conduct.

2. Board Meetings. The Board shall meet at least four times annually at such locations as the Board or its Chairman shall from time to time determine. A special meeting of the Board may be called by or at the request of the Chairman or a majority of the Board. Each Board meeting shall be opened with a devotional thought relating to the recognition and application of the first objective of the Company to the operation of the business.

3. Agendas. The Chairman shall be primarily responsible for planning agendas for a period of at least 18 months in advance with the objective of having the Board and its committees informed with respect to material and relevant matters relating to the operation and future direction of the Company. Agendas are distributed in advance to each director. Any director may request an item to be added to an agenda. With respect to each regularly scheduled meeting of the Board, the Board through its Chairman shall determine the agenda of the Board meeting.

4. Distribution of Materials. The Board and its committees shall be provided with appropriate materials in advance of each meeting, whenever feasible and appropriate. Management shall be responsible for ensuring that the materials are accurate and contain all material information necessary for the director to make an informed decision.

5. Executive Sessions and Presiding Director. At each meeting of the Board, the non-management directors of the Company shall meet in executive session without the Company's management. In the event one or more non-management directors is not independent, then only independent directors should meet in executive session at least once a year. In the event the Chairman is not independent, the Board shall select the chairperson of the Audit and Finance Committee, Compensation and Leadership Development Committee or Governance and Nominating Committee to preside at its executive sessions, without management. A presiding director should serve as such for no more than two consecutive years. The duties of such a presiding director include advising the Chairman of matters discussed in executive sessions without management, where appropriate, as well as on Board agenda items and information to be provided to the Board. Alternatively, each time the Board holds executive session without management the Board may select the chairperson of the Audit and Finance Committee, the Compensation and Leadership Development Committee or the Governance and Nominating Committee to preside. The name of the presiding director or the procedure for selecting the presiding director shall be disclosed in the Company's annual proxy statement. The Company shall also disclose in its annual proxy statement a method for interested parties to contact the presiding director, or the non-management directors as a group, directly.

6. Position of Chairman of the Board. The Board shall elect from its members a Chairman who may also be the Chief Executive Officer of the Company. The Chairman shall schedule and call Board meetings, prepare the agenda for Board meetings, chair and moderate Board meetings, lead the Board and serve Board committees.

7. Strategic Review. The Board shall regularly review the strategic direction and initiatives of the Company.

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8. Stock Ownership. Each director and member of senior management is encouraged to maintain ownership of the Company's common stock. The Company's stock ownership guidelines require each director and member of senior management to hold a number of shares equal to 50% of (i) the vested shares of restricted stock and (ii) the number of option shares granted to the director and member of senior management after providing for payment of the exercise price and taxes, in each case granted on or after July 17, 2003 until the director leaves the Board or the member of senior management ceases to be employed by the Company. All purchases and sales of the Company's common stock by a director and member of senior management must comply with the Company's Policy Regarding Insider Trading and Confidentiality.

9. Loans. The Company shall not directly or indirectly extend or maintain credit, arrange for the extension of credit or renew an extension of credit in the form of a personal loan to or for a director or executive officer. An extension of credit maintained by the Company on July 30, 2002 is not subject to this prohibition provided there is no material modification or any renewal of such credit on or after July 30, 2002.

Board Committees

1. Committee Structure. The Board shall have an Executive Committee, Audit and Finance Committee, Compensation and Leadership Development Committee and Governance and Nominating Committee. After considering the recommendation of the Governance and Nominating Committee, the Board shall designate one person to serve as Chairman of each committee. The Board shall establish such additional committees as it deems necessary or appropriate.

2. Committee Charters. The Executive Committee may act on behalf of the Board between Board meetings. Each of the Audit and Finance Committee, Compensation and Leadership Development Committee and Governance and Nominating Committee shall have its own charter approved by the Board. Each charter shall set forth the purposes, duties and responsibilities of the committee.

3. Frequency and Length of Committee Meetings. Each committee through its Chairman shall determine the agenda, frequency and length of the committee meetings consistent with its respective charter. A report on regularly scheduled and special committee meetings shall be made at each regularly scheduled meeting of the Board.

Director Access to Management and Advisers

Each director shall have access to the management of and advisers to the Company. Each director shall use his or her judgment to ensure that any such contact is not disruptive to the business operations of the Company. The Board and its committees, as set forth in their respective charter, shall have the right to consult and retain independent counsel and other advisers, as they determine necessary or appropriate to carry out their duties, at the expense of the Company.

Director Compensation

The Compensation and Leadership Development Committee shall recommend to the Board the compensation of members of the Board who are not employees of the Company in accordance with the policies and principles set forth in its charter. The Compensation and Leadership Development Committee shall consider that a director's independence may be jeopardized when a director's

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compensation exceeds customary levels, when the Company makes substantial charitable contributions to organizations in which a director is affiliated, or enters into consulting contracts with (or provides other indirect forms of compensation to) a director. Directors who are employees of the Company shall not be eligible to receive compensation for service as a director of the Company.

Director Orientation and Continuing Education

Each new director shall participate in a director orientation program within a reasonable time after the director is first elected to the Board. The orientation program shall be designed to familiarize new directors with the Company, its management structure and operations, and key operational, financial and other issues. The orientation program shall include a visit to the Company's offices to meet with senior management and visit local branches. Each director should, through seminars, conferences and similar events, remain current in matters relating to governance, disclosure, accounting or industry developments.

CEO Evaluation and Management Succession

The Compensation and Leadership Development Committee shall review and approve the corporate goals and objectives of the Chief Executive Officer. The Compensation and Leadership Development Committee shall annually evaluate the performance of the Chief Executive Officer in light of the Chief Executive Officer's competencies, corporate goals, objectives, potential and such other considerations as the Committee deems appropriate and determine the Chief Executive Officer's compensation based on such evaluation. The Compensation and Leadership Development Committee shall conduct a review of succession planning and make a report annually to the Board, including plans for interim succession for the Chief Executive Officer in the event of an emergency or the retirement of the Chief Executive Officer.

Evaluation of Board and Committee Performance

The Governance and Nominating Committee shall conduct annual evaluations of the performance of the Board and its committees. The evaluations shall serve as the basis for a discussion of Board and committee performance.

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AUDIT AND FINANCE COMMITTEE CHARTER

The ServiceMaster Company
(adopted by the Board of Directors June 9, 2000,
revised July 19, 2002, July 18, 2003 and January 30, 2004)

The Board of Directors of the Company has considered and approved this Charter in order to set forth the purpose, membership requirements, duties and responsibilities of the Audit and Finance Committee.

Purposes

The purpose of the Committee in its capacity as an audit committee is to assist the Board in its oversight of (1) the integrity of the Company's financial statements, (2) the Company's compliance with legal and regulatory requirements, (3) the independent auditor's qualifications and independence and (4) the performance of the Company's internal audit function and independent auditor. The purpose of the Committee in its capacity as a finance committee is to assist the Board in its oversight of financial matters affecting the Company.

Number of Members and Independence Requirements

The members of the Committee are nominated and appointed as provided in the Bylaws and Charter of the Governance and Nominating Committee. The Committee shall have at least three directors. After considering the recommendation of the Governance and Nominating Committee, the Board will designate one person to serve as Chairman of the Committee. Committee members may not simultaneously serve on the audit committees of more than two other public companies.

Each member of the Committee shall be independent within the meaning of Rule 10A-3(b)(1) under the Securities Exchange Act of 1934 and the New York Stock Exchange listing standards. Specifically, no Committee member may (1) accept directly or indirectly any consulting, advisory, or other compensation fee from the Company or any subsidiary, other than fees for serving as a director or (2) be an affiliated person of ServiceMaster or any subsidiary. Additionally, in accordance with the New York Stock Exchange listing standards no Committee member may:

(1) have a material relationship with the Company (as affirmatively determined by the Board), either directly or indirectly as a partner, shareholder or officer of an organization that has a relationship with the Company; provided, that a director will not be considered to have a material relationship with the Company if (i) the director is a partner, principal, counsel or advisor to, shareholder, director or officer of another company that does business with the Company and the annual sales to, or purchases from, the Company are less than 1% of the annual revenues of the other company and the director does not receive any compensation (paid, deferred or otherwise) as a direct result of such business with the Company and (ii) the director is an officer, director or trustee of a charitable organization, and the Company's discretionary charitable contributions to the organization are less than 1% (and no more than $50,000) of that organization's total

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annual charitable receipts (the Company's automatic matching of employee charitable contributions will not be included in the amount of the Company's contributions for this purpose); provided, further, that a director will be considered to have a material relationship with the Company if the director is an officer of another company that is not a charitable organization and any of the Company's present executives serves on that other company's board of directors;

(2) be an employee, or have an immediate family member who is an executive officer, of the Company;

(3) receive, or have an immediate family member who receives, more than $100,000 per year in direct compensation from the Company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service);

(4) be affiliated with or employed by, or have an immediate family member who is affiliated with or employed in a professional capacity by, a present or former internal or external auditor of the Company;

(5) be employed, or have an immediate family member who is employed, as an executive officer of another company where any of the Company's present executives serve on that other company's compensation committee; or

(6) be an executive officer or an employee, or have an immediate family member who is an executive officer, of a company that makes payments to, or receives payments from, the Company for property or services in an amount which, in any single fiscal year, exceeds the greater of $1 million, or 2% of such other company's consolidated gross revenues.

An immediate family member includes a director's spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law and anyone (other than domestic employees) who shares the director's home.

No Committee member will be considered independent until a period of three years (or any shorter period provided under the New York Stock Exchange listing standards) has elapsed from the end of the relationships described in subsections (2)-(6) above.

The Company will disclose in its proxy statement the Board's determinations regarding the independence of each Committee member.

Finance and Accounting Requirements

Each member of the Committee must in the judgment of the Board be financially literate, such as having a basic understanding of finance and accounting and be able to read and understand fundamental financial statements. At least one member of the Committee must in the judgment of the Board have accounting or related financial management expertise in accordance with the New York Stock Exchange listing standards, which requirement may be met by the Board determining that one member is an audit committee financial expert as described below. The

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Committee will review and recommend to the Board that financial literacy and accounting or related financial management expertise of the members of the Committee.

The Company will disclose in its proxy statement whether at least one member of the Committee is in the judgment of the Board an audit committee financial expert. The audit committee financial expert must have each of the following five attributes:

(1) an understanding of generally accepted accounting principles and financial statements;

(2) the ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;

(3) experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the Company's financial statements, or experience actively supervising one or more persons engaged in such activities;

(4) an understanding of internal controls and procedures for financial reporting; and

(5) an understanding of audit committee functions.

The audit committee financial expert must have acquired the above five attributes through (1) education and experience as a chief financial officer, controller, public accountant or auditor; (2) experience actively supervising a chief financial officer, controller, public accountant or auditor; (3) experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or (4) other relevant experience.

Meetings

The Committee will meet at least four times annually, or more frequently as circumstances may warrant. Generally, and as appropriate, the Committee will meet with, and receive reports from management, the internal audit department and the Company's independent auditor. The Committee will meet separately, periodically, with management, with internal audit and with the independent auditor to discuss any matters that the Committee or any of these groups believe should be discussed privately. The Committee may hold executive sessions without management to discuss any matters that the Committee believes should be discussed privately.

Duties and Responsibilities

The Committee has the following duties and responsibilities which may not be delegated to another Committee:

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A. General

1. regularly report to the Board any issues that arise with respect to the quality or integrity of the Company's financial statements, the Company's compliance with legal or regulatory requirements, the performance and independence of the Company's independent auditor or the performance of the internal audit function;

2. engage independent counsel and other advisers, as it determines necessary to carry out its duties;

3. receive appropriate funding, as determined by the Committee, from the Company for payment of compensation to the independent auditor, independent counsel or other advisers retained by the Committee and ordinary administrative expenses of the Committee that are necessary or appropriate in carrying out its duties;

4. prepare the audit committee report to be included in the Company's proxy statement relating, among other matters, to whether the audit committee has reviewed and discussed the audited financial statements with management and discussed certain matters with the independent auditor;

5. evaluate the Committee's performance at least annually;

6. determine through its Chairman the agenda of its meetings;

7. periodically review the adequacy of this Charter and submit this Charter to the Board for its approval and, thereafter, include this Charter in the Company's proxy statement as required by the rules of the Securities and Exchange Commission; and

8. perform any other activities consistent with this Charter, the Company's Bylaws, and applicable laws as the Committee or the Board deems necessary or appropriate.

B. Financial Information and Reporting; Risk Management

1. discuss the annual audited financial statements and quarterly financial statements with management, including the Company's disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations" which should include a discussion of all material trends, demands, commitments, uncertainties or events that are reasonably likely to have a material effect on the Company's results of operations or financial condition;

2. discuss generally earnings press releases with management and the independent auditor prior to the issuance of such press releases, including pro forma or adjusted non-GAAP information, and other financial information and earnings guidance provided to analysts and rating agencies;

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3. review major issues regarding accounting principles and financial statement presentations, including any significant changes in the Company's selection or application of accounting principles, and major issues regarding the adequacy of the Company's internal controls and any special audit steps adopted in light of material control deficiencies;

4. review analyses prepared by management and/or the independent auditor setting forth significant financial reporting issues and judgments made in connection with the preparation of the financial statements, including analyses of the effects of alternative GAAP methods on the financial statements;

5. review the effect of regulatory and accounting initiatives, as well as off-balance sheet structures, on the financial statements of the Company;

6. recommend to the Board, based on the reviews and discussions of the annual audited financial statements, the matters required to be communicated in accordance with American Institute of Certified Public Accountants ("AICPA") Statements of Auditing Standards ("SAS") 61 and the independent auditor's independence, that the annual audited financial statements be included in the Company's Annual Report on Form 10-K;

7. discuss policies with respect to risk assessment and risk management, including guidelines and policies to govern the process by which risk assessment and risk management is undertaken;

8. discuss the Company's major financial risk exposures and the steps management has taken to monitor and control such exposures;

9. discuss material consultations made by management with outside accountants (other than the independent auditor) with respect to the financial and/or tax accounting treatment of a particular event or completed transaction;

10. discuss significant issues related to tax accounting, reporting or payment;

11. discuss significant issues related to operation, development and implementation of information systems;

12. periodically review with management the adequacy of, and related disclosures in the Company's quarterly and annual reports, the Company's disclosure controls and procedures and internal control over financial reporting;

13. review disclosures to the Committee made by the Company's Chief Executive Officer and Chief Financial Officer during the certification process relating to the annual and quarterly reports about any significant deficiencies or material weaknesses in the design or operation of internal control over financial reporting and any fraud

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involving management or other employees who have a significant role in the Company's internal control over financial reporting;

14. review management's annual report on internal control over financial reporting; and

15. regularly review internal audit reports to management prepared by the internal audit and review the internal audit department's function and performance, including organizational structure and qualifications, responsibilities, budget and staffing and seek to ensure the effectiveness and independence of this department.

C. Independent Auditor

1. the Committee must (i) directly appoint, retain, compensate, evaluate and terminate the Company's independent auditor, including resolving any disagreement between management and the independent auditor regarding financial reporting, and (ii) the Company's independent auditor shall report directly to the Committee;

2. review with the independent auditor in advance the scope of its annual audit;

3. discuss the annual audited financial statements and quarterly financial statements with the independent auditor, including the Company's disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations" which should include a discussion of all material trends, demands, commitments, uncertainties or events that are reasonably likely to have a material effect on the Company's results of operations or financial condition;

4. obtain and review, at least annually, a report by the independent auditor describing (i) all critical accounting policies and practices to be used; (ii) all alternative treatments of financial information within GAAP that have been discussed with management, ramifications of the use of such alternative disclosure and treatments and the treatment preferred by the independent auditor; and (iii) other material written communications between the independent auditor and management, including the management letter and schedule of unadjusted differences;

5. review with the independent auditor any audit problems or difficulties and management's response, including (i) any restrictions on the scope of the independent auditor's activities or access to requested information; (ii) any significant disagreements with management; (iii) any accounting adjustments that were noted or proposed by the independent auditor but were passed as immaterial or otherwise; (iv) any communications between the audit team and the independent auditor's national office respecting auditing or accounting issues presented by the engagement; (v) any management or internal control letter issued, or proposed to be issued, by the independent auditor to the Company; and (vi) the responsibilities, budget and staffing of internal audit;

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6. review and discuss with the independent auditor or management the matters required to be communicated to the Committee in accordance with AICPA SAS 61;

7. review the independent auditor's attestation report on management's assessment of internal control over financial reporting;

8. review the Company's compliance with the Company's Public Accounting Firm Policy, including (i) the prohibitions on certain non-audit services that the independent auditor may not perform; (ii) the pre-approval of all audit and non-audit services to be performed by the independent auditor; (iii) the rotation of the lead partner and concurring partner; (iv) receipt of regular reports from management of all audit and non-audit services performed by the independent auditor; and (v) the limitations on employing employees or former employees of the independent auditor;

9. review and discuss with the independent auditor whether any officer or director of the Company, or persons acting under their direction, have or may have taken any action to coerce, manipulate, mislead or fraudulently influence the independent auditor within the meaning of Rule 13b2-2 under the Securities Exchange Act of 1934;

10. obtain and review, at least annually, a report by the independent auditor describing (i) the independent auditor's internal quality control procedures; (ii) any material issues raised by the most recent internal quality control review, or peer review, of the independent auditor, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, relating to one or more independent audits conducted by the independent auditor, and any steps taken to deal with any such issues; and (iii) all relationships between the independent auditor and the Company (to assess the independence of the independent auditor);

11. obtain and review, at least annually, a letter from the independent auditor regarding the independent auditor's independence; review and discuss the independent auditor's independence, including all significant consulting and other relationships with the Company that could impair the independent auditor's independence;

12. review the independent auditor's work for the company, including the review and evaluation of the lead partner of the independent auditor, taking into account the opinions of management and internal audit; and

13. based upon the reviews described in the preceding two subparagraphs relating to the review and evaluation of the independent auditor's qualifications, performance and independence, present the Committee's conclusions with respect to the independent auditor to the Board.

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D. Financial Matters

1. periodically review and approve the Company's Commitment Authority Policy;

2. review the Company's dividend policy and make recommendations to the Board with respect thereto;

3. review management's recommendations concerning new financing arrangements, whether debt or equity, and make determinations or recommendations to the Board with respect thereto;

4. review management's recommendations concerning significant acquisitions, dispositions, capital investments, venture fund investments and other significant financial commitments and make determinations or recommendations to the Board with respect thereto;

5. review proposed major contracts or programs and make determinations or recommendations to the Board with respect thereto;

6. review matters relating to the repurchase of stock or the repurchase or redemption of debt and make recommendations to the Board with respect thereto; and

7. review financial reports and analyses.

E. Other Matters

1. in accordance with the New York Stock Exchange listing standards and Rule 10A-3(b)(3) under the Securities Exchange Act of 1934, the Committee must establish procedures for (i) the receipt, retention, and treatment of complaints received by the Company regarding accounting, internal accounting controls, or auditing matters; and (ii) the confidential, anonymous submission by employees of the Company of concerns regarding questionable accounting or auditing matters;

2. review situations involving actual, potential or alleged conflicts of interest, misconduct or similar activities;

3. periodically review environmental stewardship standards and practices, the Company's compliance systems and controls to enforce these standards, and significant cases of variance from these standards;

4. periodically review legal compliance matters, including securities trading practices and policies; and

5. periodically review any significant pending, threatened or potential litigation matters, including with regulatory agencies, that could have a significant impact on the Company's financial statements.

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COMPENSATION AND LEADERSHIP DEVELOPMENT COMMITTEE CHARTER

The ServiceMaster Company
(as adopted by the Board of Directors July 19, 2002, revised January 30, 2004)

The Board of Directors of the Company has considered and approved this Charter in order to set forth the purpose, membership requirements, duties and responsibilities of the Compensation and Leadership Development Committee.

Purpose and Responsibilities

The purpose and responsibilities of the Committee are to (1) have direct responsibility to review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of the CEO's competencies, corporate goals and objectives and potential, and determine and approve the CEO's compensation level based on such evaluation and (2) prepare an annual report on executive compensation for inclusion in the Company's proxy statement.

Number of Members and Independence Requirements

The members of the Committee are nominated and appointed as provided in the Bylaws and Charter of the Governance and Nominating Committee. The Committee shall have at least three directors. After considering the recommendation of the Governance and Nominating Committee, the Board will designate one person to serve as Chairman of the Committee.

In accordance with the New York Stock Exchange listing standards, no Committee member may:

(1) have a material relationship with the Company (as affirmatively determined by the Board), either directly or indirectly as a partner, shareholder or officer of an organization that has a relationship with the Company; provided, that a director will not be considered to have a material relationship with the Company if (i) the director is a partner, principal, counsel or advisor to, shareholder, director or officer of another company that does business with the Company and the annual sales to, or purchases from, the Company are less than 1% of the annual revenues of the other company and the director does not receive any compensation (paid, deferred or otherwise) as a direct result of such business with the Company and (ii) the director is an officer, director or trustee of a charitable organization, and the Company's discretionary charitable contributions to the organization are less than 1% (and no more than $50,000) of that organization's total annual charitable receipts (the Company's automatic matching of employee charitable contributions will not be included in the amount of the Company's contributions for this purpose); provided, further, that a director will be considered to have a material relationship with the Company if the director is an officer of another company that is not a charitable organization and any of the Company's present executives serves on that other company's board of directors;

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(2) be an employee, or have an immediate family member who is an executive officer, of the Company;

(3) receive, or have an immediate family member who receives, more than $100,000 per year in direct compensation from the Company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service);

(4) be affiliated with or employed by, or have an immediate family member who is affiliated with or employed in a professional capacity by, a present or former internal or external auditor of the Company;

(5) be employed, or have an immediate family member who is employed, as an executive officer of another company where any of the Company's present executives serve on that other company's compensation committee; or

(6) be an executive officer or an employee, or have an immediate family member who is an executive officer, of a company that makes payments to, or receives payments from, the Company for property or services in an amount which, in any single fiscal year, exceeds the greater of $1 million, or 2% of such other company's consolidated gross revenues.

An immediate family member includes a director's spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law and anyone (other than domestic employees) who shares the director's home.

No Committee member will be considered independent until a period of three years (or any shorter period provided under the New York Stock Exchange listing standards) has elapsed from the end of the relationships described in subsections (2)-(6) above.

The Company will disclose in its proxy statement the Board's determinations regarding the independence of each Committee member.

Membership Criteria under Internal Revenue Service and Securities Law Regulations

Each member of the Committee should be an "outside director" within the meaning of Internal Revenue Service regulations and a "non-employee director" within the meaning of Rule 16b-3 under the Securities Exchange Act of 1934.

Meetings

The Committee will meet at least four times annually, or more frequently as circumstances may warrant. Generally, and as appropriate, the Committee will meet with, and receive reports from management. The Committee may hold executive sessions without management to discuss any matters that the Committee believes should be discussed privately.

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Duties

The Committee has the following duties:

1. establish the overall compensation structure and executive compensation philosophy and principles of the Company;

2. review and approve the corporate goals and objectives of the CEO, including base salary, annual bonus, stock options, restricted stock and other compensation arrangements;

3. evaluate annually the performance in light of the CEO's competencies, corporate goals and objectives and potential and determine and approve the CEO's compensation level based on such evaluation; in determining the long-term incentive component of CEO compensation, the Committee may consider (i) the Company's performance and relative shareholder return, (ii) the value of similar incentive awards to CEOs at comparable companies and (iii) the awards given to the Company's CEO in past years;

4. review and approve the compensation of the Company's executive officers;

5. make recommendations to the Board with respect to non-CEO and non-executive officer compensation plans, incentive compensation plans and equity-based compensation plans;

6. recommend to the Board compensation policies and programs for the compensation of members of the Board who are not employees of the Company;

7. conduct such other reviews of leadership development strategy, people development strategy and succession plans as the Committee from time to time determines;

8. conduct reviews of high potential individuals, succession planning and the diversity of the Company's management team;

9. approve change in control agreements for officers;

10. recommend to the Board the appointment of Corporate Officers;

11. adopt rules and guidelines and otherwise administer the Company's health and welfare plans and compensation plans, including, without limitation, its annual incentive bonus plan, long-term performance award plan, stock option plans, employee stock purchase plans, 401(k) plan and deferred compensation plans;

12. approve members of the Equity Plans Administrative Committee or other similar committee designated for the purpose of overseeing the administration of certain equity plans;

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13. approve members of the Benefits Committee or other similar committee designated for the purpose of overseeing the administration of health and welfare plans;

14. engage independent counsel and other advisers, as it determines necessary or appropriate to carry out its duties;

15. the Committee has sole authority to retain and terminate any compensation consultant hired to assist in the evaluation of director, CEO or senior executive compensation, including sole authority to approve the firm's fees and other retention terms;

16. evaluate the Committee's performance at least annually;

17. make regular reports to the Board regarding its activities;

18. determine through its Chairman the agenda of its meetings;

19. periodically review the adequacy of this Charter and submit this Charter to the Board for its approval; and

20. perform any other activities consistent with this Charter, the Company's Bylaws and applicable laws as the Committee or Board deems necessary or appropriate.

The Committee shall have the authority to delegate any of its responsibilities to subcommittees as the Committee deems appropriate.

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GOVERNANCE AND NOMINATING COMMITTEE CHARTER

The ServiceMaster Company
(as adopted by the Board of Directors on July 19, 2002, revised October 24, 2003)

The Board of Directors of the Company has considered and approved this Charter in order to set forth the purpose, membership requirements, duties and responsibilities of the Governance and Nominating Committee.

Purpose and Responsibilities

The purpose and responsibilities of the Committee are to (1) develop and recommend to the Board a set of corporate governance principles applicable to the Company, (2) identify individuals qualified to become Board members, consistent with criteria approved by the Board, and to select, or to recommend that the Board select, the director nominees for the next annual meeting of shareholders and (3) oversee the evaluation of the Board and management.

Number of Members and Independence Requirements

The members of the Committee are nominated and appointed as provided in the Bylaws and this Charter. The Committee shall have at least three directors. After considering the recommendation of the Committee, the Board will designate one person to serve as Chairman of the Committee.

In accordance with the New York Stock Exchange listing standards, no Committee member may:

(1) have a material relationship with the Company (as affirmatively determined by the Board), either directly or indirectly as a partner, shareholder or officer of an organization that has a relationship with the Company; provided, that a director will not be considered to have a material relationship with the Company if (i) the director is a partner, principal, counsel or advisor to, shareholder, director or officer of another company that does business with the Company and the annual sales to, or purchases from, the Company are less than 1% of the annual revenues of the other company and the director does not receive any compensation (paid, deferred or otherwise) as a direct result of such business with the Company and (ii) the director is an officer, director or trustee of a charitable organization, and the Company's discretionary charitable contributions to the organization are less than 1% (and no more than $50,000) of that organization's total annual charitable receipts (the Company's automatic matching of employee charitable contributions will not be included in the amount of the Company's contributions for this purpose); provided, further, that a director will be considered to have a material relationship with the Company if the director is an officer of another company that is not a charitable organization and any of the Company's present executives serves on that other company's board of directors;

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(2) be an employee, or have an immediate family member who is an executive officer, of the Company;

(3) receive, or have an immediate family member who receives, more than $100,000 per year in direct compensation from the Company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service);

(4) be affiliated with or employed by, or have an immediate family member who is affiliated with or employed in a professional capacity by, a present or former internal or external auditor of the Company;

(5) be employed, or have an immediate family member who is employed, as an executive officer of another company where any of the Company's present executives serve on that other company's compensation committee; or

(6) be an executive officer or an employee, or have an immediate family member who is an executive officer, of a company that makes payments to, or receives payments from, the Company for property or services in an amount which, in any single fiscal year, exceeds the greater of $1 million, or 2% of such other company's consolidated gross revenues.

An immediate family member includes a director's spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law and anyone (other than domestic employees) who shares the director's home.

No Committee member will be considered independent until a period of three years (or any shorter period provided under the New York Stock Exchange listing standards) has elapsed from the end of the relationships described in subsections (2)-(6) above.

The Company will disclose in its proxy statement the Board's determinations regarding the independence of each Committee member.

Process for Considering Director Candidates Recommended by Shareholders

As set forth in Section 4.5 of the Bylaws, only qualified candidates may be elected to the Board. The Committee will review the nomination by a shareholder of the Company of a qualified candidate for election to the Board if all of the requirements set forth in Section 4.5 of the Bylaws are satisfied. Section 4.5 of the Bylaws is attached as Exhibit A to this Charter.

Meetings

The Committee will meet at least four times annually, or more frequently as circumstances may warrant. Generally, and as appropriate, the Committee will meet with, and receive reports from management. The Committee may hold executive sessions without management to discuss any matters that the Committee believes should be discussed privately.

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Duties

The Committee has the following duties:

1. develop and recommend to the Board a set of corporate governance principles applicable to the Company, and periodically review the adequacy of such principles;

2. recommend to the Board guidelines and criteria to determine the qualifications to serve and continue to serve as a director;

3. identify and review the qualifications of, and recommend to the Board, (i) individuals to be nominated by the Board for election to the Board by shareholders at each annual meeting of shareholders and (ii) individuals to be elected to any vacancy on the Board which shall occur for any reason;

4. review the nomination by a shareholder of the Company of a qualified candidate for election to the Board if such nomination is submitted within the time limits and in the manner prescribed in this Charter and the Bylaws;

5. recommend to the Board appointments to committees of the Board;

6. periodically review the size, composition and organization of the Board and its committees and recommend policies, changes or other action it deems necessary or appropriate, including recommendations to the Board regarding retirement age, resignation or removal of a director, stock ownership guidelines, independence requirements, frequency of Board meetings and terms of directors;

7. oversee the evaluation of the performance of the Board, its committees and of members of the Board who are not employees of the Company;

8. review other corporate governance and similar matters relevant to the Company, including, without limitation, the Charters of other committees of the Board and the independence of directors, and recommend policies, changes or other action it deems necessary or appropriate;

9. review the Company's charitable contributions budget;

10. review and periodically assess the adequacy of the Company's code of conduct, including compliance with (i) the New York Stock Exchange listing standards which requires a code of conduct for the Board, officers and employees that addresses (1) conflicts of interest; (2) corporate opportunities; (3) confidentiality; (4) fair dealing; (5) protection and proper use of Company assets; (6) compliance with laws, rules, and regulations (including insider trading laws); and (7) encouraging the reporting of any illegal or unethical behavior and (ii) Item 406 of Regulation S-K which requires the disclosure of whether the Company has adopted a code of conduct that applies to the

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Chief Executive Officer, Chief Financial Officer, Controller or persons performing similar functions that addresses (1) honest and ethical conduct; (2) full, fair, accurate, timely and understandable disclosure in Securities and Exchange Commission reports and other public communications; (3) compliance with applicable governmental laws, rules and regulations; (4) prompt internal reporting of any violation of the code of conduct to an appropriate person identified in the code of conduct; and (5) accountability for adherence to the code of conduct;

11. review transactions or arrangements (financial or otherwise) between the Company and one or more directors or corporate officers, other than compensation decisions, and make recommendations to the Board with respect thereto;

12. engage independent counsel and other advisers, as it determines necessary or appropriate to carry out its duties;

13. the Committee has sole authority to retain and terminate any search firm to be used to identify director candidates, including sole authority to approve the search firm's fees and other retention terms;

14. evaluate the Committee's performance at least annually;

15. make regular reports to the Board regarding its activities;

16. determine through its Chairman the agenda of its meetings;

17. periodically review the adequacy of this Charter and submit this Charter to the Board for its approval; and

18. perform any other activities consistent with this Charter, the Company's Bylaws and applicable laws as the Committee or Board deems necessary or appropriate.

The Committee shall have the authority to delegate any of its responsibilities to subcommittees as the Committee deems appropriate.

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EXHIBIT A

Section 4.5 *Election of Directors by Stockholders.*

(a) *Election by Plurality Vote.* Qualified candidates (as hereinafter defined) for election as directors at any meeting of the stockholders of the Company shall be elected by plurality vote. Accordingly, if votes are cast for more individuals than the number of positions to be filled at that meeting, then a qualified candidate shall be deemed elected to one of those positions if the number of qualified candidates who received more votes than that individual are less than the number of positions on the Board which are to be filled at that meeting. (For example, if five positions on the Board were up for election at any particular stockholders meeting, then the five qualified candidates who receive more votes than any other qualified candidates shall be deemed elected at that meeting). Without limiting by implication the generality of the preceding provision, it shall not be necessary for election to the Board that a candidate receive a majority of the votes comprising the quorum for the meeting so long as the individual receives a number of votes sufficient for election under the terms of this paragraph (a).

(b) *Number of Votes Cast by a Stockholder.* Each stockholder shall be entitled to cast with respect to each position on the Board to be elected by stockholders at that meeting a number of votes attributable to the record shares in the common voting class held of record by that stockholder at the relevant record date and such stockholder may distribute those votes among qualified candidates for election to that position in such manner as such stockholder may wish.

(c) *No Cumulative Voting.* Voting for directors shall not be cumulative. Accordingly, the maximum number of votes a stockholder shall be entitled to cast for any particular qualified candidate shall not exceed the number of votes attributable to the record shares in the common voting class held of record by that stockholder at the relevant record date.

(d) *Effective Voting Limited to Qualified Candidates.* Only qualified candidates may be elected to the Board at any particular stockholders meeting. Votes cast in favor of an individual who is not a qualified candidate shall not be effective to elect that individual to the Board regardless of whether (i) that individual receives a greater number of votes than qualified candidates who are elected to the Board under the preceding provisions of this section or (ii) no other individual receives any votes at that meeting (which might be the case if an individual were proposed for election to a vacant position on the Board at a special meeting which was not called by the Board for the purpose of electing directors or for which no qualified candidate was nominated).

(e) *Identification of Qualified Candidates.* An individual shall be deemed a qualified candidate for election to the Board at any particular stockholders meeting if that individual (i) is younger than age 70 at the date he or she is to be elected and (ii) shall have been nominated for election by the Board or shall have been nominated for election in a manner which satisfies all of the requirements specified in paragraph (g) of this Section 4.5.

(f) *Status of Non-Independent Candidates.* As used in this paragraph (f), the term "non-independent candidate" as applied to any particular election of directors means an individual

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who satisfies the conditions of clauses (i) and (ii) of paragraph (e) above but who is not an "independent director" under the standard prescribed in Section 7.5.2 of the Certificate of Incorporation. In the event that in any particular election of directors Section 7.5.1 of the Certificate of Incorporation would permit some but not all of the non-independent candidates for director at that election to be elected to the Board, then paragraph (d) of this Section 4.5 shall be applied to fill positions on the Board as if all of the non-independent candidates were qualified candidates until all positions available for non-independent candidates at that election under Section 7.5.1 of the Certificate of Incorporation are filled. The remaining non-independent candidates shall, in accordance paragraph (d) of this Section 4.5, be deemed to be not qualified candidates.

(g) *Candidates Not Nominated by the Board.* In order for an individual not nominated by the Board to be a "qualified candidate" for election to the Board at any particular meeting of stockholders, all of the following requirements must be satisfied:

(1) The nomination must be made for an election to be held at an annual meeting of stockholders or a special meeting of stockholders in which the Board has determined that candidates will be elected by the common voting class to one or more positions on the Board;

(2) The individual must be nominated by a stockholder who shall be the record owner on the record date for that meeting and at that meeting of shares entitled to be voted at that meeting for the election of directors (a "nominating stockholder");

(3) The nominating stockholder must deliver a timely written nomination notice to the office of the Company's Corporate Secretary at the Company's principal executive office which provides the information required by these Bylaws;

(4) To be timely for an annual meeting, a stockholder's notice must be actually delivered to the Corporate Secretary's office not later than the close of business on the 75th day nor earlier than the close of business on the 105th day prior to the first anniversary of the preceding year's annual meeting; provided, however, that:

(i) if the date of the annual meeting is more than 30 days before or more than 60 days after such anniversary date, notice by the stockholder to be timely must be so delivered not earlier than the close of business on the 105th day prior to such annual meeting and not later than the close of business on the later of the 75th day prior to such annual meeting or the 10th day following the day on which public announcement of the date of such meeting is first made by the Company, and

(ii) if the number of directors to be elected to the Board is increased and there in no public announcement by the Company naming all of the nominees for director or specifying the size of the increased Board at least 115 days prior to the first anniversary of the preceding year's annual meeting, a stockholder's nominating notice required by this Bylaw shall also be

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considered timely, but only with respect to nominees for any new positions created by such increase, if (x) the stockholder shall have nominated candidates in accordance with the requirements in these Bylaws for all Board positions not covered by such increase and (y) the nomination notice for candidates to fill the expanded positions shall be actually delivered to the Corporate Secretary at the Company's principal executive office not later than the close of business on the 10th day following the day on which such public announcement is first made by Company;

(5) If the election is to be held at a special stockholders meeting, a stockholder's nominating notice required by this Bylaw shall be considered timely for that meeting if it shall be actually delivered to the Corporate Secretary's office at the Company's principal executive office not later than the close of business on the 10th day following the day on which the Company shall first publicly announce the date of the special meeting and that a vote by stockholders will be taken at that meeting to elect a director or directors;

(6) In no event shall the public announcement of an adjournment of an annual meeting commence a new time period for the giving of a stockholder's notice as described above. For purposes of these Bylaws, "public announcement" shall mean disclosure in a press release reported by the Dow Jones News Service, Associated Press or comparable national news service or in a document publicly filed by the Company with the Securities and Exchange Commission pursuant to Section 13, 14 or 15(d) of the Exchange Act;

(7) Such stockholder's nomination notice shall --

(i) set forth as to each person whom the stockholder proposes to nominate for election or re-election as a director all information relating to such person that is required to be disclosed in solicitations of proxies for election of directors in an election contest, or is otherwise required, in each case pursuant to Regulation 14A under the Exchange Act and Rule 14a-11 thereunder;

(ii) be accompanied by each nominee's written consent to being named in the proxy statement as a nominee and to serving as a director if elected;

(iii) set forth the name and address of the stockholder giving the notice and the beneficial owner of the shares owned of record by the beneficial owner, and the telephone number at which the Company will be able to reach the stockholder, the beneficial owner and each nominee during usual business hours during the period through the meeting at which the nomination is to take place;

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(iv) set forth the class and number of shares of the Company which are owned beneficially and of record by such stockholder and such beneficial owner; and

(v) be accompanied by each nominee's undertaking to affirm, at the time of his or her election to the Board, his or her independence under the standard prescribed in Section 7.5 of the Certificate of Incorporation, or if the nominee cannot affirm his or her independence, then the nominee shall explain in reasonable detail why he or she is unable to do so; and

(8) The nominating stockholder, the beneficial owner and each nominee shall provide such other information as any Executive Officer shall reasonably deem relevant within such time limits as any Executive Officer shall reasonably impose for such information.

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AUDIT AND FINANCE COMMITTEE DUTIES AND RESPONSIBILITIES (July 22, 2004)

AFC DUTIES AND RESPONSIBILITIES	REQUIRED BY:	FEB	MAY	JUL	OCT	DEC	NOTES
General							
1. Regularly report to the Board any issues that arise with respect to the quality or integrity of the Company's financial statements, the Company's compliance with legal or regulatory requirements, the performance and independence of the Company's independent auditor or the performance of the internal audit function	Commentary to and Section 303A(7)(c)(iii)(H) of NYSE						
2. Engage independent counsel and other advisers, as it determines necessary to carry out its duties	Rule 10A-3(b)(4) of the Securities Exchange Act of 1934						
3. Receive appropriate funding, as determined by the Committee, from the Company for payment of compensation to the independent auditor, independent counsel or other advisors retained by the Committee and ordinary administrative expenses of the Committee that are necessary or appropriate in carrying out its duties	Rule 10A-3(b)(5) of the Securities Exchange Act of 1934						

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AFC DUTIES AND RESPONSIBILITIES	REQUIRED BY:	FEB	MAY	JUL	OCT	DEC	NOTES
4. Prepare the audit committee report to be included in the Company's proxy statement relating, among other matters, to whether the audit committee has reviewed and discussed the audited financial statements with management and discussed certain matters with the independent auditor	Section 303A(7)(c)(i)(B) of NYSE	X					
5. Evaluate the Committee's performance at least annually	Section 303A(7)(c)(ii) of NYSE					X	
6. Determine through its Chairman the agenda of its meetings				X			
7. Periodically review the adequacy of AFC Charter and submit Charter to the Board for its approval and, thereafter, include Charter in the Company's proxy statement as required by the rules of the Securities and Exchange Commission	Section 303A(7)(c) of NYSE				X		
8. Perform any other activities consistent with this Charter, the Company's Bylaws and applicable laws as the Committee or Board deems necessary or							

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AFC DUTIES AND RESPONSIBILITIES	REQUIRED BY:	FEB	MAY	JUL	OCT	DEC	NOTES
appropriate							
Financial Information and Reporting; Risk Management							
1. Discuss the annual audited financial statements and quarterly financial statements with management, including the Company's disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations" which should include a discussion of all material trends, demands, commitments, uncertainties or events that are reasonably likely to have a material effect on the Company's results of operations or financial condition	Section 303A(7)(c)(iii)(B) of NYSE	X	X	X	X		
2. Discuss generally earnings press releases with management and the independent auditor prior to the issuance of such press releases, including pro forma or adjusted non-GAAP information, and other financial information and earnings guidance provided to analysts and	Commentary to Section 303A(7)(c)(iii)(C) of NYSE	X	X	X	X		

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AFC DUTIES AND RESPONSIBILITIES	REQUIRED BY:	FEB	MAY	JUL	OCT	DEC	NOTES
rating agencies							
3. Review major issues regarding accounting principles and financial statement presentations, including any significant changes in the Company's selection or application of accounting principles, and major issues regarding the adequacy of the Company's internal controls and any special audit steps adopted in light of material control deficiencies	Commentary to Section 303A(7)(c)(iii)(H) of NYSE						
4. Review analyses prepared by management and/or the independent auditor setting forth significant financial reporting issues and judgments made in connection with the preparation of the financial statements, including analyses of the effects of alternative GAAP methods on the financial statements	Commentary to Section 303A(7)(c)(iii)(H) of NYSE	**X**					
5. Review the effect of regulatory and accounting initiatives, as well as off-balance sheet structures, on the financial statements of the Company	Commentary to Section 303A(7)(c)(iii)(H) of NYSE				**X**		

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AFC DUTIES AND RESPONSIBILITIES	REQUIRED BY:	FEB	MAY	JUL	OCT	DEC	NOTES
6. Recommend to the Board, based on the reviews and discussions of the annual audited financial statements, the matters required to be communicated in accordance with American Institute of Certified Public Accountants ("AICPA") Statements of Auditing Standards ("SAS") 61 and the independent auditor's independence, that the annual audited financial statements be included in the Company's Annual Report on Form 10-K	Item 7(d)(3)(i) of Schedule 14A	X					
7. Discuss policies with respect to risk assessment and risk management, including guidelines and policies to govern the process by which risk assessment and risk management is undertaken	Section 303A(7)(c)(iii)(D) of NYSE		X		X		
8. Discuss the Company's major financial risk exposures and the steps management has taken to monitor and control such exposures	Commentary to Section 303A(7)(c)(iii)(D) of NYSE				X		

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AFC DUTIES AND RESPONSIBILITIES	REQUIRED BY:	FEB	MAY	JUL	OCT	DEC	NOTES
9. Discuss material consultations made by management with outside accountants (other than the independent auditor) with respect to the financial and/or tax accounting treatment of a particular event or completed transaction							
10. Discuss significant issues related to tax accounting, reporting or payment		X	X	X	X		
11. Discuss significant issues related to operation, development and implementation of information systems							
12. Periodically review with management the adequacy of, and related disclosures in the Company's quarterly and annual reports, the Company's disclosure controls and procedures and internal control over financial reporting	Rule 13a-14(a)/Rule 15d-14(a) of the Securities Exchange Act of 1934	X	X	X	X		
13. Review disclosures to the Committee made by the Company's Chief Executive Officer and	Rule 13a-14(a)/Rule 15d-14(a) of the Securities	X	X	X	X		

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AFC DUTIES AND RESPONSIBILITIES	REQUIRED BY:	FEB	MAY	JUL	OCT	DEC	NOTES
Chief Financial Officer during the certification process relating to the annual and quarterly reports about any significant deficiencies or material weaknesses in the design or operation of internal control over financial reporting and any fraud involving management or other employees who have a significant role in the Company's internal control over financial reporting	Exchange Act of 1934						
14. Review management's annual report on internal control over financial reporting	Item 308 of Regulation S-K	X					
15. Regularly review internal audit reports to management prepared by internal audit and review the internal audit department's function and performance, including organizational structure and qualifications, responsibilities, budget and staffing and seek to ensure the effectiveness and independence of this	Section 303A(7)(d) of NYSE	X	X	X	X	X	

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AFC DUTIES AND RESPONSIBILITIES	REQUIRED BY:	FEB	MAY	JUL	OCT	DEC	NOTES
department							
Independent Auditor							
1. The Committee must (i) directly appoint, retain, compensate, evaluate and terminate the Company's independent auditor, including resolving any disagreement between management and the independent auditor regarding financial reporting, and (ii) the Company's independent auditor shall report directly to the Committee	Rule 10A-3(b)(2) of the Securities Exchange Act of 1934	**X**		**X**			
2. Review with the independent auditor in advance the scope of its annual audit				**X**			
3. Discuss the annual audited financial statements and quarterly financial statements with the independent auditor, including the Company's disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations" which should include a discussion of all material trends, demands,	Section 303A(7)(c)(iii)(B) of NYSE	**X**	**X**	**X**	**X**		

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AFC DUTIES AND RESPONSIBILITIES	REQUIRED BY:	FEB	MAY	JUL	OCT	DEC	NOTES
commitments, uncertainties or events that are reasonably likely to have a material effect on the Company's results of operations or financial condition							
4. Obtain and review, at least annually, a report by the independent auditor describing (i) all critical accounting policies and practices to be used; (ii) all alternative treatments of financial information within GAAP that have been discussed with management, ramifications of the use of such alternative disclosure and treatments and the treatment preferred by the independent auditor; and (iii) other material written communications between the independent auditor and management, including the management letter and schedule of unadjusted differences	Rule 2-07 of Regulation S-X	X					
5. Review with the independent auditor any audit problems or difficulties and management's response,	Section 303A(7)(c)(iii)(F) of NYSE	X	X				

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AFC DUTIES AND RESPONSIBILITIES	REQUIRED BY:	FEB	MAY	JUL	OCT	DEC	NOTES
including (i) any restrictions on the scope of the independent auditor's activities or access to requested information; (ii) any significant disagreements with management; (iii) any accounting adjustments that were noted or proposed by the independent auditor but were passed as immaterial or otherwise; (iv) any communications between the audit team and the independent auditor's national office respecting auditing or accounting issues presented by the engagement; (v) any management or internal control letter issued, or proposed to be issued, by the independent auditor to the Company; and (vi) the responsibilities, budget and staffing of internal audit							
6. Review and discuss with the independent auditor or management the matters required to be communicated to the Committee in accordance with AICPA SAS 61	Item 7(d)(3)(i) of Schedule 14A	**X**					

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AFC DUTIES AND RESPONSIBILITIES	REQUIRED BY:	FEB	MAY	JUL	OCT	DEC	NOTES
7. Review the independent auditor's attestation report on management's assessment of internal control over financial reporting	Item 308 of Regulation S-K	X					
8. Review the Company's compliance with the Company's Public Accounting Firm Policy, including (i) the prohibitions on certain non-audit services that the independent auditor may not perform; (ii) the pre-approval of all audit and non-audit services to be performed by the independent auditor; (iii) the rotation of the lead partner and concurring partner; (iv) receipt of regular reports from management of all audit and non-audit services performed by the independent auditor; and (v) the limitations on employing employees or former employees of the independent auditor	Section 303A(7)(c)(iii)(G) of NYSE			X			
9. Review and discuss with the independent auditor whether any officer or director of the Company,	Rule 13b2-2 under Section 303 of the SOA	X					

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AFC DUTIES AND RESPONSIBILITIES	REQUIRED BY:	FEB	MAY	JUL	OCT	DEC	NOTES
or persons acting under their direction, have or may have taken any action to coerce, manipulate, mislead or fraudulently influence the independent auditor within the meaning of Rule 13b2-2 under the Securities Exchange Act of 1934							
10. Obtain and review, at least annually, a report by the independent auditor describing (i) the independent auditor's internal quality control procedures; (ii) any material issues raised by the most recent internal quality control review, or peer review, of the independent auditor, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, relating to one or more independent audits conducted by the independent auditor, and any steps taken to deal with any such issues; and (iii) all relationships between the independent auditor and the Company	Section 303A(7)(c)(iii)(A) of NYSE	X					

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AFC DUTIES AND RESPONSIBILITIES	REQUIRED BY:	FEB	MAY	JUL	OCT	DEC	NOTES
(to assess the independence of the independent auditor)							
11. Obtain and review, at least annually, a letter from the independent auditor regarding the independent auditor's independence; review and discuss the independent auditor's independence, including all significant consulting and other relationships with the Company that could impair the independent auditor's independence		X		X			
12. Review the independent auditor's work for the company, including the review and evaluation of the lead partner of the independent auditor, taking into account the opinions of management and internal audit	Commentary to Section 303A(7)(c)(iii)(A) of NYSE			X			
13. Based upon the reviews described in the preceding two subparagraphs 11 and 12 relating to the review and evaluation of the independent auditor's	Commentary to Section 303A(7)(c)(iii)(A) of NYSE			X			

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AFC DUTIES AND RESPONSIBILITIES	REQUIRED BY:	FEB	MAY	JUL	OCT	DEC	NOTES
qualifications, performance and independence, present the Committee's conclusions with respect to the independent auditor to the Board							
Financial Matters							
1. Periodically review and approve the Company's Commitment Authority Policy			X				
2. Review the Company's dividend policy and make recommendations to the Board with respect thereto					X		
3. Review management's recommendations concerning new financing arrangements, whether debt or equity, and make determinations or recommendations to the Board with respect thereto							
4. Review management's recommendations concerning significant acquisitions, dispositions, capital investments, venture fund investments and other significant financial commitments and							

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AFC DUTIES AND RESPONSIBILITIES	REQUIRED BY:	FEB	MAY	JUL	OCT	DEC	NOTES
make determinations or recommendations to the Board with respect thereto							
5. Review proposed major contracts or programs and make determinations or recommendations to the Board with respect thereto							
6. Review matters relating to the repurchase of stock or the repurchase or redemption of debt and make recommendations to the Board with respect thereto							
7. Review financial reports and analyses							
Other Matters							
1. In accordance with the New York Stock Exchange listing standards and Rule 10A-3(b)(3) under the Securities Exchange Act of 1934, the Committee must establish procedures for (i) the receipt, retention, and treatment of complaints received by the Company regarding accounting, internal accounting controls, or auditing matters; and (ii) the confidential, anonymous	Rule 10A-3(b)(2) of the Securities Exchange Act of 1934					X	

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AFC DUTIES AND RESPONSIBILITIES	REQUIRED BY:	FEB	MAY	JUL	OCT	DEC	NOTES
submission by employees of the Company of concerns regarding questionable accounting or auditing matters							
2. Review situations involving actual, potential or alleged conflicts of interest, misconduct or similar activities							
3. Periodically review environmental stewardship standards and practices, the Company's compliance systems and controls to enforce these standards, and significant cases of variance from these standards				X			
4. Periodically review legal compliance matters, including securities trading practices and policies		X	X	X	X		
5. Periodically review any significant pending, threatened or potential litigation matters, including with regulatory agencies, that could have a significant impact on the Company's financial statements		X	X	X	X		

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COMPENSATION AND LEADERSHIP DEVELOPMENT COMMITTEE DUTIES AND RESPONSIBILITIES (July 22, 2004)

CLDC DUTIES AND RESPONSIBILITIES	REQUIRED BY:	FEB	MAY	JUL	OCT	DEC	NOTES
1. Establish the overall compensation structure and executive compensation philosophy and principles of the Company	Section 303A(5)(b)(i)(C) of NYSE				X		
2. Review and approve the corporate goals and objectives of the CEO, including base salary, annual bonus, stock options, restricted stock and other compensation arrangements	Section 303A(5)(b)(i)(A) of NYSE					X	
3. Evaluate annually the performance in light of the CEO's competencies, corporate goals and objectives and potential and determine and approve the CEO's compensation level based on such evaluation; in determining the long-term incentive component of CEO compensation, the Committee may consider (i) the Company's performance and relative shareholder return, (ii) the value of similar incentive awards to CEOs at comparable companies and (iii) the awards given to the Company's CEO in past years	Commentary to and Section 303A(5)(b)(i)(A) of NYSE	X				X	

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CLDC DUTIES AND RESPONSIBILITIES	REQUIRED BY:	FEB	MAY	JUL	OCT	DEC	NOTES
4. Review and approve the compensation of the Company's executive officers						X	
5. Make recommendations to the Board with respect to non-CEO and non-executive officer compensation plans, incentive compensation plans and equity-based compensation plans	Section 303A(5)(b)(i)(B) of NYSE					X	
6. Recommend to the Board compensation policies and programs for the compensation of members of the Board who are not employees of the Company				X			
7. Conduct such other reviews of leadership development strategy, people development strategy and succession plans as the Committee from time to time determines		X	X	X	X	X	
8. Conduct reviews of high potential individuals, succession planning and the diversity of the Company's management team		X	X	X	X	X	

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CLDC DUTIES AND RESPONSIBILITIES	REQUIRED BY:	FEB	MAY	JUL	OCT	DEC	NOTES
9. Approve change in control agreements for officers			X		X		
10. Prepare an annual report on executive compensation for inclusion in the Company's proxy statement	Section 303(a)(5)(b)(i) of NYSE	X					
11. Recommend to the Board the appointment of Corporate Officers			X				
12. Adopt rules and guidelines and otherwise administer the Company's health and welfare plans and compensation plans, including, without limitation, its annual incentive bonus plan, corporate performance plan, stock option plans, employee stock purchase plans, 401(k) plan and deferred compensation plans				X			
13. Approve members of the Equity Plans Administrative Committee or other similar committee designated for the purpose of overseeing the administration of compensation plans				X			

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CLDC DUTIES AND RESPONSIBILITIES	REQUIRED BY:	FEB	MAY	JUL	OCT	DEC	NOTES
14. Approve members of the Benefits Committee or other similar committee designated for the purpose of overseeing the administration of health and welfare plans				X			
15. Engage independent counsel and other advisers, as it determines necessary or appropriate to carry out its duties							
16. The Committee has sole authority to retain and terminate any compensation consultant hired to assist in the evaluation of director, CEO or senior executive compensation, including sole authority to approve the firm's fees and other retention terms	Commentary to Section 303A(5) of NYSE			X			
17. Evaluate the Committee's performance at least annually	Section 303A(5)(b)(iii) of NYSE					X	
18. Make regular reports to the Board regarding its activities		X	X	X	X	X	
19. Determine through its Chairman the agenda of its meetings				X			

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CLDC DUTIES AND RESPONSIBILITIES	REQUIRED BY:	FEB	MAY	JUL	OCT	DEC	NOTES
20. Periodically review the adequacy of the Committee's Charter and submit the Charter to the Board for its approval						X	
21. Perform any other activities consistent with the Charter, the Company's Bylaws and applicable laws as the Committee or Board deems necessary or appropriate							

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GOVERNANCE AND NOMINATING COMMITTEE DUTIES AND RESPONSIBILITIES (July 22, 2004)

GNC DUTIES AND RESPONSIBILITIES	REQUIRED BY:	FEB	MAY	JUL	OCT	DEC	NOTES
1. Develop and recommend to the Board a set of corporate governance principles applicable to the Company, and periodically review the adequacy of such principles	Section 303A(4)(b)(i) of NYSE					X	
2. Recommend to the Board guidelines and criteria to determine the qualifications to serve and continue to serve as a director	Section 303A(4)(b)(i) of NYSE					X	
3. Identify and review the qualifications of, and recommend to the Board, (i) individuals to be nominated by the Board for election to the Board by shareholders at each annual meeting of shareholders and (ii) individuals to be elected to any vacancy on the Board which shall occur for any reason	Section 303A(4)(b)(i) of NYSE	X					
4. Review the nomination by a shareholder of the Company of a qualified candidate for election to the Board if such nomination is submitted	Section 303A(4)(b)(i) of NYSE	X					

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GNC DUTIES AND RESPONSIBILITIES	REQUIRED BY:	FEB	MAY	JUL	OCT	DEC	NOTES
within the time limits and in the manner prescribed in this Charter and the Bylaws							
5. Recommend to the Board appointments to committees of the Board			X				
6. Periodically review the size, composition and organization of the Board and its committees and recommend policies, changes or other action it deems necessary or appropriate, including recommendations to the Board regarding retirement age, resignation or removal of a director, stock ownership guidelines, independence requirements, frequency of Board meetings and terms of directors							
7. Oversee the evaluation of the performance of the Board, its committees and of members of the Board who are not employees of the Company	Section 303A(4)(b)(i) of NYSE				X	X	
8. Review other corporate governance and similar matters relevant to the Company, including,							

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GNC DUTIES AND RESPONSIBILITIES	REQUIRED BY:	FEB	MAY	JUL	OCT	DEC	NOTES
without limitation, the Charters of other committees of the Board and the independence of directors, and recommend policies, changes or other action it deems necessary or appropriate							
9. Review the Company's charitable contributions budget						X	
10. Review and periodically assess the adequacy of the Company's code of conduct, including compliance with (i) the New York Stock Exchange listing standards which requires a code of conduct for the Board, officers and employees that addresses (1) conflicts of interest; (2) corporate opportunities; (3) confidentiality; (4) fair dealing; (5) protection and proper use of Company assets; (6) compliance with laws, rules, and regulations (including insider trading laws); and (7) encouraging the reporting of any illegal or unethical behavior and (ii) Item 406 of Regulation S-	Section 303A(10) of NYSE and Item 406 of Regulation S-K						

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GNC DUTIES AND RESPONSIBILITIES	REQUIRED BY:	FEB	MAY	JUL	OCT	DEC	NOTES
K which requires disclosure of whether the Company has adopted a code of conduct that applies to the Chief Executive Officer, Chief Financial Officer, Controller or persons performing similar functions that addresses (1) honest and ethical conduct; (2) full, fair, accurate, timely and understandable disclosure in Securities and Exchange Commission reports and other public communications; (3) compliance with applicable governmental laws, rules and regulations; (4) prompt internal reporting of any violation of the code of conduct to an appropriate person identified in the code of conduct; and (5) accountability for adherence to the code of conduct							
11. Review transactions or arrangements (financial or otherwise) between the Company and one or more directors or corporate officers, other than							

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GNC DUTIES AND RESPONSIBILITIES	REQUIRED BY:	FEB	MAY	JUL	OCT	DEC	NOTES
compensation decisions, and make recommendations to the Board with respect thereto							
12. Engage independent counsel and other advisers, as it determines necessary or appropriate to carry out its duties							
13. The Committee has sole authority to retain and terminate any search firm to be used to identify director candidates, including sole authority to approve the search firm's fees and other retention terms	Commentary to Section 303A(4) of NYSE						
14. Evaluate the Committee's performance at least annually	Section 303A(4)(b)(ii) of NYSE					X	
15. Make regular reports to the Board regarding its activities	Commentary to 303A(4) of NYSE	X	X	X	X	X	
16. Determine through its Chairman the agenda of its meetings							
17. Periodically review the adequacy of the Committee's Charter and submit Charter to the					X		

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GNC DUTIES AND RESPONSIBILITIES	REQUIRED BY:	FEB	MAY	JUL	OCT	DEC	NOTES
Board for its approval							
18. Perform any other activities consistent with the Charter, the Company's Bylaws and applicable laws as the Committee or Board deems necessary or appropriate							

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Board of Directors
The ServiceMaster Company
July 2004

Board Performance Questionnaire

This Questionnaire, to be completed by individual Board members, is part of an annual Board self evaluation review conducted by the Governance and Nominating Committee to aid the Board in evaluating and assuring the adequacy and effectiveness of its governance process.

In response to the results of our first Board Performance Questionnaire discussed at our January 2003 meeting, the Governance and Nominating Committee has revised this Questionnaire to reflect the Board's desire to emphasize strategic planning, succession planning and quality of management presentations and reports to the Board. We have included a copy of the January 2003 presentation that summarized the results of our initial Board Performance Questionnaire.

The questions focus on key areas of responsibility. The questions are divided into five parts and cover: **I. Structure and Effectiveness of Meetings; II. Membership; III. Material and Communications; IV. Duties and Responsibilities; and V. Overall Evaluation.**

A separate Questionnaire is utilized to evaluate the performance of each Committee of the Board.

We have engaged ____________________ as the independent third party to collect, evaluate and prepare a report on the responses to this Questionnaire. Director responses will be reported to the Board at our October 2004 Board meeting. Please indicate your response to each of the following:

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I. Structure and Effectiveness of Meetings	Acceptable	Needs Improvement
1. Frequency of Board meetings		
2. Length of Board meetings		
3. Board's input on Board agendas		
4. Use of time at Board meetings		
5. Director participation in Board meetings		
6. Open communication and participation at Board meetings		
7. Candid and constructive executive sessions with Chairman		
8. Candid and constructive executive sessions without management		
9. Committee reports to the Board		
10. Structure of the Board and Committees		
11. Board exercise of proper independence		
12. Directors' disclosure of personal interests in transactions and abstinence from voting where appropriate		

Comments or suggestions on Structure and Effectiveness of Meetings:
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II. Membership	Acceptable	Needs Improvement
13. Skills and experience reflected in the Board's membership, including CEO level, marketing, technology, financial and accounting experience.		
14. Diversity reflected in the Board's membership		
15. Process for identification, consideration, recruitment and nomination of prospective Board members		

Comments or suggestions on Membership:
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III. Material and Communications	Acceptable	Needs Improvement
16. Quality of management presentations and reports regarding:		
-strategic plans		
-competition and markets		
-customers and marketing		
-CEO performance and succession planning		
-high potential review		
-succession planning		
-operations and initiatives		
-financial performance		
-mergers and acquisitions		
-technology		
-compliance and ethics programs		
-legal and regulatory issues		
17. Appropriate use of “trendline” information in presentations and reports		
18. Quality of materials provided for review in advance of meetings		
19. Materials received sufficiently in advance of meetings so that director feels properly prepared		
20. Access to senior management inside and outside of meetings for information		
21. Access to external advisers such as auditors, legal counsel and regulatory, investment banking and compensation advisers		

Comments or suggestions on Material and Communications:

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IV. Duties and Responsibilities	Acceptable	Needs Improvement
22. Corporate governance principles		
23. Board fosters a continued understanding and implementation of the Company's objectives		
24. Board review of and input on vision and strategy		
25. Board review of competition and markets		
26. Board review of customers and marketing		
27. Board review of CEO performance and succession planning		
28. Board review of high potential employees		
29. Board review of succession planning		
30. Board review of annual budgets and operating plans		
31. Board review of operations		
32. Board monitoring of Company performance as compared with plan and budgets		
33. Board review of high profile critical issues		
34. Board review of corporate governance matters		
35. Quality of Board minutes		
36. Board communications with CEO and management about Board's goals, expectations and concerns		

Comments or suggestions on Duties and Responsibilities:
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V. Overall Evaluation	Acceptable	Needs Improvement
37. Overall responsiveness of management to results of January 2003 Board Performance Questionnaire:		
-strategic planning		
-succession planning		
-quality of management presentations and reports to the Board		
38. Overall effectiveness of Board, including meeting corporate governance duties		

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Please provide any additional comments, concerns or suggestions you may have regarding the adequacy and effectiveness of the Board.

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Director:___________________________

Date:_______________________________

Board Performance Questionnaire: July 16, 2004

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Board of Directors
The ServiceMaster Company

Director Self-Assessment Questionnaire
November 2003

Name: ____
Term and/or Expiration Date ______________________________
Retirement Date (if appropriate)______________________________

This Questionnaire, to be completed by individual Board members, is part of a self evaluation review conducted by the Governance and Nominating Committee to aid the Board in evaluating and assuring the adequacy and effectiveness of its governance process. The Governance and Nominating Committee will collect, evaluate and prepare a report on the responses to this Questionnaire.

A separate Questionnaire will be utilized to evaluate the performance of the Board and each Committee of the Board.

Please indicate your opinion with respect to each of the following areas.

1. Rate your knowledge and/or understanding of the business in the following areas.	**5-Outstanding** **4-Commendable** **3-Fully Satisfactory** **2-Satisfactory Low** **1-Unsatisfactory**
Customer Profiles	
Employees/Talent Management	
Competition	
Strategic Plans	
Key Financial Indicators	
Critical Accounting Policies	
Operations/Six Sigma	
Use of Technology	
Shareholder Relations	
Conflicts of Interest/Ethics	
Compliance with Laws/Regulations	
Legal Proceedings	
Risk Management	

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2. Are there other areas of the business that should be included in the list that you wish to comment on?

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3. Rate your contribution to Board deliberations (during the Board meeting) in the following areas:	**5-Outstanding 4-Commendable 3-Fully Satisfactory 2-Satisfactory Low 1-Unsatisfactory**
Marketing/Customer Management	
Employees/Talent Management	
Competitive Assessment	
Strategic Plans	
Financial Strategy	
Critical Accounting Policies	
Operations/Six Sigma	
Use of Technology	
Shareholder Relations	
Conflicts of Interest/Ethics	
Compliance with Laws/Regulations	
Legal Proceedings	
Risk Management	

4. Are there other areas in which you feel you make a major contribution to Board deliberations?

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5. Rate your level of satisfaction in the following areas:	**VS-Very Satisfied S-Satisfied N-Not Sure D-Dissatisfied VD-Very Dissatisfied**
Your ability to take firm constructive stands, when necessary	
Your ability to communicate with management	
Your ability to communicate with and influence other Board members	
Conflict is adequately sought, addressed and resolved	

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6. Other comments:

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7. Overall, since the beginning of your current term in what ways are you satisfied with your performance as a Board member?

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8. Since the beginning of your current (three-year period) term, in what ways are you dissatisfied with your performance (e.g., meeting preparation time, meeting participation level, etc.) as a Board member?

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9. What would help you (e.g., information, process changes, etc.) to better fulfill your responsibilities/obligations as a Director in the future?

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Director:_____________________________

Date:_________________________________

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Board of Directors
The ServiceMaster Company
November 2003

Audit and Finance Committee Performance Questionnaire

This Questionnaire, to be completed by individual Committee members, is part of a self evaluation review conducted by the Governance and Nominating Committee to aid the Board in evaluating and assuring the adequacy and effectiveness of its governance process. The Governance and Nominating Committee will collect, evaluate and report on the responses to this Questionnaire.

The questions focus on key areas of responsibility. The questions are divided into five parts and cover: **I. Structure and Effectiveness of Meetings; II. Membership; III. Material and Communications; IV. Duties and Responsibilities; and V. Additional Comments.**

A separate Questionnaire is utilized to evaluate the performance of the Board and other Committees of the Board.

Please indicate your response to each of the following:

I. Structure and Effectiveness of Meetings	Acceptable	Needs Improvement
1. Frequency of Committee meetings		
2. Length of Committee meetings		
3. Committee's input on Committee agendas		
4. Use of time at Committee meetings		
5. Director participation in Committee meetings		
6. Open communication and participation at Committee meetings		
7. Candid and constructive private meetings with independent auditor		
8. Candid and constructive private meetings with internal audit		
9. Candid and constructive meetings with management		
10. Candid and constructive executive sessions without management		
11. Committee reports to the Board		
12. Structure of the Committee		
13. Committee exercise of proper independence		
14. Overall effectiveness of Committee, including meeting corporate governance duties		

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Comments or suggestions on Structure and Effectiveness of Meetings
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II. Membership	Acceptable	Needs Improvement
15. Skills and experience reflected in the Committee's membership, including financial and accounting experience		
16. Diversity reflected in the Committee's membership		
17. Process for identification, consideration and selection of prospective Committee members		

Comments or suggestions on Membership
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III. Material and Communications	Acceptable	Needs Improvement
18. Quality of management presentations and reports regarding:		
-operations and initiatives		
-results of operations (quarter, year-to-date and projections)		
-financial condition/contingent liabilities		
-financial statements		
-dividend policy		
-tax matters		
-internal control over financial reporting		
-disclosure controls and procedures		
-securities laws		
-securities trading by directors and executive officers		
-M&A activity		
-financial relations		
-commitment authority		
-enterprise risk assessment and management		
-internal audit work plans and activities		
-risk management (insurance, captive insurance company, loss control, safety, claims)		
-procedures regarding complaints relating to accounting, financial reporting or other matters		
19. Appropriate use of "trendline" information in presentations and reports		
20. Quality of materials provided for review in advance of meetings		
21. Materials received sufficiently in advance of meetings so that director feels properly prepared		
22. Access to senior management inside and outside of meetings for information		
23. Communications with external advisers such as auditors, legal counsel and regulatory and financial advisors		

Comments or suggestions on Material and Communications:
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IV. Duties and Responsibilities	Acceptable	Needs Improvement
24. Committee charter		
25. Committee's actions demonstrate direct responsibility for appointment, compensation and oversight of auditor		
26. Review of auditor engagement letter, scope of audit, work plans and audit fees		
27. Review of non-audit services and fees		
28. Review of audit results		
29. Review of auditor's independence		
30. Review of [_________]		
29. Review of Committee report for proxy statement		
30. Discussion or review of financial statements		
31. Discussion or review of press releases		
32. Discussion or review of use of non-GAAP financial measures		
33. Review of internal audit work plans and activities		
34. Review of internal control over financial reporting		
35. Review of disclosure controls and procedures		
36. Review of fraud-related matters		
37. Review of high profile critical issues		
38. Communications with CEO and management about Committee's goals, expectations and concerns		
39. Quality of Committee minutes		
40. Overall effectiveness of Committee		

Comments or suggestions on Duties and Responsibilities:
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V. Additional Comments

Please provide any additional comments, concerns or suggestions you may have regarding the adequacy and effectiveness of the Audit and Finance Committee
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Director:______________________________

Date:__________________________________

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Board of Directors
The ServiceMaster Company

November 2003

Compensation and Leadership Development Committee Performance Questionnaire

This Questionnaire, to be completed by individual Committee members, is part of a self evaluation review conducted by the Governance and Nominating Committee to aid the Board in evaluating and assuring the adequacy and effectiveness of its governance process. The Governance and Nominating Committee will collect, evaluate and report on the responses to this Questionnaire.

The questions focus on key areas of responsibility. The questions are divided into five parts and cover: **I. Structure and Effectiveness of Meetings; II. Membership; III. Material and Communications; IV. Duties and Responsibilities; and V. Overall Evaluation.**

A separate Questionnaire is utilized to evaluate the performance of the Board and other Committees of the Board.

Please indicate your response to each of the following.

I. Structure and Effectiveness of Meetings	Acceptable	Needs Improvement
1. Frequency of Committee meetings		
2. Length of Committee meetings		
3. Committee's input on Committee agendas		
4. Use of time at Committee meetings		
5. Director participation in Committee meetings		
6. Open communication and participation at Committee meetings		
7. Candid and constructive meetings with management		
8. Candid and constructive executive sessions without management		
9. Committee reports to the Board		
10. Structure of the Committee		
11. Committee exercise of proper independence		

Comments or suggestions on Structure and Effectiveness of Meetings:
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II. Membership	Acceptable	Needs Improvement
12. Skills and experience reflected in the Committee's membership		
13. Diversity reflected in the Committee's membership		
14. Process for identification, consideration and selection of prospective Committee members		

Comments or suggestions on Membership:

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III. Material and Communications	Acceptable	Needs Improvement
15. Quality of management presentations and reports regarding:		
- performance management		
- succession planning/high potential reviews		
- executive compensation developments		
- CEO compensation		
- executive compensation		
- annual and long-term bonuses		
- stock-based compensation		
- compensation plans for employees and directors (annual, long-term, stock-based)		
- change in control agreements		
16. Appropriate use of "trendline" information in presentations and reports		
17. Quality of materials provided for review in advance of meetings		
18. Materials received sufficiently in advance of meetings so that director feels properly prepared		
19. Access to senior management inside and outside of meetings for information		
20. Communications with external advisers such as legal counsel and compensation specialists		

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Comments or suggestions on Material and Communications:
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IV. Duties and Responsibilities	Acceptable	Needs Improvement
21. Committee charter		
22. Committee review of CEO compensation		
23. Committee review of executive officer compensation		
24. Committee review of director compensation		
25. Committee review of compensation plans for employees and directors		
26. Committee review of CEO performance		
27. Committee review of leadership development strategy and people development strategy		
28. Committee review of succession planning		
29. Committee review of high potential individuals		
30. Committee review of Committee report for proxy statement on executive compensation		
31. Committee review of high profile critical issues		
32. Committee communications with CEO and management about Committee's goals, expectations and concerns		
33. Quality of Committee minutes		

Comments or suggestions on Duties and Responsibilities:
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IV. Overall Evaluation	Acceptable	Needs Improvement
34. Overall effectiveness of Committee, including meeting corporate governance duties		

Please provide any additional comments, concerns or suggestions you may have regarding the adequacy and effectiveness of the Compensation and Leadership Development Committee.

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Director:_________________________

Date:___________________________

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Board of Directors
The ServiceMaster Company

November 2003

Governance and Nominating Committee Performance Questionnaire

This Questionnaire, to be completed by individual Committee members, is part of a self evaluation review conducted by the Governance and Nominating Committee to aid the Board in evaluating and assuring the adequacy and effectiveness of its governance process. The Governance and Nominating Committee will collect, evaluate and report on the responses to this Questionnaire.

The questions focus on key areas of responsibility. The questions are divided into five parts and cover: **I. Structure and Effectiveness of Meetings; II. Membership; III. Material and Communications; IV. Duties and Responsibilities; and V. Overall Evaluation.**

A separate Questionnaire is utilized to evaluate the performance of the Board and other Committees of the Board.

Please indicate your response to each of the following areas.

I. Structure and Effectiveness of Meetings	Acceptable	Needs Improvement
1. Frequency of Committee meetings		
2. Length of Committee meetings		
3. Committee's input on Committee agendas		
4. Use of time at Committee meetings		
5. Director participation in Committee meetings		
6. Open communication and participation at Committee meetings		
7. Candid and constructive meetings with management		
8. Candid and constructive executive sessions without management		
9. Committee reports to the Board		
10. Structure of the Committee		
11. Committee exercise of proper independence		

Comments or suggestions on Structure and Effectiveness of Meetings:
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II. Membership	Acceptable	Needs Improvement
12. Skills and experience reflected in the Committee's membership		
13. Diversity reflected in the Committee's membership		
14. Process for identification, consideration, recruitment and nomination of prospective Committee and Board members		

Comments or suggestions on Membership:
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III. Material and Communications	Acceptable	Needs Improvement
15. Quality of management presentations and reports regarding:		
- compliance with New York Stock Exchange listing requirements		
- corporate governance developments		
- operations of the ServiceMaster Foundation		
- charitable contributions		
16. Quality of materials provided for review in advance of meetings		
17. Materials received sufficiently in advance of meetings so that director feels properly prepared		
18. Access to senior management inside and outside of meetings for information		
19. Communications with external advisers such as legal counsel and director search specialists		

Comments or suggestions on Material and Communications:
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IV. Duties and Responsibilities	Acceptable	Needs Improvement
20. Committee review of director candidates		
21. Committee review of the structure, responsibilities, and effectiveness of Board Committees		
22. Committee effectiveness in evaluating performance of Board and individual directors		
23. Committee review of director independence		
24. Committee review of the high profile critical issues		
25. Committee communications with CEO and management about Committee's goals, expectations and concerns		
26. Quality of Committee minutes		

Comments or suggestions on Duties and Responsibilities:
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IV. Overall Evaluation	Acceptable	Needs Improvement
27. Overall effectiveness of Committee, including meeting corporate governance duties		

Please provide any additional comments, concerns or suggestions you may have regarding the adequacy and effectiveness of the Governance and Nominating Committee.
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Director:______________________________

Date:_________________________________

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THE SERVICEMASTER COMPANY **April 30, 2004**
NYSE Listing Standards Compliance Chart

Basic Principle	Responsible Party	Status
Basic Principle 1: The Board must have a majority of independent directors.		
Basic Principle 2: An independent director must satisfy the following requirements. The director must not: • have a material relationship with ServiceMaster, either directly or as a partner, shareholder or officer of an organization that has a relationship with ServiceMaster; • be an employee, or have an immediate family member who is an executive officer, of ServiceMaster; • receive, or have an immediate family member who receives, more than $100,000 per year in direct compensation from ServiceMaster, other than director and committee fees and pension and other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service); • be affiliated with or employed by, or have an immediate family member who is affiliated with or employed in a professional capacity by, a present or former internal or external auditor of ServiceMaster; • be employed, or have an immediate family member who is employed, as an executive officer of another company where any of ServiceMaster's present executives serve on that company's compensation committee; or • be an executive officer or an employee, or have an immediate family member who is an executive officer, of a company that makes payments to, or receives payments from, the company for property or services in an amount which, in any single fiscal year, exceeds the greater of $1 million, or 2% of such other company's consolidated gross revenues.		

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In addition, no director will be considered independent until a three-year "cooling-off" period has elapsed from the end of any of the above relationships. In order to facilitate a smooth transition to the new independence standards, the NYSE will apply a one-year "cooling-off" period through November 3, 2004.		
Basic Principle 3: Non-employee directors must meet in regularly scheduled executive sessions without management.		
Basic Principle 4: Our GNC must be comprised entirely of independent directors and have a written charter that addresses: • the GNC's purpose and responsibilities, including to identify individuals qualified to become board members, consistent with the criteria approved by the Board; select or recommend director nominees; develop and recommend to the Board corporate governance principles; and oversee the evaluation of the Board and management; and • the charter must also address an annual performance evaluation of the GNC, as well as its membership, structure, operations and reporting.		
Basic Principle 5: Our CLDC must be comprised entirely of independent directors and have a written charter that addresses: • the CLDC's purpose and responsibilities, including to review and approve objectives relevant to the CEO's compensation; evaluate the CEO's performance; determine the CEO's compensation; make recommendations with respect to non-CEO compensation, incentive compensation and equity-based plans; and produce an annual report on executive compensation for inclusion in ServiceMaster's proxy statement; and • the charter must also address an annual performance evaluation of the CLDC, as well as its membership, structure, operations and reporting.		

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Basic Principle 6: Each member of the AFC must meet two additional independence criteria. A director may not (1) accept directly or indirectly any consulting, advisory, or other compensatory fee from ServiceMaster or any subsidiary, other than fees for serving as a director or (2) be affiliated with ServiceMaster or any subsidiary.		
Basic Principle 7: Our AFC must be comprised entirely of independent directors and have a written charter that addresses: • the AFC's purpose, including to assist the Board in its oversight of (1) the integrity of ServiceMaster's financial statements; (2) ServiceMaster's compliance with legal and regulatory requirements; (3) our independent auditor's qualifications and independence; and (4) the performance of our internal audit function and independent auditor and prepare the audit report for inclusion in ServiceMaster's proxy statement. • the charter must also address an annual performance evaluation of the committee and the following duties and responsibilities, including to: o directly appoint, retain, compensate, evaluate and terminate our independent auditor; o establish procedures for the receipt, retention and treatment of complaints from employees on accounting, internal accounting controls or auditing matters, as well as for confidential, anonymous submissions by employees of concerns regarding questionable accounting or auditing matters; o obtain advice and assistance from outside legal, accounting or other advisors as the AFC deems necessary to carry out its duties; o receive appropriate funding, as determined by the AFC, from ServiceMaster for payment of compensation to the outside legal, accounting or other advisors retained by the AFC; o at least annually, obtain and review a		

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report by our independent auditor describing our auditor's internal quality-control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of our auditors, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by our auditors, and any steps taken to deal with any such issues; and (to access the auditor's independence) all relationships between the independent auditor and ServiceMaster; o review the independent auditor's work for ServiceMaster, including the review and evaluation of the lead partner of the independent auditor, taking into account the opinions of management and internal audit; o discuss the annual audited financial statements and quarterly financial statements with management and our independent auditor, including ServiceMaster's disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations;" o discuss generally earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies; o discuss policies with respect to risk assessment and risk management; o meet separately, periodically, with management, internal auditors and our independent auditor; o review with the independent auditor any audit problems or difficulties and management's response; o set clear hiring policies for employees or former employees of our independent auditors; and o report regularly to the Board.		

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Basic Principle 8: All equity compensation plans, and any material revisions to such plans, will be subject to shareholder approval, subject to three limited exemptions for inducement awards, M&A related awards and qualified plans, parallel excess plans and Section 423 plans. Further, brokers will be prohibited from voting on equity compensation plans unless the beneficial owner of the shares has given voting instructions to the broker.		
Basic Principle 9: The GNC must develop and recommend to the Board corporate governance principles. These principles must be posted on our website. The principles must address the following topics: • director qualification standards; • director responsibilities; • director access to management and, as necessary and appropriate, independent advisors; • director compensation; • director orientation and continuing education; • management succession; and • annual performance of the Board.		
Basic Principle 10: ServiceMaster must adopt and disclose a code of business conduct and ethics for directors, officers and employees, and promptly disclose any waivers of the code for directors or executive officers. Any waiver of the code for directors or executive officers may be made only by the Board or a Board committee and must be promptly disclosed to shareholders. The code must also be posted on our website. The code should address the following topics: • conflicts of interest; • corporate opportunities; • confidentiality; • fair dealing; • protection and proper use of ServiceMaster's assets; • compliance with laws, rules and regulations (including insider trading laws); and • encouraging the reporting of illegal or unethical behavior.		

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Basic Principle 11: Foreign private issuers must disclose any significant ways in which their corporate governance practices differ from those followed by domestic companies.		
Basic Principle 12: Jon Ward, as CEO, must certify to the NYSE annually that he is not aware of any violation of the NYSE's listing standards. In addition, Jon will be required to promptly notify the NYSE after any executive officer (i.e., Kitchen Cabinet member) becomes aware of any material non-compliance with the listing standards.		
Basic Principle 13: The NYSE may issue a public reprimand letter to any listed company that violates a NYSE listing standard.		

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CERTIFICATION OF CHIEF EXECUTIVE OFFICER EXHIBIT 31.1

I, Jonathan P. Ward, certify that:

1. I have reviewed this quarterly report on Form 10-Q of The ServiceMaster Company;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary 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 this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August __, 2004

/s/ Jonathan P. Ward
Jonathan P. Ward
Chairman and Chief Executive Officer

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EXHIBIT 32.1

Certification of Chief Executive Officer Pursuant to Section 1350 of Chapter 63 of Title 18 Of The United States Code

I, Jonathan P. Ward, the Chairman and Chief Executive Officer of The ServiceMaster Company, certify that (i) the Quarterly Report on Form 10-Q for the quarter ended June 30, 2004, fully complies with requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and (ii) the information contained in such Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of The ServiceMaster Company.

/s/ Jonathan P. Ward
Jonathan P. Ward
Chairman and Chief Executive Officer
August __, 2004

A signed original of this written statement required by Section 906 has been provided to The ServiceMaster Company and will be retained by The ServiceMaster Company and furnished to the Securities and Exchange Commission or its staff upon request.

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August __, 2004

The ServiceMaster Company
3250 Lacey Road, Suite 600
Downers Grove, IL 60515
Attn: Chief Executive Officer
Chief Financial Officer

Re: Quarterly Report on Form 10-Q for the quarter ended June 30, 2004

Ladies and Gentlemen:

I am the Senior Vice President and Controller of The ServiceMaster Company ("ServiceMaster"). I address this letter to ServiceMaster in connection with ServiceMaster's obligation under Section 13(a) of the Securities Exchange Act of 1934 to file with the Securities and Exchange Commission a Quarterly Report on Form 10-Q for the quarter ended June 30, 2004 (the "Report").

1. In connection with the preparation of this letter, I have reviewed the portions of the Report that are identified on the attached Exhibit A opposite my initials (the "Responsible Portions") and each Business Unit Management Representation Letter.

2. Based on my knowledge, no Responsible Portion in the Report contains any untrue statement of a material fact or omits to state a material fact necessary 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.

3. Based on my 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 ServiceMaster as of, and for, the periods presented in the Report.

4. ServiceMaster's Chief Executive Officer, Chief Financial Officer, other officers and I are responsible for establishing and maintaining disclosure controls and procedures for ServiceMaster and we have:

   a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to ServiceMaster, including its consolidated subsidiaries, is made known to us by others within ServiceMaster and such subsidiaries, particularly during the period in which the Report is being prepared;

   b) evaluated the effectiveness of ServiceMaster's disclosure controls and procedures and presented in the Report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by the Report based on such evaluation; and

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c) disclosed in the Report any change in ServiceMaster's internal control over financial reporting that occurred during ServiceMaster's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, ServiceMaster's internal control over financial reporting.

5. I understand that ServiceMaster's Chief Executive Officer, Chief Financial Officer and other officers will disclose, based on their most recent evaluation of internal control over financial reporting, to Deloitte & Touche LLP, ServiceMaster's auditors ("Deloitte"), and the Audit and Finance Committee of ServiceMaster's Board of Directors:

   a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect ServiceMaster's ability to record, process, summarize and report financial information; and

   b) any fraud, whether or not material, that involves management or other employees who have a significant role in ServiceMaster's internal control over financial reporting.

   Except as set forth on the Audit and Finance Committee Disclosure Form attached as Exhibit B, there are no significant deficiencies or material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect ServiceMaster's ability to record, process, summarize and report financial information and there has been no fraud involving management or other employees who have a significant role in internal control over financial reporting.

I also confirm that the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934.

In providing this letter, I confirm that I have made investigations and have relied upon sources, with a good faith basis for such reliance, which were necessary or useful with respect to matters for which I do not have direct knowledge or expertise, inquiries of individuals who report to me and/or inquiries of individuals who have (or whom I reasonably believe have) knowledge of such matters.

This letter is being delivered in order to provide factual support for the certifications being made in the Report by the Chief Executive Officer and Chief Financial Officer of ServiceMaster.

Very truly yours,

____

Deborah A. O'Connor
Senior Vice President and Controller

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EXHIBIT A

Name of Report	Portion of Report Reviewed	Responsible Party	Additional Responsible Parties
Quarterly Report on Form 10-Q for the Quarter Ended June 30, 2004	**PART I** Item 1. Financial Statements	DAO	WHU
	Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	DAO/JLK	WHU/HAT
	Item 3. Quantitative and Qualitative Disclosures About Market Risk	DAO/ERZ	WHU
	Item 4. Controls and Procedures	DAO/JLK	CLK/HAT
	PART II Item 1. Legal Proceedings	JLK	TEW
	Item 2. Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities	ERZ/JLK	BER/HAT
	Item 3. Defaults Upon Senior Securities	ERZ/JLK	BER/HAT
	Item 4. Submission of Matters to a Vote of Security Holders	JLK	SLG
	Item 5. Other Information	DAO/JLK	WHU/HAT
	Item 6. Exhibits and Reports on Form 8-K	DAO/JLK	WHU/HAT

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EXHIBIT B

AUDIT AND FINANCE COMMITTEE DISCLOSURE FORM	
Significant Deficiencies:	
Material Weaknesses:	

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August __, 2004

The ServiceMaster Company
3250 Lacey Road, Suite 600
Downers Grove, IL 60515
Attn: Chief Executive Officer
Chief Financial Officer

Re: Quarterly Report on Form 10-Q for the quarter ended June 30, 2004

Ladies and Gentlemen:

I am the Senior Vice President and General Counsel of The ServiceMaster Company ("ServiceMaster"). I address this letter to ServiceMaster in connection with ServiceMaster's obligation under Section 13(a) of the Securities Exchange Act of 1934 to file with the Securities and Exchange Commission a Quarterly Report on Form 10-Q for the quarter ended June 30, 2004 (the "Report").

1. In connection with the preparation of this letter, I have reviewed the portions of the Report that are identified on the attached Exhibit A opposite my initials (the "Responsible Portions"), each Business Unit General Counsel Confirmation Letter and the Legal Department Report on Disclosure Controls and Procedures.

2. Based on my knowledge, no Responsible Portion in the Report contains any untrue statement of a material fact or omits to state a material fact necessary 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.

3. Nothing has come to my attention that causes me to believe that the financial statements, and other financial information included in the Report, do not fairly present in all material respects the financial condition, results of operations and cash flows of ServiceMaster as of, and for, the periods presented in the Report.

4. ServiceMaster's Chief Executive Officer, Chief Financial Officer, other officers and I are responsible for establishing and maintaining disclosure controls and procedures for ServiceMaster and:

   a) we have designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to ServiceMaster, including its consolidated subsidiaries, is made known to us by others within ServiceMaster and such subsidiaries, particularly during the period in which the Report is being prepared;

   b) we have evaluated the effectiveness of ServiceMaster's disclosure controls and procedures and presented in the Report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by the Report based on such evaluation; and

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c) nothing has come to my attention that causes me to believe that we have not disclosed in the Report any change in ServiceMaster's internal control over financial reporting that occurred during ServiceMaster's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, ServiceMaster's internal control over financial reporting.

5. I understand that ServiceMaster's Chief Executive Officer, Chief Financial Officer and other officers will disclose, based on their most recent evaluation of internal control over financial reporting, to Deloitte & Touche LLP, ServiceMaster's auditors ("Deloitte"), and the Audit and Finance Committee of ServiceMaster's Board of Directors:

a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect ServiceMaster's ability to record, process, summarize and report financial information; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in ServiceMaster's internal control over financial reporting.

Except as set forth on the Audit and Finance Committee Disclosure Form attached as Exhibit B, there are no significant deficiencies or material weaknesses in our internal control over compliance with laws and regulations that result in significant deficiencies or material weaknesses in the design and operation of internal control over financial reporting which are reasonably likely to adversely affect ServiceMaster's ability to record, process, summarize and report financial information and there has been no fraud involving management or other employees who have a significant role in internal control over financial reporting.

I have reviewed the Legal Department Report on Disclosure Controls and Procedures and have concluded that ServiceMaster's disclosure controls and procedures provide reasonable assurance that ServiceMaster can meet its disclosure obligations regarding non-financial matters.

I also confirm that the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934.

In providing this letter, I confirm that I have made investigations and have relied upon sources, with a good faith basis for such reliance, which were necessary or useful with respect to matters for which I do not have direct knowledge or expertise, inquiries of individuals who report to me and/or inquiries of individuals who have (or whom I reasonably believe have) knowledge of such matters.

This letter is being delivered in order to provide factual support for the certifications being made in the Report by the Chief Executive Officer and Chief Financial Officer of ServiceMaster.

Very truly yours,

____

Jim L. Kaput
Senior Vice President and General Counsel

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EXHIBIT A

Name of Report	Portion of Report Reviewed	Responsible Party	Additional Responsible Parties
Quarterly Report on Form 10-Q for the Quarter Ended June 30, 2004	**PART I** Item 1. Financial Statements	DAO	WHU
	Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	DAO/JLK	WHU/HAT
	Item 3. Quantitative and Qualitative Disclosures About Market Risk	DAO/ERZ	WHU
	Item 4. Controls and Procedures	DAO/JLK	CLK/HAT
	PART II Item 1. Legal Proceedings	JLK	TEW
	Item 2. Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities	ERZ/JLK	BER/HAT
	Item 3. Defaults Upon Senior Securities	ERZ/JLK	BER/HAT
	Item 4. Submission of Matters to a Vote of Security Holders	JLK	SLG
	Item 5. Other Information	DAO/JLK	WHU/HAT
	Item 6. Exhibits and Reports on Form 8-K	DAO/JLK	WHU/HAT

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EXHIBIT B

AUDIT AND FINANCE COMMITTEE DISCLOSURE FORM	
Significant Deficiencies:	
Material Weaknesses:	

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August __, 2004

The ServiceMaster Company
3250 Lacey Road, Suite 600
Downers Grove, IL 60515
Attn: Chief Executive Officer
Chief Financial Officer

Re: Quarterly Report on Form 10-Q for the quarter ended June 30, 2004

Ladies and Gentlemen:

I am the Vice President, Internal Audit of The ServiceMaster Company ("ServiceMaster"). I address this letter to ServiceMaster in connection with ServiceMaster's obligation under Section 13(a) of the Securities Exchange Act of 1934 to file with the Securities and Exchange Commission a Quarterly Report on Form 10-Q for the quarter ended June 30, 2004 (the "Report").

Management of ServiceMaster and its subsidiaries is responsible for establishing and maintaining appropriate disclosure controls and procedures and internal control over financial reporting. The responsibility of Internal Audit is to audit, on a test basis, disclosure controls and procedures and internal control over financial reporting to: (i) provide reasonable assurances that ServiceMaster's disclosure controls and procedures are designed to ensure that material information relating to ServiceMaster, including its consolidated subsidiaries, is made known to ServiceMaster's Chief Executive Officer, Chief Financial Officer and others within ServiceMaster and its subsidiaries; (ii) identify whether there are any significant deficiencies or material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect ServiceMaster's ability to record, process, summarize and report financial information; and (iii) review any change in ServiceMaster's internal control over financial reporting that has been reported to us as having occurred during ServiceMaster's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, ServiceMaster's internal control over financial reporting. During the period commenced April 1, 2004 through June 30, 2004, Internal Audit has completed, or has pending, the following activities:

[Insert activities]

Based upon the foregoing:

1. In connection with the preparation of this letter, I have reviewed the Report.

2. Based on our activities described above and my review of the Report, nothing has come to my attention, except as noted on Exhibit A where the total effect of any deficiency or adjustment cannot be quantified at this time, that causes me to believe that:

    a) the Report, including Part I, Item 4 of the Report, contains any untrue statement of a material fact or omits to state a material fact necessary 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;

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b) the financial statements, and other financial information included in the Report, do not fairly present in all material respects the financial condition, results of operations and cash flows of ServiceMaster as of, and for, the periods presented in the Report;

c) the disclosure controls and procedures are not designed to ensure that material information relating to ServiceMaster, including its consolidated subsidiaries, is made known to ServiceMaster's Chief Executive Officer, Chief Financial Officer and other officers within ServiceMaster and such subsidiaries, particularly during the period in which the Report is being prepared;

d) the Report does not disclose any change in ServiceMaster's internal control over financial reporting that occurred during ServiceMaster's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, ServiceMaster's internal control over financial reporting;

e) ServiceMaster's Chief Executive Officer, Chief Financial Officer and other officers have not disclosed, based on their most recent evaluation of ServiceMaster's internal control over financial reporting, to Deloitte & Touche LLP, ServiceMaster's auditors, and the Audit and Finance Committee of ServiceMaster's Board of Directors:

(1) all significant deficiencies or material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect ServiceMaster's ability to record, process, summarize and report financial information; and

(2) any fraud, whether or not material, that involves management or other employees who have a significant role in ServiceMaster's internal control over financial reporting.

f) the Report does not fully comply with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934.

In providing this letter, I confirm that I have made investigations and have relied upon sources, with a good faith basis for such reliance, which were necessary or useful with respect to matters for which I do not have direct knowledge or expertise, inquires of individuals who report to me and/or inquires of individuals who have (or whom I reasonably believe have) knowledge of such matters.

This letter is being delivered in order to provide factual support for the certifications being made in the Report by the Chief Executive Officer and Chief Financial Officer of ServiceMaster.

Very truly yours,

____

Marsha L. Lauck
Vice President, Internal Audit

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EXHIBIT A

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August __, 2004

The ServiceMaster Company
3250 Lacey Road, Suite 600
Downers Grove, IL 60515
Attn: Senior Vice President and General Counsel

Re: Quarterly Report on Form 10-Q for the quarter ended June 30, 2004

Ladies and Gentlemen:

I am the Vice President and General Counsel of The TruGreen Companies L.L.C. ("TruGreen"), an indirect subsidiary of The ServiceMaster Company ("ServiceMaster"). I address this letter to ServiceMaster in connection with ServiceMaster's obligation under Section 13(a) of the Securities Exchange Act of 1934 to file with the Securities and Exchange Commission a Quarterly Report on Form 10-Q for the quarter ended June 30, 2004 (the "Report").

1. In connection with the preparation of this letter, I have reviewed the portions of the Report that are identified on the attached Exhibit A as being the responsibility of the Business Unit General Counsel (the "Responsible Portions"). In my review I have assumed responsibility, along with other officers of TruGreen, for the Responsible Portions only to the extent such Responsible Portion applies to TruGreen.

2. Based on my knowledge, no Responsible Portion in the Report contains any untrue statement of a material fact relating to TruGreen or omits to state a material fact relating to TruGreen necessary 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.

3. I have provided to my Business Unit Chief Financial Officer all information and materials necessary to appropriately reserve, accrue or disclose for contingent liabilities related to outstanding litigation, fines, penalties, regulatory or enforcement actions in accordance with Statement of Accounting Standards No. 5.

4. I understand that ServiceMaster's Chief Executive Officer, Chief Financial Officer and other officers of ServiceMaster and its subsidiaries, including TruGreen, are responsible for establishing and maintaining disclosure controls and procedures for ServiceMaster and its subsidiaries. Officers of TruGreen, including myself, are responsible for establishing and maintaining disclosure controls and procedures for TruGreen have:

   a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to TruGreen is made known to us by others within TruGreen, particularly during the period in which the Report is being prepared; and

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b) presented to ServiceMaster our written description of TruGreen's disclosure controls and procedures.

5. I understand that ServiceMaster's Chief Executive Officer, Chief Financial Officer and other officers will disclose, based in part on TruGreen's most recent evaluation of TruGreen's internal control over financial reporting, to Deloitte & Touche LLP, ServiceMaster's auditors ("Deloitte"), and the Audit and Finance Committee of ServiceMaster's Board of Directors:

   a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect ServiceMaster's ability to record, process, summarize and report financial information; and

   b) any fraud, whether or not material, that involves management or other employees who have a significant role in ServiceMaster's and its subsidiaries' internal control over financial reporting.

   Except as set forth on the Audit and Finance Committee Legal Disclosure Form attached as Exhibit B, there are no significant deficiencies or material weaknesses in our compliance with laws and regulations that result in significant deficiencies or material weaknesses in the design and operation of internal control over financial reporting which are reasonably likely to adversely affect ServiceMaster's ability to record, process, summarize and report financial information and there has been no fraud involving management or other employees who have a significant role in internal control over financial reporting.

In providing this letter, I confirm that I have made investigations and have relied upon sources, with a good faith basis for such reliance, which were necessary or useful with respect to matters for which I do not have direct knowledge or expertise, inquiries of individuals who report to me and/or inquiries of individuals who have (or whom I reasonably believe have) knowledge of such matters.

This letter is being delivered in order to provide factual support for the certifications being made by ServiceMaster's General Counsel.

Very truly yours,

Name (please print):___________________________
Title (please print): ___________________________

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EXHIBIT A

Name of Report	Portion of Report Reviewed	Business Unit Responsible Party
Quarterly Report on Form 10-Q for the Quarter Ended June 30, 2004	**PART I** Item 1. Financial Statements	N/A
	Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	Business Unit Chief Financial Officer/ Business Unit General Counsel
	Item 3. Quantitative and Qualitative Disclosures About Market Risk	N/A
	Item 4. Controls and Procedures	Business Unit Chief Financial Officer/ Business Unit General Counsel
	PART II Item 1. Legal Proceedings	Business Unit General Counsel
	Item 2. Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities	N/A
	Item 3. Defaults Upon Senior Securities	N/A
	Item 4. Submission of Matters to a Vote of Security Holders	N/A
	Item 5. Other Information	N/A
	Item 6. Exhibits and Reports on Form 8-K	N/A

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EXHIBIT B

AUDIT AND FINANCE COMMITTEE LEGAL DISCLOSURE FORM	
Business Unit:	
Date of Disclosure:	
Means of Disclosure:	
Matter Type:	
Status:	

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The ServiceMaster Company
Disclosure Committee Charter
(May 2004)

Purpose

The purpose of the Disclosure Committee (the "Committee") of The ServiceMaster Company ("ServiceMaster") is to assist the Chief Executive Officer and Chief Financial Officer of ServiceMaster in their certification obligations under Section 302 of the Sarbanes-Oxley Act of 2002 through administering and maintaining disclosure controls and procedures that ensure the information required to be disclosed in any reports filed or submitted under the Securities Exchange Act of 1934 (the "Exchange Act") is recorded, processed, summarized and reported appropriately and within the time periods required.

Composition of Committee

The Committee shall be comprised of:

- The General Counsel;
- The Chief Financial Officer;
- The Controller;
- The Senior Vice President, Communications;
- The Vice President, Investor Relations; and
- Other officers and/or employees as deemed appropriate by the Committee.

The Committee shall designate a chairperson from among the Committee members.

Meetings

The Committee shall meet with such frequency and at such intervals as it shall determine is necessary to carry out its duties and responsibilities, but in any case, not less than one meeting per quarter in advance of each annual and quarterly Exchange Act report.

The chairperson will preside, when present, at all meetings of the Committee. The Committee may meet by telephone. Two-thirds of the Committee members must be in attendance for a meeting to be held. The Committee shall be authorized to take any permitted action only by the affirmative vote of a majority of the Committee members present at any meeting at which two-thirds of the Committee membership is present.

The Committee shall maintain copies of minutes of each meeting of the Committee reflecting the actions so authorized or taken by the Committee. A copy of the minutes of each meeting shall be maintained by the Company's legal department.

Duties and Responsibilities

The Committee shall:

1. Assist the Chief Executive Officer and Chief Financial Officer in their certification obligations under Section 302 of the Sarbanes-Oxley Act of 2002.

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2. Meet in person regularly as is necessary to carry out its duties and responsibilities, but in any case, not less than one meeting per quarter in advance of the filing of each annual and quarterly Exchange Act report for the purpose of reviewing the process for preparing and completing each annual and quarterly Exchange Act report, including the process by which ServiceMaster's disclosures are recorded, processed, summarized and reported.

3. At least annually review ServiceMaster's disclosure controls and procedures for financial and non-financial disclosures, taking into account the provisions of the Exchange Act, the Sarbanes-Oxley Act of 2002 and the NYSE listing standards, and any other sources that the Committee deems appropriate.

4. Consider as necessary specific questions regarding the materiality and timing of information for disclosure.

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THE SERVICEMASTER COMPANY
AUDIT AND FINANCE COMMITTEE
FINANCIAL EXPERT WORKSHEET
(December 2003)

Beginning with our Form 10-K to be filed in March 2004, ServiceMaster must disclose whether at least one member of the Audit and Finance Committee ("AFC") meets the definition of an "audit committee financial expert" as defined under SEC regulations. In addition, the NYSE listing standards require that at least one member of the AFC have accounting or related financial management expertise. However, we can rely on the "audit committee financial expert" determination for purposes of satisfying the NYSE listing standards. Please complete, sign, date and fax a copy of the Worksheet to Sandy Groman (see fax number below) by January 9, 2004. If necessary, please provide further explanation on a separate sheet of paper. The completed Worksheets will be reviewed by the AFC at its January 29, 2004 meeting. Upon recommendation by the AFC, the Board will determine whether at least one member of the AFC meets the definition of an "audit committee finance expert" at its January 30, 2004 meeting.

* * * * * *

1. The SEC defines an "audit committee financial expert" as a person who has **all** of the following **five attributes**. Please check each box that applies:

	Yes	No
(a) Do you have an understanding of generally accepted accounting principles and financial statements?	☐	☐
(b) Do you have the ability to assess the general application of generally accepted accounting principles in connection with the accounting for estimates, accruals and reserves?	☐	☐
(c) Do you have experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by ServiceMaster's financial statements, or experience actively supervising one or more persons engaged in such activities?	☐	☐
(d) Do you have an understanding of internal controls and procedures for financial reporting?	☐	☐
(e) Do you have an understanding of audit committee functions?	☐	☐

If you answered yes to any of the above questions, please check each box that applies and explain how you acquired the attribute(s):

☐	Education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions.
☐	Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions.
☐	Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements.
☐	Other relevant experience.

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Explanation (including relevant positions, organizations, dates and job duties):

2. Please describe your financial and accounting education (i.e., undergraduate, graduate, and post-graduate education), including the name of the institution and the type of degree(s) you received:

Institutions	Finance and/or Accounting Degrees	Year Degree Received

If your degree(s) are not in a finance or accounting field, have you taken courses in finance or accounting?

Yes ☐ No ☐

If your answer is yes, please list the title of the course(s) and the institution(s) that administered the course(s) and state the approximate number of hours that you participated in the course(s):

Course Title	Institution	Hours

3. Have you taught any course(s) relating to financial or accounting matters?

Yes ☐ No ☐

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If your answer is yes, please describe:

4. Do you hold any financial or accounting-related professional certificates or licenses?

Yes ☐ No ☐

If your answer is yes, please list the certificates and licenses that you have received, the year you received them and the requirements (if any) to maintain such certificates and licenses:

Financial or Accounting-Related Certificates/Licenses	Year of Receipt	Requirements to Maintain the Certificates and Licenses

5. Are you a member in good standing of a financial or accounting-related professional association?

Yes ☐ No ☐

If your answer is yes, please list any financial or accounting-related professional associations of which you are a member, including for how long you have been a member in good standing of such associations:

Financial or Accounting-Related Professional Associations	Member Since

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6. Please identify any other public company on which you serve or have served as a member of such public company's audit committee, including a description of how long you have served in that capacity:

7. Please describe any other relevant qualifications or experience you have that would assist you in understanding and evaluating ServiceMaster's financial statements and other financial information:

* * * * * *

Signed By: ____________________________

Name: ____________________________

Date: ____________________________

PLEASE FAX THE COMPLETED WORKSHEET TO SANDY GROMAN BY JANUARY 9, 2004

Fax Number: 630-663-2020

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PUBLIC ACCOUNTING FIRM POLICY
THE SERVICEMASTER COMPANY
(adopted October 24, 2002, revised July 17, 2003)

Purpose

The purpose of this Policy is to comply with Sections 201, 202, 203 and 206 of the Sarbanes-Oxley Act of 2002 (Sections 10A(g)-(j) and (l) of the Securities Exchange Act of 1934) and related regulations which govern the Company's relationship with its independent auditor.

Role of Audit and Finance Committee

In accordance with Rule 10A-3(b)(2) under the Securities Exchange Act of 1934, the Audit and Finance Committee (the "Committee") of the Board of Directors shall be directly responsible for the appointment, compensation, retention and oversight of the work of the Company's independent auditor engaged for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the Company. The Company's independent auditor shall report directly to the Committee.

Permitted Audit and Non-Audit Services Requiring Pre-approval

In accordance with Rule 2-01(c)(7) of Regulation S-X, and except for prohibited non-audit services as described in this Policy, the Committee shall pre-approve all audit and non-audit services proposed to be provided to the Company and/or its subsidiaries (collectively, the "Company") by the Company's independent auditor.

When presenting to the Committee a request to pre-approve any audit or non-audit service proposed to be provided by the Company's independent auditor, management of the Company should include in its presentation whether any such proposed service constitutes:

(1) an audit service, which may include (a) tax services, accounting consultations and other services to the extent such services are necessary to perform an audit or review in accordance with generally accepted auditing standards and (b) services that only the Company's independent auditor can reasonably provide, such as comfort letters, statutory audits, attest services required by law or regulation, consents, and assistance with and review of documents filed with the Securities and Exchange Commission;

(2) an audit-related service, which may include assurance and related services, such as employee benefit plan audits, due diligence related to mergers and acquisitions, accounting consultations and audits in connection with acquisitions, internal control reviews, attest services that are not required by law or regulation, and consultations concerning financial accounting and reporting standards;

(3) a tax service, which may include all services performed by professional staff of the tax division of the Company's independent auditor (except to the extent such services are audit services because they are necessary to perform an audit or review in accordance with GAAS), such as tax compliance (e.g., preparation of original and amended tax returns, claims for refund and tax payment planning) and tax planning and advice (e.g., assistance with tax audits and appeals, advice related to

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mergers and acquisitions, employee benefit plans and requests for rulings, and technical advice from taxing authorities); or

(4) any service other than an audit, audit-related or tax service.

The Committee may waive compliance with this pre-approval requirement with respect to any service (other than audit, review or attest services) provided by its independent auditor if:

(a) the aggregate amount of all services (other than audit, review or attest services) provided to the Company and its subsidiaries constitutes no more than five percent (5%) of the total amount of revenues paid by the Company to its independent auditor during the fiscal year in which the services are provided;

(b) the services were not recognized by the Company at the time of the engagement to be services; and

(c) the services are promptly brought to the attention of the Committee and approved prior to the completion of the audit by the Committee or by one or more members of the Committee who are members of the Board of Directors to whom authority to grant such approvals has been delegated by the Committee.

Delegation of Pre-approval Authority

In accordance with Rule 2-01(c)(7) of Regulation S-X, the Committee may delegate to one or more members of the Committee who are independent within the meaning of the Sarbanes-Oxley Act of 2002 and related regulations the authority to pre-approve audit and non-audit services proposed to be provided to the Company or its subsidiaries by the Company's independent auditor.

Each member of the Committee to whom authority is delegated under this Policy shall exercise such authority under circumstances which the member believes are necessary or appropriate and, in such case, the member shall present his or her pre-approval decisions to the Committee.

Prohibited Non-Audit Services

In accordance with Rule 2-01(c)(4) of Regulation S-X, the Company's independent auditor shall not provide, and none of the Board of Directors, the Committee or any director shall pre-approve, approve or ratify the following non-audit services:

(1) bookkeeping or other services related to the Company's accounting records or financial statements;

(2) financial information systems design and implementation;

(3) appraisal or valuation services, fairness opinions or contribution-in-kind reports;

(4) actuarial services;

(5) internal audit outsourcing services;

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(6) management functions, including acting as a director, officer or employee of the Company or performing any decision-making, supervisory or ongoing monitoring function;

(7) human resource services, including searching for candidates for managerial, executive or director positions, engaging in testing or evaluation programs or undertaking reference checks for executive or director positions, acting as a negotiator for the Company, or recommending a specific candidate (other than advising the Company on a candidate's competence for financial accounting, administrative or control positions);

(8) broker or dealer, investment adviser or investment banking services;

(9) legal services;

(10) expert services unrelated to the audit, including providing an expert opinion for the Company for the purpose of advocating the Company's interests in litigation or in a regulatory or administrative proceeding or investigation; and

(11) any other service that is prohibited by law, rule or regulation.

Notwithstanding the foregoing, the services identified in subsections (1)-(5) above may be provided by the Company's independent auditor if, after receiving written advice from the Company's independent auditor that the independent auditor concludes that the results of any such service will not be subject to audit procedures during an audit of the Company's financial statements, the Committee pre-approves such service in accordance with this Policy.

Prohibition on Contingent Fees

In accordance with Rule 2-01(c)(5) of Regulation S-X, the Company shall not pay or become obligated to pay any contingent fee or commission to the Company's independent auditor.

Disclosure of Policy and Services

The Company will disclose in its proxy statement this Policy (or a description of this Policy) and audit and non-audit services approved by the Committee or one or more members of the Committee.

Audit Partner Rotation

In accordance with Rule 2-01(c)(6) of Regulation S-X, the Company's independent auditor shall not provide audit, review or attest services to the Company if:

(1) the lead audit partner of the Company's independent auditor having primary responsibility for the audit or review of the Company and its subsidiaries performs the services of a lead partner or concurring partner for more than five consecutive years;

(2) the audit partner of the Company's independent auditor having responsibility for performing a second level of review to provide additional assurance that the Company's financial statements are in conformity with generally accepted accounting principles and the audit or review and any associated

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report are in accordance with generally accepted auditing standards and rules performs the services of a lead partner or concurring partner for more than five consecutive years;

(3) any audit partner of the Company's independent auditor (other than the lead or concurring partner) provides more than ten hours of audit, review or attest services in connection with the Company's annual or interim consolidated financial statements or serves as the lead partner in connection with any audit or review related to the annual or interim financial statements of a subsidiary of the Company whose assets or revenues constitute 20% or more of the Company's consolidated assets or revenues for more than seven consecutive years;

(4) an audit partner of the Company's independent auditor performs the services of a lead partner or concurring partner for the maximum five-year period and performs the services of a lead partner or concurring partner within the following five-year period; or

(5) any audit partner of the Company's independent auditor provides services or serves as the lead partner in connection with a subsidiary's annual or interim financial statements for the maximum seven-year period (each as described in subsection (3) above) and provides any such services, serves as any such lead partner for such a subsidiary or performs the services of a lead or concurring partner within the following two-year period.

Restrictions on Employment

In accordance with Rule 2-01(c)(2) of Regulation S-X, the Company's independent auditor shall not provide audit, review or attest services to the Company or its subsidiaries if any of the members of the Company's Board of Directors, the Company's Chief Executive Officer, Chief Operating Officer, Chief Financial Officer, Controller, General Counsel, Vice President – Accounting and Business Practices or Treasurer was a partner, principal or shareholder of, or was employed by, the Company's independent auditor and participated as a member of the audit engagement team of the Company during the one-year period preceding the date the audit procedures commenced for the fiscal period that includes the date of initial employment by the Company of the audit engagement team member.

Review of Audit and Non-Audit Services

Management of the Company shall report periodically to the Committee on the scope of audit and non-audit services provided, to be provided and proposed to be provided to the Company and its subsidiaries by the Company's independent auditor.

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THE SERVICEMASTER COMPANY

Procedures Relating to Earnings Releases and Associated Earnings Conference Calls, SEC Filings, Investor Conferences and Discussions with Potential and Existing Stakeholders

(November 2003)

Purpose

The purpose of this Policy is to ensure that The ServiceMaster Company complies with Regulation G, Item 12 of Form 8-K, Item 10 of Regulation S-K and Regulation FD by establishing procedures relating to earnings releases and associated earnings conference calls, SEC filings, investor conferences and discussions with potential and existing stakeholders.

Use of Non-GAAP Financial Measures

As set forth in more detail below, it is ServiceMaster's policy to refrain from using a non-GAAP financial measure in connection with an earnings release and associated earnings conference call, SEC filing, investor conference and discussion with a potential or existing stakeholder, unless the Chief Financial Officer ("CFO"), Controller, General Counsel and Vice President – Investor Relations approve the use of such non-GAAP financial measure. If ServiceMaster uses a non-GAAP financial measure in connection with an earnings release and associated earnings conference call, SEC filing, investor conference or discussion with a potential or existing stakeholder, such use will comply with the requirements of Regulation G, Item 12 of Form 8-K and Item 10 of Regulation S-K.

Earnings Releases and Associated Earnings Conference Calls

ServiceMaster issues quarterly earnings releases which are accompanied by an earnings conference call. Each earnings conference call should be web cast live on ServiceMaster's website and archived on the website for at least 30 days. The earnings conference call should also be broadly accessible to the public by a call-in number and available through the call-in number for at least seven days. The following procedures should be followed in connection with each earnings release and earnings conference call:

Step 1: Issue a press release announcing the pending earnings release and associated earnings conference call at least two weeks prior to the issuance of the earnings release. The earnings conference call must be broadly accessible to the public by call-in number, by web cast, by broadcast or similar means. The press release should include:

- The date of release of the earnings results; and
- The details of any accompanying oral, telephonic, web cast, broadcast or similar presentation, including: the date and time of the earnings conference call; the call-in number; and the location of the information on ServiceMaster's website.

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Step 2: Issue earnings release on the scheduled date. If the earnings release includes a non-GAAP financial measure, the CFO, Controller, General Counsel and Vice President – Investor Relations should approve of the use of such non-GAAP financial measure. If circumstances warrant, the CFO, Controller and/or General Counsel may designate another person for review and approval purposes and, in all cases, review and approval must be conducted by at least one member each of the financial and legal departments. If the use of the non-GAAP financial measure is approved, the release must include:

- A presentation, with equal or greater prominence, of the most directly comparable GAAP financial measure; and
- A reconciliation, which must be quantitative for historical non-GAAP financial measures presented, and quantitative, to the extent available without unreasonable efforts, for forward-looking information, of the non-GAAP financial measure to the most directly comparable GAAP financial measure.

Step 3: Upon issuing the earnings release, ServiceMaster should furnish a Form 8-K under Item 12[1] no later than five calendar days after the date the press release is issued with the earnings release included as an exhibit "99".[2] However, in order to avoid furnishing on a separate Form 8-K any material nonpublic information regarding ServiceMaster's results of operations or financial condition that is complementary to, and that is provided as part of the earnings conference call:

- The Form 8-K must be furnished to the SEC prior to the start of the earnings conference call;
- The earnings conference call must occur within 48 hours after the earnings release; and
- The financial and other statistical information that will be provided during the earnings conference call must be posted on ServiceMaster's website prior to the start of the earnings conference call.

In addition, as to each non-GAAP financial measure used in the earnings release, ServiceMaster must disclose:

- The reasons why management believes that presentation of the non-GAAP financial measure provides useful information to investors regarding ServiceMaster's financial condition and results of operations; and

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[1] In order to limit ServiceMaster's liability under Section 11 and 12(a)(2) of the Securities Act of 1933 and Section 18 of the Securities Exchange Act of 1934, "furnishing" a Form 8-K to the SEC is required where available instead of "filing."

[2] Even though an Item 12 Form 8-K must be furnished no later than five calendar days after the date the earnings release is issued, it is ServiceMaster's policy to furnish the Form 8-K to the SEC prior to the start of the earnings conference call.

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- Any material additional purposes, for which management uses the non-GAAP financial measure.

The SEC permits these disclosures to be made:

- In the earnings release itself, which is furnished as an exhibit to the Form 8-K;
- In the body of the Form 8-K under Item 12; or
- In the most recent annual report on Form 10-K or in a subsequent filing subject to certain prohibitions as noted under Step 2 of SEC Filings (provided this disclosure is updated if necessary to ensure accuracy).

Step 4: Post the financial and other statistical information that will be provided during the earnings conference call on ServiceMaster's website (before the earnings conference call).

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ServiceMaster must provide on its website, at or prior to the start of the earnings conference call, the financial and other statistical information contained in the earnings conference call. If a non-GAAP financial measure is included in the financial or other statistical information, the information discussed in **Step 2** must also be posted on ServiceMaster's website. This information should remain on ServiceMaster's website for at least 12 months.

Step 5: Earnings conference call (within 48 hours after issuing the press release).

The earnings conference call must take place within 48 hours after the related press release is issued and the Form 8-K under Item 12 must be furnished to the SEC prior to the start of the earnings conference call. The earnings conference call must be broadly accessible to the public by dial-in number, by web cast, by broadcast or similar means. During the earnings conference call, ServiceMaster must communicate the location of the website where any non-GAAP financial measure will be available.

Step 6: Furnish a second Form 8-K (when applicable).

If (i) the earnings conference call is more than 48 hours after the issuance of the earnings press release, or (ii) the Form 8-K under Item 12 is not furnished to the SEC prior to start of the earnings conference call, or (iii) the financial and statistical information contained in the earnings conference call is not provided on ServiceMaster's website, or (iv) the information provided during the earnings conference call is not complementary to the earnings release, ServiceMaster must furnish a second Form 8-K containing the text of any announcement or release (or an update of an earlier announcement or release) disclosing material nonpublic information regarding ServiceMaster's results of operations or financial condition for a completed quarterly or annual fiscal

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period that is included in the earnings conference call. If a Form 8-K must be furnished, it should include:

- Text of that announcement or release;
- Financial and statistical information not furnished on the first Form 8-K, if any, which contained the earnings release; and
- Information relating to any non-GAAP financial measure used in the announcement or release or the financial and other statistical information, including:
    - A presentation, with equal or greater prominence, of the most directly comparable GAAP financial measure;
    - A reconciliation, which must be quantitative for historical non-GAAP financial measures presented, and quantitative, to the extent available without unreasonable efforts, for forward-looking information, of the non-GAAP financial measure to the most directly comparable GAAP financial measure;
    - The reasons why management believes that presentation of the non-GAAP financial measure provides useful information to investors regarding ServiceMaster's financial condition and results of operations; and
    - Any material additional purposes, for which management uses the non-GAAP financial measure.

Step 7: After the conclusion of the earnings conference call and question and answer session, confirm that ServiceMaster complied with Regulation FD and Regulation G.

The Vice President – Investor Relations must confirm with the Controller and General Counsel (or a designee) that ServiceMaster complied with Regulation FD and Regulation G. If a presenter made an unintentional disclosure of material nonpublic information or disclosed a non-GAAP financial measure, ServiceMaster must furnish a Form 8-K to the SEC.

SEC Filings

ServiceMaster files quarterly reports on Form 10-Q, an annual report on Form 10-K and current reports on Form 8-K with the SEC ("SEC Filings"). The following procedures should be followed in connection with each SEC Filing.

Step 1: Prepare a draft of the SEC Filing.

Form 10-Q: The finance department prepares a draft of the Form 10-Q with the legal department responsible for preparing a draft of the information required under Part II.

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Form 10-K: The legal department prepares a draft of the Form 10-K with the finance department responsible for preparing a draft of the information required under Part II.

Form 8-K: As general rule, the finance department is responsible for notifying the legal department of Form 8-K's under Items 2, 4, 5[3] and 7. The legal department is responsible for notifying the finance department of Form 8-K's under Items 1, 3, 5, 6, 8, 9, 10, 11 and 12. The actual preparation of the Form 8-K is determined based on subject matter. All Form 8-K's must be reviewed by the finance and legal departments. The following sets forth Items 1-12 of Form 8-K:

Form 8-K		**Responsible Party**
Item 1.	Change in Control	Legal Department
Item 2.	Acquisition or Disposition of Assets	Finance Department
Item 3.	Bankruptcy or Receivership	Legal Department
Item 4.	Changes in Certifying Accountant	Finance Department
Item 5.	Other Events and Regulation FD Disclosure	Finance/Legal Department
Item 6.	Resignations of Directors	Legal Department
Item 7.	Financial Statements and Exhibits	Finance Department
Item 8.	Change in Fiscal Year	Legal Department
Item 9.	Regulation FD Disclosure	Legal Department
Item 10.	Amendments to Code of Ethics or Waiver of a Provision of the Code of Ethics	Legal Department
Item 11.	Temporary Suspension of Trading Under Employee Benefit Plans	Legal Department
Item 12.	Results of Operations and Financial Condition	Legal Department

Annual Report to Shareholders: The communications department, working with the finance department, is responsible for preparing a draft of the Annual Report to Shareholders.

Step 2: Determine whether a non-GAAP financial measure is included in the SEC Filing.

If the SEC Filing includes a non-GAAP financial measure, determine whether the non-GAAP financial measure is prohibited under Item 10 of Regulation S-K. Item 10 prohibits the following at all times:[4]

[3] If a Form 8-K under Item 5 relates to financial information, the finance department is responsible for notifying the legal department of the Form 8-K.
[4] The prohibitions under Item 10 of Regulation S-K do not apply to a Form 8-K that is "furnished" to the SEC. Therefore, a Form 8-K under Item 12, including the earnings release 8-K, that is furnished to the SEC may include an Item 10 prohibition.

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- excluding charges or liabilities that require or will require cash settlement from non-GAAP liquidity measures (other than EBIT and EBITDA);
- adjusting a non-GAAP performance measure to eliminate or smooth items identified as non-recurring, infrequent or unusual, when the nature of the charge or gain is such that it is reasonably likely to recur within two years or there was a similar charge or gain within the prior two years;[5]
- presenting non-GAAP financial measures on the face of financial statements prepared in accordance with GAAP or in the accompanying notes;
- presenting non-GAAP financial measures on the face of any pro forma financial required by Article 11 of Regulation S-X; and
- using titles or descriptions for non-GAAP financial measures that are the same as or confusingly similar to title or descriptions of GAAP financial measures.

If the non-GAAP financial measure is prohibited under Item 10, **remove** the prohibited non-GAAP financial measure from the SEC Filing.

Step 3: If the SEC Filing includes a non-GAAP financial measure that is not prohibited under Item 10 of Regulation S-K, the CFO, Controller, General Counsel and Vice President – Investor Relations should approve of the use of such non-GAAP financial measure. If circumstances warrant, the CFO, Controller and/or General Counsel may designate another person for review and approval purposes and, in all cases, review and approval must be conducted by at least one member each of the financial and legal departments.

If the use of the non-GAAP financial measure is approved, the SEC Filing must include:

- A presentation, with equal or greater prominence, of the most directly comparable GAAP financial measure;
- A reconciliation, which must be quantitative for historical non-GAAP financial measures presented, and quantitative, to the extent available without unreasonable efforts, for forward-looking information, of the non-GAAP financial measure to the most directly comparable GAAP financial measure;

[5] In November 2003, ServiceMaster recorded a non-cash impairment charge. Further, ServiceMaster recorded a restructuring charge and non-cash impairment charge in the fourth quarter of 2001. Consequently, ServiceMaster is prohibited from excluding the impairment charge in its SEC Filings in order to eliminate or smooth operating performance. That being said, Question 8 of the SEC's Frequently Asked Questions Regarding the Use of Non-GAAP Financial Measures permits the use in SEC filings of a non-GAAP performance measure that is not identified as non-recurring, infrequent or unusual but only by satisfying strict requirements.

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- The reasons why management believes that presentation of the non-GAAP financial measure provides useful information to investors regarding ServiceMaster's financial condition and results of operations; and
- Any material additional purposes, for which management uses the non-GAAP financial measure.

Investor Conferences

ServiceMaster participates in various investor conferences throughout the year, including an annual ServiceMaster Investors Day. Each investor conference should be web cast live on ServiceMaster's website and archived on the website for at least 30 days. In addition, the presentation should be posted on ServiceMaster's website prior to the start of the investor conference. The following procedures should be followed in connection with each investor conferences:

Step 1: Finalize presentation.

In advance of any investor conference, the CFO, Controller, General Counsel and Vice President – Investor Relations should review and approve the presentation. If circumstances warrant, the CFO, Controller and/or General Counsel may designate another person for review and approval purposes and, in all cases, review and approval must be conducted by at least one member each of the financial and legal departments.

- Typically ServiceMaster discloses material nonpublic information regarding ServiceMaster's results of operations or financial condition, including for completed fiscal periods and projections of future performance through quarterly and year-end earnings releases. However, if the presentation contains any previously undisclosed material information regarding ServiceMaster's results of operations or financial condition for a completed fiscal period, ServiceMaster must furnish a Form 8-K under Item 12 no later than five calendar days after the date of the public disclosure with the presentation included as an exhibit "99" (unless the disclosure is complementary to and occurs within 48 hours after a written press release that is furnished on Form 8-K prior to the start of the investor conference). **See Step 3.**

- If the presentation contains any previously undisclosed material information that does not relate to ServiceMaster's results of operations or financial condition for a completed fiscal period, such as a projection of future performance, ServiceMaster must furnish a Form 8-K under Item 9 no later than five calendar days after the date of the public disclosure with the presentation included as an exhibit "99". **See Step 3.**

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- If the presentation contains a non-GAAP financial measure, ServiceMaster must post the following information on its website prior to the start of the investor conference:

  - A presentation of the most directly comparable GAAP financial measure;[6] and
  - A reconciliation, which must be quantitative for historical non-GAAP financial measures presented, and quantitative, to the extent available without unreasonable efforts, for forward-looking information, of the non-GAAP financial measure to the most directly comparable GAAP financial measure.

  The location and availability of the information must be disclosed during the presentation. In addition, if the presentation will be furnished under Item 12 of Form 8-K, include:

  - The reasons why management believes that presentation of the non-GAAP financial measure provides useful information to investors regarding ServiceMaster's financial condition and results of operations; and
  - Any material additional purposes, for which management uses the non-GAAP financial measure.

Step 2: Issue a press release announcing the web cast of the investor conference at least 24 hours prior to the start of the investor conference. The press release should include:

- The date and time of the investor conference; and
- The details of any accompanying oral, telephonic, web cast, broadcast or similar presentation, including: the date and time of the presentation; the call-in number; and the location of the information on ServiceMaster's website.

Step 3: Furnish a Form 8-K under Item 9 or 12 with the presentation included as an exhibit "99" if a determination is made that the presentation contains any:

- Previously undisclosed material information regarding ServiceMaster's results of operations or financial condition for a completed fiscal period; or

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[6] Regulation G requires a presentation of the most directly comparable GAAP financial measure. However, if the presentation is furnished as an exhibit "99" under Item 12 of Form 8-K as set forth in **Step 3**, the Form 8-K must include a presentation, with equal or greater prominence, of the most directly comparable GAAP financial measure.

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- Previously undisclosed material information that does not relate to ServiceMaster's results of operations or financial condition for a completed fiscal period.

The Vice President – Investor Relations must email the presentation to the finance department as soon as practicable.[7] The legal department must prepare and provide the finance department with the Form 8-K. If the presentation is less than 15 PowerPoint slides, the finance department furnishes the Form 8-K to the SEC, otherwise, the finance department emails the Form 8-K and presentation to a third party provider (e.g., Merrill Corporation) to be edgarized and furnished to the SEC prior to the start of the investor conference.[8]

Step 4: After the conclusion of the investor conference, confirm that ServiceMaster complied with Regulation FD and Regulation G.

The Vice President – Investor Relations must confirm with the Controller and General Counsel (or a designee) that ServiceMaster complied with Regulation FD and Regulation G. If a presenter made an unintentional disclosure of material nonpublic information or disclosed a non-GAAP financial measure, ServiceMaster must furnish a Form 8-K to the SEC.

Discussions with Potential and Existing Stakeholders

ServiceMaster participates in various discussions with potential and existing stakeholders throughout the year. Such discussions may immediately follow an investor conference. The CFO or Vice President – Investor Relations attempt to be present at each meeting to ensure compliance with Regulation FD and Regulation G. If a presenter made an unintentional disclosure of material nonpublic information or disclosed a non-GAAP financial measure, ServiceMaster must furnish a Form 8-K to the SEC. **See previous steps.**

[7] Edgarizing a PowerPoint presentation is an extremely time consuming process. In order to ensure that the Form 8-K is furnished timely to the SEC, it is important that the finance department receive the final presentation as soon as practicable.
[8] Even though Item 9 and 12 Form 8-K's must be furnished no later than five calendar days after the date of the public disclosure, it is ServiceMaster's policy to furnish the Form 8-K to the SEC prior to the start of the investor conference.

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THE SERVICEMASTER COMPANY

FINANCIAL CODE OF ETHICS
(approved by Governance and Nominating Committee on March 4, 2004)

ServiceMaster is committed to maintaining high standards related to our accounting and reporting processes and internal accounting controls. This commitment must be supported by the high ethical standards of our financial employees. This Financial Code of Ethics embodies these principles and has been approved pursuant to ServiceMaster's Financial Code of Ethics Policy.

While ServiceMaster expects all financial employees to adhere to these principles, our financial leaders play a key role in ensuring compliance with these principles. As such, individuals holding the following positions shall acknowledge in writing his or her responsibility for adherence to the Financial Code of Ethics:

- Chief Executive Officer
- President
- Chief Financial Officer
- Controller
- Assistant Controller(s)
- Treasurer
- Business Unit President
- Business Unit Chief Financial Officers
- Other key financial or accounting employee as may be designated by the Chief Executive Officer, President or Chief Financial Officer

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As an employee covered by this Financial Code of Ethics, I will:

- Act with honesty and integrity in my professional relationships. I will promote and be an example of ethical behavior as a responsible partner among my peers and subordinates in the work environment;

- Avoid conflicts of interest. In doing so, I will ethically handle any actual or apparent conflict of interest in personal and professional relationships and will promptly disclose to the ServiceMaster General Counsel the nature of any transaction or relationship that reasonably could be expected to give rise to such a conflict of interest;

- Provide full, fair, accurate, timely and understandable financial disclosures in documents filed with, or submitted to, the Securities and Exchange Commission, any other government agency or self-regulatory organization, or used in other public communications. Any accounting records for which I am responsible that underlie the financial statements included in these disclosures will be prepared in accordance with generally accepted accounting principles applied consistently with the principles used to prepare the audited financial statements;

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The ServiceMaster Company
Financial Code of Ethics

- Comply with applicable laws, rules and regulations of federal, state, provincial and local governments, the Securities and Exchange Commission, the New York Stock Exchange, and other applicable private and public regulatory agencies;
- Act in good faith, responsibly, with due care, competence and diligence, and without misstating, misrepresenting or omitting material facts or circumstances or allowing my independent judgment to be subordinated;
- Maintain the confidentiality of information acquired in the course of my work, except where disclosure is authorized and appropriate to carry out my assigned responsibilities, or where I am otherwise legally obligated to disclose such information. I will not use confidential information acquired in the course of my work for personal advantage;
- Responsibly use and control assets and other resources employed or entrusted to my supervision;
- Maintain professional skills and share knowledge with my peers and subordinates to enable me to carry out my assigned responsibilities and obligations;
- Not improperly or fraudulently influence, coerce, manipulate, or mislead any authorized audit or interfere with any auditor engaged in the performance of an internal or independent audit of the ServiceMaster financial statements or accounting books and records;
- Report questionable accounting, internal accounting control, auditing or fraud matters, or allegations of non-compliance with this Financial Code of Ethics to management. If I do not feel that any such issues raised have been resolved appropriately, I will report my concerns to any member of the ServiceMaster Board of Directors, or by using the Compliance Helpline as provided in the ServiceMaster Code of Ethics and Business Conduct; and
- Be accountable for my actions and decisions. I acknowledge that failure to adhere to this Financial Code of Ethics or to the ServiceMaster Code of Ethics and Business Conduct may result in disciplinary action, up to and including termination.

______________________	______________________
Signature	Business Unit
Name	Date
Title	

NOTE – A signed copy of this Financial Code of Ethics for each of the applicable employee, as listed above, must be returned by regular mail or facsimile to Sandy Groman with the ServiceMaster Legal Department, 3250 Lacey Road, Suite 600, Downers Grove, IL 60515 (Fax: 630-663-2020).

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Code of Conduct

(available on www.svm.com under "Corporate Governance")

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COMPLIANCE HELPLINE POLICY

THE SERVICEMASTER COMPANY
(approved by Audit and Finance Committee on January 29, 2004)

Purpose

The purpose of the Compliance Helpline Policy ("Policy") is to establish a confidential means for employees of ServiceMaster or other persons to communicate to management any concerns that they may have regarding compliance with laws, regulations, policies or the ServiceMaster Code of Conduct. While employees are generally encouraged to use the chain-of-command to obtain answers to questions or concerns, a Compliance Helpline ("Helpline") provides an alternative in the event that employees are uncomfortable in discussing the issue with their supervisor or manager, or where they continue to have lingering concerns after receiving a response. In addition, the Helpline provides persons who are not employees with a means to communicate their concerns.

Legal Requirements

Rule 10A-3(b)(3) under the Securities Exchange Act of 1934 requires the Audit and Finance Committee ("AFC") to establish procedures for:

- The receipt, retention and treatment of complaints received by ServiceMaster regarding accounting, internal accounting controls, or auditing matters; and
- The confidential, anonymous submission by employees of ServiceMaster of concerns regarding questionable accounting and auditing matters.

Rule 13a-14(a) of the Securities Exchange Act of 1934 requires the Chief Executive Officer and Chief Financial Officer to disclose to ServiceMaster's auditors and to the AFC fraud matters that involve management or other employees who have a significant role in ServiceMaster's internal control over financial reporting. This would include fraud matters identified through the Compliance Helpline that meet this criterion.

Complaints, concerns and allegations are collectively referred to as a "matter" or "matters".

Role of the Audit and Finance Committee

The AFC oversees the design and operation of the Helpline, including the following:

- The Corporate Compliance Officer reports twice each year to the AFC regarding the operation of the Helpline. This report shall include a summary of the volume and nature of matters received. Additional detail shall be provided for any matters regarding accounting, internal accounting control, or auditing, including any allegation or discovery of fraud.

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- The Chairman of the AFC shall be notified via email within one business day of the receipt of any matter regarding accounting, internal accounting controls, auditing or fraud. Any matter of this nature, along with the status of management's response and findings, shall be reported to the AFC in a supplemental report at each regularly scheduled Board meeting.
- The Chairman of the AFC will have access to the Helpline database.

Submission of Complaints, Concerns and Allegations

The Helpline provides a means for employees and other persons to communicate in a confidential manner. It includes a toll-free telephone number, a fax number, a mailing address and an email address.

All information received through the Helpline will be kept confidential to the extent possible. However, limited disclosure may be necessary where required by law or where needed to investigate and adequately respond to a complaint, concern or allegation. Any request for anonymity will be strictly observed.

Internal Communication of Complaints, Concerns and Allegations

The third-party administrator shall notify the appropriate ServiceMaster Helpline Coordinator (as identified by ServiceMaster management) within 24 hours of receipt of a matter. Depending on the nature of the matter, the ServiceMaster Corporate Compliance Officer and / or AFC Chairman will also be notified via email regarding receipt of the matter. The Helpline Coordinator shall be responsible for assigning the matter to the appropriate party for investigation and resolution. The Helpline Coordinator shall also be responsible for monitoring the status of any outstanding matters assigned to them in order to ensure follow-up on in a timely manner.

The following table shall be used to determine how communications received will be disseminated for investigation and resolution:

- Accounting, Internal Accounting Control, Auditing and Fraud Matters

  Helpline Coordinator Corporate Compliance Officer
  Email notification Audit and Finance Committee Chairman

- Matters regarding the Corporate Compliance Officer or his/her staff

  Helpline Coordinator Audit and Finance Committee Chairman

- All Other Issues

  Helpline Coordinator Business Unit Designee
  Email notification Corporate Compliance Officer

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Investigation of Matters

Management shall investigate matters in accordance with ServiceMaster's Policy Regarding Internal Investigations.

Prohibition of Retaliation

ServiceMaster prohibits retaliation against any employee or other person who raises a matter in good faith. Anyone who retaliates against an employee or other person who has raised a matter in good faith may be subject to disciplinary action, up to and including termination of employment.

False reporting is also prohibited. Any employee who intentionally makes false or misleading allegations may be subject to disciplinary action, up to and including termination of employment.

Employee Awareness

ServiceMaster shall take reasonable efforts to ensure that employees are aware of the Helpline and are encouraged to use it as appropriate. These steps shall include discussion of the Helpline in the Code of Conduct, which will be made available to all employees and will be posted on the ServiceMaster website. Other methods of ongoing awareness communication and/or training shall be implemented as appropriate in each business unit.

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The ServiceMaster Company
(November 10, 2003)
Legal Ethics Policy for Practicing Attorneys

INTRODUCTION

The ServiceMaster Company (the "Company") relies upon its inside and outside counsel to play an important role in assisting the Company in its efforts to comply with the law and adhere to the highest ethical standards. This policy applies to inside counsel to the Company, and addresses the appropriate steps to be taken in the situation when an attorney becomes aware of a potential violation of the law relating to the business of the Company. This policy also describes the Company's policy with respect to the receipt from outside counsel of reports of matters under applicable ethical standards.

Prior to the enactment of the Sarbanes-Oxley Act of 2002, all attorneys were required to follow the professional standards established by the state or other jurisdiction in which they practiced in connection with reporting instances of potential corporate wrongdoing. In the United States, these standards are primarily based on the American Bar Association's Model Rules of Professional Conduct (the "Model Rules") and are still in effect for all attorneys. Subject to such modifications as applicable states or other jurisdictions may impose, all attorneys are expected to report violations to a higher authority in the corporate hierarchy pursuant to Model Rule 1.13 and to maintain client confidences pursuant to Model Rule 1.6. Under Section 307 of the Sarbanes-Oxley Act ("Section 307"), the Securities and Exchange Commission (the "Commission") issued separate rules of conduct for attorneys "appearing and practicing before the Commission" which impose additional obligations on attorneys. Effective August 5, 2003, the Commission enacted 17 CFR Part 205 establishing minimum standards of professional conduct for attorneys appearing and practicing before the Commission. This policy is designed to be responsive to the requirements of Section 307, as well as the Model Rules or other applicable standards implemented by jurisdictions in which counsel to the Company practices, while at the same time preserving attorney-client privilege.

The obligations described in this policy are in addition to and are considered distinct from the obligations individuals subject to this policy may have under other policies of the Company, including compliance policies.

As used in this policy, each reference to the General Counsel means ServiceMaster's General Counsel and not the General Counsel of any business unit.

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I. IDENTIFICATION OF COVERED ATTORNEYS

A. Appearing and Practicing Before the Commission

An attorney is covered by the Section 307 rules if he or she is **"appearing and practicing before the Commission in the representation of an issuer and becomes aware of evidence of a material violation by the issuer or any officer, director, employee or agent of the issuer."**

Under the Section 307 rules, attorneys appearing and practicing before the Commission consist of all attorneys:

1. Transacting business with the Commission, including communications in any form;
2. Representing the Company in a Commission administrative proceeding or in connection with any Commission investigation, inquiry, information request or subpoena;
3. Providing advice with respect to the U.S. securities laws or the Commission's rules and regulations thereunder regarding any document that the attorney has notice will be filed with or submitted to the Commission, or incorporated into any document filed with or submitted to the Commission, including providing such advice in the context of preparing, or participating in the preparation of, any such document; or
4. Advising the Company as to whether information or a statement, opinion or other writing is required under the U.S. securities laws or the Commission's rules and regulations thereunder to be filed with or submitted to the Commission, or incorporated into any document filed with or submitted to the Commission.

Covered attorneys need not be in the Company's legal department, although they must be providing legal services in the context of an attorney-client relationship with the Company. **The Company considers all attorneys providing legal services to subsidiaries of the Company to be providing legal services to the Company.** Foreign attorneys may also be subject to the Commission's rules to the extent that they do not conflict with applicable law in the jurisdiction in which the foreign attorney practices.

Because the Commission's definition of "appearing and practicing" is very broad and presents difficult interpretive questions, all inside attorneys should understand and comply with the Section 307 rules and this policy, regardless of whether they believe they are appearing and practicing before the Commission, and regardless of whether they regularly participate in securities law matters.

Inside attorneys other than the General Counsel should not attempt to determine whether they are appearing and practicing before the Commission. Instead, they should report and take other steps as required by this policy. The General Counsel, in conjunction with Company attorneys responsible for ensuring compliance with the Section 307 rules, will make the determination as to whether an attorney is appearing and practicing before the Commission.

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B. Supervising Attorneys

The General Counsel's office will designate a supervising attorney for each inside attorney subject to this policy. All inside attorneys not designated as supervising attorneys are, for the purposes of this policy, considered subordinate attorneys. The General Counsel's office will notify each supervising attorney of his or her subordinate attorneys for the purposes of this policy. An attorney may be both a subordinate attorney and a supervising attorney. The Section 307 rules specify that an attorney who reports directly to the General Counsel shall <u>not</u> be considered a subordinate attorney for the purposes of this policy.

Designations of supervising attorneys (and subordinate attorneys) as of November 10, 2003 are set forth in Exhibit A.

C. Notification and Reporting Obligation

All attorneys shall comply with the procedures set forth in Section III with respect to reporting any event described in subsection A of Section III. With respect to all other matters, all attorneys shall comply with the general reporting procedures set forth in Section II.

II. GENERAL PROCEDURES FOR MATTERS NOT SUBJECT TO SECTION 307

A. Applicable Standard

From time to time, attorneys representing the Company may face situations in which potential violations of law related to the business of the Company are brought to their attention. Many of these issues are covered by existing Company policies (e.g., policies relating to employment discrimination, sexual harassment, etc.). If a situation that is outside the scope of the Section 307 rules is covered by another Company policy, inside attorneys must comply with that Company policy. If the situation is not covered by another Company policy, inside attorneys must comply with this Section II. If any state or other jurisdiction, law or professional obligation provides a more stringent standard that sets a lower threshold for reporting improper conduct or provides for a different course of action, that standard shall apply.

B. Triggering Event

An attorney becomes subject to the requirements of this Section II if the attorney knows facts from which a reasonable lawyer, under the circumstances, would conclude that a person associated with the Company is engaged or intends to engage in conduct that is likely to result in substantial injury to the Company and would either:

1. Violate a legal obligation to the Company; or
2. Be a violation of law that can reasonably be imputed to the Company.

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C. Reporting Up

1. A subordinate attorney must report any violation or potential violation described in Section II.B. to his or her supervising attorney or to the supervising attorney responsible for the substantive area of law involved. An attorney who is not a subordinate attorney must report any violation or potential violation described in Section II.B. to the General Counsel or to the supervising attorney responsible for the substantive area of law involved.

2. A supervising attorney who receives a report of a violation as contemplated by Section II.C.1. or this Section II.C.2. shall make a preliminary review of the information provided to determine whether he or she believes a potential or actual violation exists. In connection with any such review, the supervising attorney may:

   a. Discuss the issue with the offending individual and request reconsideration of the conduct at issue; or

   b. Seek a separate legal opinion with respect to the legality of the conduct.

   If the supervising attorney is also a subordinate attorney and, following such review believes a potential or actual violation exists, he or she shall report the matter to his or her supervising attorney, who shall then comply with this Section II.C.2. If the supervising attorney is not also a subordinate attorney, and following such review believes a potential or actual violation exists, the supervising attorney shall report the matter to the General Counsel.

3. Upon receipt of a report pursuant to Section II.C.1. or Section II.C.2., the General Counsel must then take such action as is reasonably necessary, in his or her judgment, in the best interests of the Company, including:

   a. Discussing the issue with the offending individual and requesting reconsideration of the conduct at issue;

   b. Seeking a separate legal opinion with respect to the legality of the conduct; or

   c. Referring the matter to the Board of the Directors or the Audit and Finance Committee.

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III. PROCEDURES FOR MATTERS SUBJECT TO SECTION 307

A. Triggering Event

An inside attorney must comply with the provisions of this Section III when he or she becomes aware of evidence that any of the following has occurred, is ongoing or is about to occur:

1. A material violation of U.S. federal or state securities laws;
2. A material breach of a fiduciary duty arising under U.S. federal or state law; or
3. A similar violation of any U.S. federal or state law

(collectively, subsections 1, 2 and 3 are referred to as "material violations").

An attorney is deemed to be "aware" of evidence if it is credible evidence, based upon which it would be unreasonable for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is occurring or will occur in the future.

B. Reporting

The Section 307 rules require covered attorneys to report evidence of material violations up the corporate hierarchy to the General Counsel, or to both the General Counsel and the Chief Executive Officer. It is Company's policy that these reports be made only to the General Counsel, as opposed to both the General Counsel and the Chief Executive Officer, and that the reports be made in the manner set forth in this Section III.B.

Reports made pursuant to this Section III.B. shall be made in such manner and on such form as the General Counsel shall from time to time specify. **Each such report must include a statement indicating that the report is being made pursuant to Section III.B. of this policy.** The General Counsel may also establish reporting deadlines.

1. If a subordinate attorney becomes aware of evidence of a material violation, the attorney must report the evidence as follows:
    a. Except as set forth below, the subordinate attorney must report the evidence to his or her supervising attorney and shall also notify the General Counsel of the fact that the report has been made, at which point the subordinate attorney has satisfied his or her reporting obligations.
    b. Except as set forth below, if the subordinate attorney reasonably believes that it would be futile to report the evidence to his or her supervising attorney, the subordinate attorney must report the matter to the General Counsel. The subordinate attorney must also explain to the General Counsel his or her reasons for believing that it would have been futile to report the matter to his or her supervising attorney.

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A subordinate attorney who reports a matter directly to the General Counsel becomes a "Reporting Attorney" for purposes of this policy with respect to that matter, and thereafter is entitled to receive the information for Reporting Attorneys described in Sections III.B.5. and III.B.6. and is required to follow the obligations of a Reporting Attorney set forth in set forth in Sections III.B.7. and III.C.

c. If a subordinate attorney reasonably believes that it would be futile to report the evidence to his or her supervising attorney and reasonably believes that it would be futile to report the evidence to the General Counsel, the subordinate attorney must report the evidence to the Board of Directors or the Audit and Finance Committee. The attorney must also explain to the Board of Directors or the Audit and Finance Committee, as the case may be, his or her reasons for believing that it would have been futile to report the matter to his or her supervising attorney and his or her reasons for believing that it would have been futile to report the matter to the General Counsel.

   A subordinate attorney who reports a matter directly to the Board of Directors or the Audit and Finance Committee becomes a "Reporting Attorney" for purposes of this policy with respect to that matter, and thereafter is entitled to receive the information for Reporting Attorneys described in Section III.C.3. and is required to follow the obligations of a Reporting Attorney set forth in Section III.C.

2. A supervising attorney who receives a report from a subordinate attorney pursuant to Section III.B.1. shall independently assess the matter to determine whether credible evidence of a material violation exists. If the supervising attorney determines that such evidence does not exist, the attorney shall notify both the subordinate attorney who reported the matter to him or her and also the General Counsel of that determination. If the supervising attorney is also a subordinate attorney and determines that such evidence exists, he or she shall report the matter pursuant to Section III.B.1.

3. If an attorney who is <u>not</u> a subordinate attorney (x) becomes aware of evidence of a material violation subject to this Section III or (y) receives a report from a subordinate attorney pursuant to Section III.B.1. and determines that credible evidence of a material violation exists, the attorney must report the evidence as follows:

   a. Except as set forth below, the attorney must report the matter to the General Counsel. An attorney who reports a matter directly to the General Counsel becomes a "Reporting Attorney" for purposes of this policy with respect to that matter, and thereafter is entitled to receive the information for Reporting Attorneys described in Sections III.B.5. and III.B.6. and is required to follow the obligations of a Reporting Attorney set forth in set forth in Sections III.B.7. and III.C.

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   b. If an attorney reasonably believes that it would be futile to report the evidence to the General Counsel, the attorney must report the evidence to the Board of Directors or the Audit and Finance Committee. The attorney must also explain to the Board of Directors or the Audit and Finance Committee, as the case may be, his or her reasons for believing that it would have been futile to report the matter to the General Counsel.

      An attorney who reports a matter directly to the Board of Directors or the Audit and Finance Committee becomes a "Reporting Attorney" for purposes of this policy with respect to the matter, and thereafter is entitled to receive the information for Reporting Attorneys described in Section III.C.3. and is required to follow the obligations of a Reporting Attorney set forth in set forth in Section III.C.

4. A subordinate attorney who reasonably believes that his or her supervising attorney has not complied with the Section 307 rules or this policy may report the matter directly to the General Counsel. The attorney must also explain to the General Counsel his or her reasons for believing that his or her supervising attorney has not complied with the Section 307 rules or this policy. A subordinate attorney who reports a matter directly to the General Counsel becomes a "Reporting Attorney" for purposes of this policy with respect to that matter, and thereafter is entitled to receive the information for Reporting Attorneys described in Sections III.B.5. and III.B.6. and is required to follow the obligations of a Reporting Attorney set forth in Sections III.B.7. and III.C.

5. The General Counsel shall conduct a preliminary review of any matter reported to him or her pursuant to this Section III and shall assess whether the matter described in the report constitutes a material violation.

   a. If the General Counsel finds that no material violation has occurred, is ongoing or is about to occur, the General Counsel shall report that result and the basis therefor to the Reporting Attorney.

   b. If the General Counsel finds that a material violation has occurred, is ongoing or is about to occur, the General Counsel shall take all reasonable steps to cause the Company to adopt appropriate remedial measures and shall report the Company's response to the matter to the Reporting Attorney.

   c. If the General Counsel finds that the situation requires further investigation, the General Counsel must follow the procedures set out in Section III.B.6. Additionally, the General Counsel must give an interim report to the Reporting Attorney as soon as is reasonably practicable, but, in no event later than ninety days of when the Reporting Attorney reports the matter to the General Counsel, stating that further investigation of the matter is being undertaken. The General Counsel shall advise the Reporting Attorney of the conclusion of the investigation no later than thirty days after it has been completed.

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6. If the General Counsel finds that the situation requires further investigation, the General Counsel will direct the investigation by either appointing an inside attorney to conduct the investigation or retaining outside counsel, depending on the circumstances. In either case, the Board of Directors or the Audit and Finance Committee shall consent to the appointment or retention of investigating counsel.

    a. The investigating attorney(s) shall report to the General Counsel and ultimately (i) indicate that there is no material violation, (ii) provide a remedial recommendation if a material violation is found or (iii) indicate that the Company can assert a colorable defense in any investigation or proceeding relating to the matter.

    b. The General Counsel must notify the Board of Directors or the Audit and Finance Committee of the results of the investigation and the proposed response and then take steps to ensure that the Company substantially implements the remedial recommendations made by the investigating attorney(s).

    c. The General Counsel must also report the Company's response to the matter to the Reporting Attorney.

7. Upon receiving a report from the General Counsel pursuant to Sections III.B.5. or III.B.6. with respect to the Company's response to the reported matter, the Reporting Attorney shall inform the subordinate attorney(s) who initially reported the matter of such response.

C. Follow Up Responsibilities of the Reporting Attorney

1. If a Reporting Attorney who reports evidence of a material violation to the General Counsel pursuant to this policy does not receive an appropriate response from the General Counsel within ninety days, the Reporting Attorney shall first follow up with the General Counsel to seek a response.

2. If, after this follow up with the General Counsel, the Reporting Attorney still does not reasonably believe that the General Counsel has provided an appropriate response, the Reporting Attorney must report the matter to the Board of Directors or the Audit and Finance Committee. The Reporting Attorney must also explain to the General Counsel and the Board of Directors or the Audit and Finance Committee his or her reasons for believing that he or she has not received an appropriate response.

3. The entity to whom the Reporting Attorney reports the information regarding the evidence of a material violation is responsible for reviewing and, if necessary, conducting an investigation of the matter, and reporting to the Reporting Attorney the Company's response to the matter. The Reporting Attorney shall then inform any subordinate attorney(s) who initially reported the matter of such response.

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4. In fulfilling its responsibilities under this Section III.C., the Board of Directors or Audit and Finance Committee may, in its discretion, consult with the General Counsel or retain outside experts or legal counsel.

D. Reporting Responsibilities of an Inside Investigating Attorney

An inside attorney shall have no reporting obligation with respect to evidence of a material violation under Section III.B. if:

1. the attorney was directed by the General Counsel to investigate the matter and the attorney reports the results of that investigation to the General Counsel, and, except where the attorney and the General Counsel each reasonably believe that no material violation has occurred, is ongoing or is about to occur, the General Counsel reports the results of the investigation to the Board of Directors or Audit and Finance Committee; or

2. the attorney was directed by the General Counsel to assert, consistent with his or her professional obligations, a colorable defense on behalf of the Company (or any officer, director, employee or agent of the Company, as the case may be) in any investigation or judicial or administrative proceeding related to that matter, and the General Counsel provides reasonable and timely reports on the progress and outcome of that proceeding to the Board of Directors or the Audit and Finance Committee.

IV. CONFIDENTIALITY

Any reports made by an attorney pursuant to this policy, including the fact that the attorney has made such a report, and any information provided to an attorney with respect to the Company's response to a reported matter, shall be strictly confidential. Unless otherwise required by law, the attorney shall not discuss such reports or information with anyone other than:

1. the person or entity to whom the attorney reports the matter under this policy;

2. a subordinate attorney who reports the matter to the attorney;

3. the General Counsel; or

4. an individual specifically designated by the General Counsel, the Board of Directors or the Audit and Finance Committee to investigate the matter.

V. VIOLATION OF THE POLICY

Failure to comply with any of the provisions of this policy, including the confidentiality provisions of Section IV, may result in disciplinary action by the Company, up to and including termination, and may subject the non-compliant attorney to Commission enforcement action.

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VI. NON-RETALIATION

No attorney may be disciplined, reprimanded, dismissed or otherwise penalized for complying in good faith with the Section 307 rules or this policy. An attorney formerly employed or retained by Company who believes that he or she was discharged for making a report pursuant to the Section 307 rules or this policy should notify the Board of Directors or any committee of the Board of Directors.

VII. INTERPRETATION OF THIS POLICY

The Company recognizes that specific situations may require an interpretation of this policy or a determination as to the applicability of various provisions of the policy or of the Section 307 rules. If any attorney has questions about the application or interpretation of the policy or the Section 307 rules he or she should contact his or her supervising attorney or the inside attorney designated by the General Counsel to receive such questions.

VIII. OUTSIDE COUNSEL

If outside counsel is required to report any matters to the Company pursuant to such counsel's obligations under the Section 307 rules or other applicable ethical standards, that report shall be made to the General Counsel, unless otherwise required by the Section 307 rules or other applicable ethical standards.

Every inside attorney who retains outside counsel on behalf of the Company must provide that counsel with a copy of this policy.

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The ServiceMaster Company	Business Unit: American Residential Services	Current Update:
Internal Control Review	Risk Area:	Previous Update: **na**
Executive Summary	Updated by:	Date Created:

Objective: To establish and implement procedures to comply with

Rationale: (Enter discussion)

0

Impact / Magnitude of Risk = 3.1

Legal	Low
Reputation / Media	Moderate
Environmental / Health / Safety	Moderate
Financial	Less than $2.6M in lost revenue or $225k in e

Likelihood of Risk = 2.7

Outside factors	Moderate
History of previous incidents	Frequent
Strength of Internal Controls -	
Control Activities	Weak
Communication and info.	Moderate
Auditing and monitoring	None

Residual Risks (Likelihood rating = 4-5): **Considerations for Improvement in Controls:**

Other Risks (Optional - Likelihood < 4): **Considerations for Improvements in Controls (Optional):**

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The New Face of In-house Counsel

Association of Corporate Counsel

October 25-27, 2004
Chicago, Illinois

RECENT DEVELOPMENTS IN FEDERAL SECURITIES REGULATION OF CORPORATE FINANCE

AS OF JULY 22, 2004

By
John F. Olson
Jonathan C. Dickey
Stephen I. Glover
Brian J. Lane
Bradford P. Weirick
Ronald O. Mueller
Scott J. Calfas
Stanton P. Eigenbrodt
Amy L. Goodman
Paul J. Collins
James J. Moloney
Gillian McPhee
Peter W. Wardle
W. Stephen Venable, Jr.

GIBSON, DUNN & CRUTCHER LLP

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Portions of this outline may be used for other programs.
The authors gratefully acknowledge the assistance of Mari K. Anzai, Candice Choh, Patrick Dykstra, David Egdal, Lynn Hang, Farshad More, Maeling Pan, Ian Puente, Theodore Schneider and Eric Scarazzo in the preparation of this outline.

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Recent Developments in Federal Securities Regulation of Corporate Finance

I. Introduction

This outline reviews recent cases, no-action letters, releases and other information promulgated by the Securities and Exchange Commission (the "SEC" or "Commission"), the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act") and actions taken by the major securities exchanges, that address many recent and proposed changes to the federal securities laws, the related rules and regulations and the Commission's practices.

II. Current Issues

A. The Public Company Accounting Oversight Board's Auditing Standard No. 2

The Sarbanes-Oxley Act created the Public Company Accounting Oversight Board (the "PCAOB"), empowered to oversee the audit of public companies and companies offering securities to the public, and related matters, subject to oversight by the SEC.

On June 17, 2004, the SEC approved Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting. Auditing Standard No. 2 provides professional standards and related performance guidance for independent auditors to attest to, and report on, management's assessment of the effectiveness of internal control over financial reporting under Section 404 of the Sarbanes-Oxley Act.[1]

Under Auditing Standard No. 2, the auditor must evaluate whether management's assessment process has an appropriate basis for its conclusion and whether the design of the internal control is effective for supporting management's conclusion. In the process of the evaluation, a formal opinion must be issued by the auditor, with thresholds for identifying significant deficiencies or material weaknesses being established.

The auditor's opinion must address the following two areas: (i) the fairness of management's assessment on the effectiveness of financial reporting at the end of the most

[1] Public Company Accounting Oversight Board; Order Approving Proposed Auditing Standard No.2, Release No. 34-49884 (Jun. 17, 2004), *available at* http://www.sec.gov/rules/pcaob/34-49884.htm. Auditing Standard No. 2 was adopted by the Public Company Accounting Oversight Board on March 9, 2004, and submitted to the SEC for approval on March 11, 2004, pursuant to Section 107 of the Sarbanes-Oxley Act of 2002 and Section 19(b) of the Securities Exchange Act of 1934.

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recent fiscal year, and (ii) the effectiveness of the issuer's internal control over financial reporting at the end of the most recent fiscal year.[2]

Auditing Standard No. 2 also establishes thresholds that the auditor must apply when determining whether there are "significant deficiencies" or "material weaknesses" in the issuer's internal control over financial reporting:

- "Significant deficiencies" exist when a control deficiency, or a combination of control deficiencies, adversely affects the company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles ("GAAP"), such that there is more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected.[3]

- "Material weaknesses" exist when there is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.[4]

Though it approved Auditing Standard No. 2 in summary fashion, the SEC received over 30 comment letters in response to Auditing Standard No. 2, most of which were highly critical. The comment letters argued that the cost of compliance for the new auditing standard would be too high, that the SEC and the PCAOB did not offer enough guidance in the auditing standard and that the scope of management's assessment of the effectiveness of internal control over financial reporting is too large.

The SEC and the PCAOB staffs have, since the adoption of Auditing Standard No. 2, released guidance, in the form of frequently asked questions, regarding Auditing Standard No. 2.

Some of the issues upon which the SEC staff provided guidance include:

- *Recent acquisitions, consolidations, and equity investments.* For acquisitions within the last year where the registrant is unable to conduct an assessment of the acquired business's internal controls, management's report should note the exclusion and indicate the financial significance of the acquired business. For consolidations in which the registrant does not have the authority to assess the internal controls of the consolidated entity, management's report should include a disclosure that it has not

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[2] *Id.*

[3] Proposed Auditing Standard, PCAOB Release No. 2004-002 (Mar. 9, 2004), *available at* http://pcaobus.org/rules/Release-20040308-2.pdf.

[4] *Id.*

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evaluated the internal controls of the entity and any key subtotals that have resulted from the consolidation. For equity investments, the registrant must have control over the recording of amounts in the consolidated financial statements by considering the selection of accounting methods, the recognition of equity method earnings and losses, and its investment account balance.

- *Qualification on internal controls, disclosure requirements, and transition periods.* Management may not conclude that a registrant's internal control over financial reporting is effective if a material weakness exists. In fact, the registrant is obligated to identify and publicly disclose all material weaknesses. The registrant is also obligated to disclose any material changes to disclosure controls and procedures or to the internal control over financial reporting. Transition reports should be filed subject to transition provisions applied to the transition period as if it were report for the end of the fiscal year.

- *Timeline for foreign subsidiaries.* If a registrant has foreign subsidiaries and is thus subjected to a lag in reporting financial results, then it may consolidate the operations of its foreign subsidiaries, which have an earlier year-end, for the purpose of an internal control assessment.

- *Special considerations for small business issuers*. The Commission recognized that smaller issuers may encounter difficulties in implementing an evaluation system of their internal controls. The SEC staff will thus support other organizations to develop an internal control framework specifically designed for smaller issuers.[5]

The PCAOB guidance addresses, among others, the following areas:

- *Independence.* An auditor may not accept an engagement to perform any internal control-related service without pre-approval by the audit committee. If an internal control-related engagement was pre-approved prior to the effective date of Auditing Standard No. 2 in a manner that would not satisfy the new requirement, and the services are ongoing, then the auditor should request a subsequent evaluation from the audit committee.

- *Scope and Extent of Testing*. The auditor's evaluation and testing of controls applies to a company's financial statements and notes as presented in accordance to GAAP, but does not include the preparation of MD&A or other such financial information. The PCAOB also stressed that in order to complete an audit and render an opinion,

[5] Management's Report on Internal Control Over Financial Reporting and Disclosure in Exchange Act Periodic Reports Frequently Asked Questions (Jun. 22, 2004), *available at* http://www.sec.gov/info/accountants/controlfaq0604.htm. The answers in the report reflect the views of the staffs of the Office of the Chief Accountant and the Division of Corporation Finance, but have not been approved by the SEC.

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the auditor must test controls directly, regardless of the company's own assessment. However, if management of the company fails to fulfill its responsibilities of evaluating the effectiveness of its internal control, then the auditor must disclaim an opinion, and the audit cannot be completed.

- *Evaluating Deficiencies.* When evaluating whether a significant deficiency or material weakness exists, the auditor should consider the deficiencies both in isolation and in their aggregate. That includes the consideration of compensating controls. The PCAOB also noted that individual controls do not have to operate perfectly at all times to be considered effective. Hence, all control testing exceptions should not be immediately deemed control deficiencies.

- *Multi-Location Issues.* Although Auditing Standard No. 2 provides that an auditor needs to test controls over a "large portion" of the company's operations, there is no specific target percentage. However, when a company has multiple locations or business units, the auditor must select a representative sample, either statistically or non-statistically, such that it would be representative of the entire population. If the SEC has allowed management to exclude certain entities from the assessment, the auditor must include disclosure regarding the exclusion in the report.

- *Using the Work of Others.* The auditor is allowed to use the work of others when the work has been tested for its quality and effectiveness. The auditor need not test every single account in which he or she plans to use another's work. However, the testing of another's work does not count towards the "principal evidence" used to support the auditor's own work. For work that has been performed by another regarding the prevention and detection of fraud, the auditor is allowed to consider the results of the work to make his or her own assessment for additional tests.

- *Service Organizations.* If a service organization's services are part of a company's information system, then the auditor should consider the service organization's activities in his or her review. If a service organization changes its procedures or controls, the auditor should be alert for management's response to those changes. Finally, a service auditor need not be a registered public accounting firm.[6]

B. New Form 8-K Disclosure Requirements

In a release dated March 16, 2004, the SEC adopted amendments relating to current filings on Form 8-K. The amendments added eight new events that require the filing of a

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[6] Staff Questions and Answers, Auditing Internal Control Over Financial Reporting (Jun. 23, 2004), *available at* http://www.pcaobus.org/QA_Staff_Internal_Control.pdf?CFID=52893%20<http://www.pcaobus.org/QA_Staff_Internal_Control.pdf?CFID=52893&CFTOKEN=9562. The answers in the report reflect the staff's opinion, but have not been approved by the PCAOB.

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Form 8-K, relocated to Form 8-K two disclosure requirements that were previously only required in annual reports filed on Form 10-K and quarterly reports filed on Form 10-Q and expanded the disclosure required for several additional events. The amendments also shortened the deadline for filing most current reports on Form 8-K. These new requirements are effective as of August 23, 2004.

1. New Form 8-K Disclosure Events

The new rules add disclosure requirements upon the occurrence of the following eight events, for which disclosure on Form 8-K was not previously required.

a. Entry into a Material Agreement Not Made in the Ordinary Course of Business

The new rules require disclosure when a company enters into a material agreement not made in the ordinary course of business, or any amendment to such agreements. An example of such an arrangement would be a compensatory plan or contract made with a director or an executive officer of the company that would otherwise require the filing of an exhibit to Form 10-Q or Form 10-K.

b. Termination of a Material Agreement Not Made in the Ordinary Course of Business

The rules require disclosure upon the termination of a definitive material agreement entered into outside the ordinary course of business. The rules provide exceptions when the contract is terminated because all parties completing the agreement or by the occurrence of the termination date.

c. Creation of a Direct Financial Obligation or an Obligation Made Under an Off-Balance Sheet Arrangement

Under the new rules, companies must provide disclosure if the company becomes obligated under a direct financial obligation that is material, or if the company becomes directly or contingently liable for a material obligation that is the result of an off-balance sheet transaction. A direct financial obligation would include the taking on of long-term debt, the assumption of a capital lease or operating lease, or the taking on of short-term debt arising other than in the ordinary course of business.

d. Acceleration or Increase of a Direct Financial Obligation or an Obligation Under an Off-Balance Sheet Arrangement

The new rules require disclosure if a triggering event occurs causing a) the increase or acceleration of a direct financial obligation or an obligation under an off-balance sheet arrangement or b) the company's contingent

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obligation under an off-balance sheet arrangement to become a direct financial obligation.

e. Costs Associated with Exit or Disposal Activities

The rules require disclosure if an authorized officer commits the company to an exit or disposal plan, or otherwise disposes of a long-lived asset or terminates employees under certain "plans of termination." The company may omit this item until it can make a good faith estimate of the associated costs.

f. Material Impairments

Disclosure is required if an authorized officer determines that a material charge for impairment to one or more of the company's assets is required under GAAP. This includes an impairment to the company's goodwill or securities. Again, the company may omit this item until it can make a good faith estimate of the associated costs.

g. Non-Reliance on Financial Statements or a Related Audit Report or Completed Interim Review

The new rules require disclosure when and if an authorized officer determines that any previously issued financial statement covering one or more years or interim periods should no longer be relied on because of an error. The company must also provide disclosure if it is notified by its independent accountants that disclosure should be made or action taken to prevent future reliance on a previously issued audit report or completed interim review that is related to a previously issued financial statement.

h. Delisting or Failure to Satisfy a Continued Listing Rule or Standard, or Transfer of Listing

Under the new rules, disclosure is required if a) the company receives notice from a national securities exchange or national securities association that maintains the principal listing for the company's common stock that the company no longer satisfies a continued listing requirement or b) the exchange or association has filed an application with the SEC to delist the company's common stock or c) the exchange or association has taken all necessary steps to delist the company's common stock or d) the company becomes aware that material non-compliance with a continued listing requirement has taken place or e) the exchange or association has issued a public reprimand letter finding that the company has violated a listing requirement or f) an authorized officer has taken action to cause the listing of the company's common stock to be withdrawn, transferred or terminated. No disclosure is required if the delisting is because of a redemption or maturity of the company's securities.

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2. Relocated Form 8-K Disclosure Events

The two disclosure requirements listed below were formerly only required to be listed in quarterly and annual reports.

a. Unregistered Sale of Securities

Disclosure on Form 8-K is required if the company sells more than 1% of its registered equity securities in a transaction that is not registered under the Securities Act of 1933, as amended (the "Securities Act").

b. Rights of Security Holders

Disclosure on Form 8-K is required if the company makes any material modification to the rights of security holders.

3. Expanded Form 8-K Disclosure Events

The final rules also expanded existing 8-K disclosure requirements in the following ways:

a. Amendment to Articles of Incorporation or Bylaws and Change in the Fiscal Year

Under the new rules, disclosure on Form 8-K is required if the company amends its articles of incorporation or bylaws unless the company proposed the amendment in a previously filed proxy statement. This expands the old requirement that disclosure was only required when the company made a change to its fiscal year.

b. Appointment and Departure of Directors

The new rules require disclosure on Form 8-K when a new director is added to the board, other than by a vote of shareholders at an annual meeting or special meeting convened for such purpose. If a director resigns or refuses to stand for re-election because of a disagreement with the company or if a director is removed for cause and either is known to an executive officer of the company, then disclosure is also required on Form 8-K. The previous rule was much narrower and only required disclosure in limited situations of director departure.

c. Appointment and Departure of Principal Officers

In addition to directors, disclosure on Form 8-K is now required when the company’s president, CEO, CFO, COO, principal accounting officer or those performing similar functions are appointed, resign, or refuse to stand for re-election because of a disagreement with the company and it is known to an

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executive officer of the company. The previous rule did not require disclosure in relation to principal officer employment.

4. Accelerated Filing Deadline

The new rules shorten the filing deadline for Form 8-K to four business days after an event triggering the disclosure requirements. Under previous rules, the filing deadline for most items was five business days or 15 calendar days, depending upon the nature of the event. The rules also do not provide for an extension of the filing deadline for new disclosure items.

5. Safe Harbor

The SEC allows a limited safe harbor from public and private claims under Section 10(b) and Rule 10b-5. The Commission recognized that the first seven items listed above under "New Form 8-K Disclosure Events" might require management to make a quick assessment of the materiality of an event, and thus the triggering of a filing obligation. Therefore, a company that fails to file a timely 8-K after one of the first seven triggering events listed above will not incur liability as long as it discloses the event on or before the due date of the company's next periodic report. For example, if the company fails to make the required timely disclosure on a Form 8-K during a particular quarter, disclosure must be provided in the company’s quarterly report. This safe harbor does not otherwise apply to material misstatements or omissions in a Form 8-K (which still exposes the company to potential liability).

6. Eligibility to Use Forms S-2 and S-3

Forms S-2 and S-3 are both short form registration statements that many companies prefer to file for efficiency reasons. One of the requirements to file on Form S-2 and S-3 is that the company must have timely filed all required reports during the previous 12 months. The adopted rules amend Form S-2 and S-3 to allow companies that do not file a timely Form 8-K after the occurrence of any of the first seven items covered under “Safe Harbor” to still file on Form S-2 and S-3, provided that the company is current in its 8-K filings at the time it files on Form S-2 or S-3 (including disclosures with respect to the seven “Safe Harbor” items).

7. Eligibility Under Rule 144

SEC Rule 144 provides for the sale of restricted securities in limited quantities without requiring that the securities be registered. One of the requirements of using Rule 144 is that the company file all required Form 8-K reports on time during the previous 12 months. The SEC’s adopted rules provide that a company’s failure to timely file a Form 8-K relating to the seven “Safe Harbor” disclosure events listed above will not negate eligibility to use Rule 144 to sell the company’s securities. This change softens the penalty for not filing a timely Form 8-K after events that require management to make a quick assessment of filing obligations.

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C. Public Release of Staff Comment Letters

On June 24, 2004, the SEC announced it would begin publicly releasing comment letters and filer responses relating to disclosure filings under the Securities Act and the Securities Exchange Act of 1934, as amended (the "Exchange Act"), reviewed by the SEC's Division of Corporate Finance and Division of Investment Management.[7] Comment letters and responses for filings by registered investment companies made under the Investment Co. Act of 1940, as amended (the "Investment Co. Act"), will also be made publicly available under the new policy. Currently, comment letters and responses for all filings are released only pursuant to requests under the Freedom of Information Act ("FOIA").

The staff intends to release correspondence relating to filings that are made after August 1, 2004 and selected for review by the staff, and correspondence will not be made public less than 45 days after completion of a staff review. The August 1 date will look to the filing that is the primary focus of the review. For example, if a Form 10-K filed prior to August 1, is selected for review, and in conjunction with that review a Form 8-K or Form 10-Q filed after August 1, is reviewed, the comment letter would not be made public because of the pre-August 1 filing date of the Form 10-K.

Only portions of response letters that are not subject to Rule 83 confidential treatment requests will be made available. Parties seeking access to information that is the subject of a confidential treatment request will need to request release of the information under FOIA.

In connection with releasing public comments, the SEC also announced it would ask issuers whose filings are reviewed for a "Tandy" letter, in which the issuer represents that it will not use the comment process as a defense in any securities related litigation against them.

D. Governance of Mutual Funds

On June 23, 2004, the SEC adopted amendments to the rules under the Investment Co. Act designed to improve and enhance the corporate governance of investment companies and the independence of fund directors. The amendments were originally proposed by the SEC in a January 16, 2004 release.[8] The SEC voted to adopt the following amendments:

- Independent Composition of a Fund Board. The new rules will require 75% of a fund's board to be independent directors. Funds with only three directors will be exempt under this rule as long as their board is made up of no more

[7] "SEC Staff to Publicly Release Comment Letters and Responses," Release No. 2004-89, (June 24, 2004) available at http://www.sec.gov/news/press/2004-89.htm.

[8] Investment Company Governance, Release No. IC-26323 (Jan. 16, 2004), available at http://www.sec.gov/rules/proposed/IC-26323.htm.

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than a single interested director. According to the SEC, an independent board would, in addition to strengthening the presence of independent directors, improve a board's ability to negotiate lower advisory fees on behalf of the board.

- Independent Chairman. The new rules will require a fund's chairman to be an independent director. The new rule will allow an independent director more control over agenda setting and a greater influence in the board's deliberations.
- Annual Self-Assessment. Under the new rules, a fund board will be required to assess its effectiveness at least once a year. The evaluation must include consideration of the board's structure, its committees and the number of funds on whose boards the fund directors serve.
- Separate Meetings of Independent Directors. The new rules will require independent directors to meet separately from the full board at least once a quarter in an effort to promote candid discussions about fund and management performance.
- Independent Director Staff. The new rules will require the fund to authorize the independent directors to hire their own staff to deal with matters on which they need outside assistance.

The rules will require compliance 18 months after their publication and final release, which is still forthcoming.

III. The Sarbanes-Oxley Act of 2002 and Rules Thereunder

On July 30, 2002, President George W. Bush signed into law the Sarbanes-Oxley Act.[9] This sweeping legislation addresses a number of issues of critical importance to public companies. Among its many provisions are those establishing new certification and disclosure requirements applicable to companies and their CEOs and CFOs, including: the restriction of certain executive officer and director transactions; the acceleration of Section 16 reporting; the imposition of new obligations on corporate audit committees; the establishment of a new regulatory body to oversee public company auditors and to redefine the relationship between auditors and their clients; the imposition of new rules of professional responsibility on attorneys and securities analysts; and the enhancement of a variety of enforcement measures and criminal penalties for securities-related offenses. In addition, the Sarbanes-Oxley Act requires the SEC to study and issue reports on a variety of topics.

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[9] The Sarbanes-Oxley Act of 2002, 15 U.S.C.A. § 7201 (2002), *available at* http://www.financialservices.house.gov/media/pdf/H3763CR_HSE.PDF.

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Many provisions of the Sarbanes-Oxley Act are applicable to any issuer that is subject to reporting requirements under Section 13(a) or 15(d) of the Exchange Act. As a result, many of the provisions are applicable to foreign companies that are subject to the Exchange Act. Some provisions are also applicable to companies that have registered debt under the Securities Act or that have voluntarily or contractually undertaken to file Exchange Act reports, even though their equity securities may not be publicly traded.

The Sarbanes-Oxley Act covers a wide variety of issues. In many cases, the Sarbanes-Oxley Act instructs the SEC (alone or in conjunction with other regulatory organizations) to adopt implementing or clarifying regulations. In addition, in the Sarbanes-Oxley Act, Congress provided the SEC general authority to adopt "such rules and regulations, as may be necessary or appropriate in the public interest or for the protection of investors, and in furtherance of," the Sarbanes-Oxley Act. In the last year, the SEC has adopted a number of final rules to implement sections of the Sarbanes-Oxley Act.

A. Code of Ethics for Senior Financial Officers

In a January 23, 2003 release, the SEC adopted rules implementing Section 406 of the Sarbanes-Oxley Act, which requires disclosure about a company's code of ethics.[10] The rules, which go beyond the requirements of Section 406, require an issuer to disclose in its annual report whether or not it has a code of ethics applicable to its chief executive officer and senior financial officers. An issuer that has adopted a code of ethics must disclose this fact in its annual report on Form 10-K. Issuers that have not adopted a code of ethics must disclose their reasons for failing to do so. Additionally, an issuer must make the code available to the public by attaching a copy of that code as an exhibit to its annual report on Form 10-K, posting it on the company's website or providing copies of the code upon written request.

The rules define a "code of ethics" to be a codification of standards reasonably designed to: (i) deter wrongdoing and promote honest and ethical conduct; (ii) provide full, fair, accurate, timely and understandable disclosure in public reports; (iii) comply with applicable laws; (iv) ensure the prompt internal reporting of code violations; and(v) provide accountability for adherence to the code.

The rules require the prompt disclosure of any change in or waiver of an issuer's code of ethics that applies to the issuer's principal executive officer or senior financial officer. This disclosure may be made by a Form 8-K filing or by publishing a statement on the issuer's website. Issuers who elect to disclose this information on their websites, however, must give advance notice of that election in their annual reports on Form 10-K. They also must disclose the specific website address where the code of ethics information may be found.

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[10] Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Release Nos. 33-8177, 34-47235 (Jan. 23, 2003), *available at* http://www.sec.gov/rules/final/33-8177.htm.

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Finally, foreign issuers are required under the rules to disclose annually, on Form 20F, whether or not they have adopted a code of ethics. Because foreign issuers are not required to file current reports (similar to Form 8-K) under U.S. law, the press release indicates that they should disclose modifications to, and waivers of, their codes in their periodic reports or on their websites.

The final rules became effective March 1, 2003.

B. Audit Committee Financial Experts

The SEC also issued rules implementing Section 407 of the Sarbanes-Oxley Act, which requires annual disclosure regarding "audit committee financial experts."[11] Under the rules, an issuer must disclose whether or not at least one member of its audit committee is an audit committee financial expert. If an issuer's audit committee does not have such an expert, the issuer must explain their reasons for not having one. The rules permit, but do not require, the issuer to disclose the number and names of the "audit committee financial experts" serving on its audit committee. Finally, the issuer must disclose whether the audit committee financial expert or experts serving on its audit committee are "independent" of management.

The rules define the term "audit committee financial expert" as a person with all of the following attributes:

- an understanding of GAAP and financial statements;
- the ability to assess the general application of GAAP in connection with the accounting for estimates, accruals and reserves;
- experience preparing, auditing, analyzing or evaluating financial statements that are of the same level of complexity as those that can be expected to be in the registrant's financial statements or experience supervising people engaged in such activities;
- an understanding of internal controls and procedures for financial reporting; and
- an understanding of audit committee functions.

Under the rules, a company's audit committee financial expert must acquire such qualifications through one or more of the following means:

- education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor, or experience in one or more positions that involve the performance of similar functions;

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[11] *Id.*

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- experience "actively supervising" a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;
- experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of the financial statements; or
- other relevant experience.

If a person qualifies as an audit committee financial expert by virtue of "other relevant experience," the rules require the company to briefly list that person's relevant experience.

The rules implementing Section 407 also apply to foreign issuers. A foreign issuer's audit committee financial expert must have an understanding of the generally accepted accounting principles used by the foreign issuer in preparing its primary financial statements filed with the SEC. It is not mandatory that a foreign issuer's audit committee financial expert possess expertise relating to U.S. GAAP principles, but the release indicates that an ability to reconcile the foreign issuer's accounting principles to U.S. GAAP principles may be helpful.

The final rules contain a safe harbor providing that an audit committee financial expert will not be deemed an "expert" for any other purpose, including for purposes of Section 11 of the Securities Act. Additionally, the rules provide that the designation of a person as an audit committee financial expert does not impose any duties, obligations or liability on the person that are greater than those imposed on such person as a member of the audit committee in the absence of such designation, nor does it affect the duties, obligations or liability of any other member of the audit committee or board of directors.

The final rules became effective March 1, 2003.

C. Conditions for the Use of Non-GAAP Financial Information and Filing of Earnings Releases

In a release dated January 22, 2003, the Commission adopted rules pursuant to Section 401(b) of the Sarbanes-Oxley Act providing that non-GAAP financial information included in any periodic or other report filed with the Commission, or in any public disclosure or press or other release, be presented in a manner that: (i) does not contain an untrue statement of material fact or omit to state a material fact necessary to make the pro forma financial information, in light of the circumstances under which it is presented, not misleading and (ii) reconciles such pro forma information with the financial condition and results of operations of the issuer under GAAP. In order to implement the Section 401(b) directive, the Commission has adopted Regulation G and amended Item 10 of Regulations

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S-K and S-B (the "Item 10 Amendments").[12] Additionally, the Commission has amended Form 8-K to require public companies to file certain press releases.

1. Regulation G

Regulation G requires any public company that publicly discloses material information that includes a non-GAAP financial measure to accompany the non-GAAP information with the most direct comparative GAAP financial measure and provide a quantified reconciliation of the non-GAAP financial measure with the most direct comparative GAAP financial measure.

A non-GAAP financial measure is defined as a numeric measure of an issuer's financial performance that either: (i) excludes amounts or is subject to adjustments that have the effect of excluding amounts, that are included in the comparative measure calculated and presented in accordance with GAAP in the statement of income, balance sheet or statement of cash flows of the issuer or (ii) includes amounts or is subject to adjustments that have the effect of including amounts that are excluded from the comparative measure calculated and presented in accordance with GAAP. A non-GAAP financial measure does not include:

- operating and other statistical measures such as unit sales and number of employees;
- ratios or statistical measures that are calculated using exclusively one or both of: (i) financial measures calculated in accordance with GAAP and (ii) operating measures or other measures that are not non-GAAP financial measures; or
- financial measures required to be disclosed by GAAP, SEC rules or governmental or self-regulatory rules that are applicable to a registrant.

Examples of non-GAAP financial measures include earnings before interest and taxes ("EBIT"), earnings before interest, taxes, depreciation and amortization ("EBITDA") and operating income that excludes expense or revenue items identified as non-recurring. Examples of ratios and measures that are not non-GAAP financial measures include sales per square foot (if the sales figure is computed in accordance with GAAP), same store sales (if the sales figure is computed in accordance with GAAP), estimated revenues or expenses of a new product line (if the estimates are made in the same manner as would be computed under GAAP) and measures of profits and losses for segments required to be disclosed in accordance with GAAP.

If the non-GAAP financial measure is released orally, telephonically, by webcast, by broadcast or by similar means, the company may provide the

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[12] Conditions for Use of Non-GAAP Financial Measures, Release Nos. 33-8176, 34-47226 (Jan. 22, 2003), *available at* http://www.sec.gov/rules/final/33-8176.htm.

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accompanying information required by Regulation G by posting the information on the company's web site and disclosing the location and availability of the required accompanying information during its presentation.

Regulation G and Regulation FD will operate in tandem. Thus, for example, if a company official communicates material, non-public information regarding a non-GAAP financial measure to an analyst or a shareholder, it must satisfy the Regulation FD public disclosure requirements and the Regulation G requirements regarding quantitative reconciliation.

With regard to the reconciliation of forward-looking non-GAAP financial measures, Regulation G requires a schedule or other presentation detailing the differences between the forward-looking non-GAAP financial measure and the appropriate forward-looking GAAP financial measure. If the GAAP financial measure is not accessible on a forward-looking basis, the registrant must disclose that fact and provide reconciling information that is available without an unreasonable effort. The company must also identify information that is unavailable and disclose its probable significance.

Regulation G also prohibits public companies from making public disclosure of a non-GAAP financial measure which, when taken together with the information accompanying it, contains an untrue statement of material fact, or omits to state a material fact necessary in order to make the presentation of the non-GAAP financial measure in light of the circumstances presented, not misleading.

Regulation G applies to all public companies, including foreign private issuers. An exception exists, however, for certain disclosures or releases of non-GAAP financial measures made by foreign private issuers when the following three conditions are met: (i) the securities of the foreign private issuer are listed or quoted on a securities exchange or inter-dealer quotation system outside the United States; (ii) the non-GAAP financial measure and comparative financial measure are not presented in accordance with U.S. GAAP; and (iii) the disclosure is made outside the United States or is included in a written communication released only outside the United States or the communication is released in the United States, but occurs contemporaneously with or after the release of information outside the United States and is not otherwise targeted at persons located in the United States. As applied to foreign private issuers, GAAP refers to the accounting principles of the country under which the issuer's principal financial statements are prepared.

Regulation G does not apply to disclosure of non-GAAP financial information relating to a proposed business combination, if the disclosure is contained in a communication that is subject to the communications rules applicable to business combination transactions.

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2. Item 10 Amendments

As noted above, the Commission also amended Item 10 of Regulations S-K and S-B to codify the Commission's policy on the use of non-GAAP financial information in SEC filings by requiring any non-GAAP presentations to be accompanied by a quantified reconciliation to GAAP as well as a discussion of why investors may find such non-GAAP financial measures useful. As adopted, Item 10 permits the use of non-GAAP per-share measures and EBITDA measures.

For purposes of these amendments, the definition of non-GAAP financial measures is the same as it is for Regulation G. These amendments require companies using non-GAAP financial measures in filings with the SEC to provide:

- a presentation, with equal or greater prominence, of the most directly comparable GAAP financial measure;
- the same quantified reconciliation to GAAP as required by Regulation G;
- a statement disclosing the reasons why the company's management believes that presentation of the non-GAAP financial measure provides useful information to investors regarding the registrant's financial condition and results of operations; and
- to the extent material, a statement disclosing the additional purposes, if any, for which the registrant's management uses the non-GAAP financial measures that are not otherwise disclosed.

With respect to forward-looking information, the rules include the same unreasonable efforts exception from quantitative reconciliation as that contained in Regulation G. In addition, Item 10 of Regulations S-K and S-B prohibit the following:

- excluding charges or liabilities that required, or will require, cash settlement, or would have required cash settlement absent an ability to settle in another manner, from non-GAAP liquidity measures, other than EBIT or EBITDA;
- adjusting a non-GAAP performance measure to eliminate or smooth items identified as non-recurring, infrequent or unusual, when: (i) the nature of the charge or gain is such that it is reasonably likely to recur within two years or (ii) there was a similar charge or gain within the prior two years;
- presenting non-GAAP financial measures on the face of the registrant's financial statements prepared in accordance with GAAP or in the accompanying notes;
- presenting non-GAAP financial measures on the face of any pro forma financial information required to be disclosed by Article 11 of Regulation S-X; and

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- using titles or descriptions of non-GAAP financial measures that are the same as, or confusingly similar to, titles or descriptions used for GAAP financial measures.

Unlike the proposed rules, the final rules do not prohibit the use of non-GAAP per share financial measures.

The Item 10 prohibitions do not apply to SEC filings submitted by a non- U.S. issuer if:

- the non-GAAP financial measure relates to the GAAP used in the issuer's primary financial statements included in its filing with the SEC;
- the non-GAAP financial measure included in the SEC filing is required or expressly permitted by the standard setter that is responsible for establishing the GAAP used in such financial statements; and
- the non-GAAP financial measure is included in the annual report prepared by the issuer for use in the jurisdiction in which it is domiciled, incorporated or organized for distribution to its security holders.

3. Item 12

Finally, the Commission added Item 12 to Form 8-K requiring public companies to "furnish" any earnings release or earnings announcement for any completed fiscal period on Form 8-K.[13] Item 12 relates to any public announcement or release that discloses material, non-public information regarding a registrant's results of operations or financial condition for a completed annual or quarterly fiscal period (generally, an earnings release) that is made after March 28, 2003. The rule does not, however, require companies to issue earnings releases or other press releases.

The filing requirement is triggered when material, non-public information is released regarding results of operations or financial operations for a completed fiscal quarter or year, but is not triggered by earnings updates during a fiscal period unless

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[13] As originally proposed, Item 12 would have required registrants to "file" the quarterly information on a Form 8-K. As adopted, however, Item 12 requires that the registrant only "furnish" this information on a Form 8-K. The difference between "furnishing" and "filing" is that information "furnished" to the Commission is: (i) not subject to Section 18 of the Exchange Act unless the registrant specifically states that the information is to be considered "filed"; (ii) not incorporated by reference into a registration statement, proxy statement or other report unless the registrant specifically incorporates that information into those documents by reference; and (iii) not subject to the requirements of amended Item 10 of Regulation S-K or Item 10 of Regulation S-B. Final Rule: Conditions for Use of Non-GAAP Financial Measures, Release No. 33-8176, (Jan. 22, 2003), *available at* http://www.sec.gov/rules/final/33- 8176.htm.

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such earnings updates include material non-public earnings information for a *completed* fiscal period. However, any public disclosure of financial information for a completed fiscal period that is made orally, telephonically, by webcast, broadcast or other similar means in a presentation that is complementary to, and occurs within 48 hours after, a related written release or announcement that triggers the requirements of Item 12 would not be required to be furnished if:

- the related, written release or announcement has been furnished to the SEC on Form 8-K pursuant to Item 12 prior to the presentation;
- the presentation is broadly accessible to the public by dial-in conference call, webcast or similar technology;
- the financial and statistical information contained in the presentation is provided on the company's web site, together with any information that would be required under Regulation G; and
- the presentation was announced by a widely disseminated press release that included instructions as to when and how to access the presentation and the location on the company's web site where the information would be available.

Pursuant to new Item 12, within five days of the public announcement or release, registrants will be required to furnish to the SEC a Form 8-K identifying the public announcement or release and including the announcement or release as an exhibit.

New Item 12 requires that any earnings release furnished to the SEC must present the most directly comparable GAAP financial measure with equal or greater prominence as the non-GAAP financial measure presented and must provide a reconciliation to the most directly comparable GAAP financial measure.

If any non-GAAP financial measure is used in a public announcement or release, then the requirements of Regulation G are triggered and, in addition, Item 12 of Form 8-K requires that the most directly comparable GAAP financial measure be presented with equal or greater prominence and that an explanation be included in the Form 8-K report (or in the release or announcement) as to why management believes the non-GAAP financial measure is useful to investors.

An earnings release that triggers the requirements of Item 12 is also subject to Regulation FD. Regulation FD permits a registrant to satisfy its disclosure obligations under that rule by furnishing the relevant information to the SEC pursuant to Item 9 of Form 8-K, as long as the registrant furnishes the information within the time frame required by Regulation FD. A registrant may simultaneously satisfy the requirements of the new earnings release rule and those of Regulation FD by furnishing a release to the SEC pursuant to Item 9 and Item 12 of the same Form 8-K, as long as it furnishes the release within the time frames required by both rules.

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Due to a delay in completion of the programming necessary to add new Item 12 of Form 8-K to the EDGAR system, the SEC issued interim guidance, effective March 28, 2003, regarding its filing requirements. This interim guidance will remain in effect until the SEC announces that the EDGAR system permits registrants to file or furnish information using Item 12 designations. The interim guidance relating to Item 12 disclosure is as follows:

- Registrants should furnish the information required by Item 12 under Item 9 ("Regulation FD Disclosure") of Form 8-K within five business days after the occurrence of an event specified in Item 12. However, should information that is provided under Item 12 also be required to be disclosed under Regulation FD, registrants should comply with any applicable earlier deadline for Item 9 disclosure.
- When furnishing Item 12 information under Item 9, registrants should indicate in the caption of the Form 8-K that the information is being provided under Item 12 (or under Items 9 and 12, if appropriate). Unless the registrant specifically states that the information contained in the Form 8-K is to be considered "filed" under the Exchange Act, or incorporated by reference into a filing under the Securities Act or the Exchange Act, the information is not deemed to be "filed" for the purposes of Section 18 of the Exchange Act.

4. Points to Remember

Companies should consider the following when they review their use of non-GAAP financial information:

- Non-GAAP financial measures may not appear on the face of financial statements or pro formas, or in the related notes. If a company wants to use these measures in a Form 10-K, Form 10-Q or registration statement, it should include them in the MD&A discussion.
- Non-GAAP financial measures may not be given more prominence than GAAP measures.
- Companies should expect the SEC Staff to carefully scrutinize non-GAAP financial measures that exclude non-recurring charges and to challenge the categorization of a charge as non-recurring.
- If management plans to disclose a non-GAAP financial measure in a conference call or meeting with investors and analysts, it should post the reconciliation required by the new rules on its website before the call, and inform participants that the reconciliation is available on the website.
- The Staff has indicated informally that the ratio of earnings to fixed charges is not a non-GAAP financial measure within the meaning of the new rules, since disclosure of this measure is required by SEC rules.

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- The Staff has also indicated that disclosure of revenues generated by a particular product line will not be treated as a non-GAAP financial measure, as long as the company also discloses total revenues.
- If a company discloses non-GAAP financial information and complies with Regulation FD by "furnishing" the information to the SEC pursuant to Item 9 of Form 8-K, it need not comply with the new Item 10 requirements. The Staff has clarified that the requirements apply only to material that is "filed" with the SEC, and not to material "furnished" to the SEC.

With respect to the new earnings release requirement, companies should keep in mind the following points:

- Repetition of earnings release information in quarterly and annual reports to shareholders does not trigger a new filing requirement.
- Corrections that are material will trigger a new filing requirement.
- Companies that schedule earnings release conference calls can satisfy their obligations under both Item 12 and Regulation FD by: (i) furnishing the earnings release to the SEC on Form 8-K at the same time that the release is publicly disseminated; (ii) posting the release on the website; (iii) ensuring that the public has access to the call; and (iv) making a public announcement regarding the call. The call should be held within 48 hours of the time the release is first disseminated.
- Companies should be aware that the foregoing requirement regarding website posting is broader than the obligation under Regulation FD. Regulation FD does not necessarily require that earnings information disclosed in a conference call be posted on the company's website, whereas the new rules do require that the information be posted.
- Companies should remember that if they include a non-GAAP financial measure in an earnings release, they must satisfy the new Item 10 requirements, as described above. It is not enough that they simply provide a reconciliation to GAAP. In addition, they must ensure that the most directly comparable GAAP measure is displayed at least as prominently as the non-GAAP financial measure, explain why they believe the non-GAAP measure is useful to investors and, if material, identify any other purposes for which they use the non-GAAP financial measure. The prohibitions set forth in Item 10, however, do not apply.
- Earnings information furnished on Form 8-K will not be automatically incorporated by reference in registration statements. Companies that wish to incorporate the earnings release information by reference into a registration statement that is already on file may state in their 8-K that they want the earnings release to be incorporated by reference.

In general, companies should be aware of the potential breadth of the new 8-K requirement. Read literally, the rule applies whenever management discloses

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information regarding its results of operation or financial condition for a completed annual period or quarter. Thus, for example, if the CEO provides information regarding revenue attributable to a particular product line or information regarding a particular type of expense for a completed quarter during a conference call with analysts, this information arguably must be furnished to the SEC pursuant to Item 12 of Form 8-K. Unless and until the SEC Staff provides guidance, the safest course would be to comply with Item 12 by furnishing a Form 8-K whenever such disclosures are made.

D. Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments

In a January 27, 2003 release, the SEC adopted amendments implementing Section 401(a) of the Sarbanes-Oxley Act.[14] Section 401(a) added Section 13(j) to the Exchange Act, which required the Commission to adopt final rules mandating each annual and quarterly financial report required to be filed with the Commission 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 financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses."

The new rules implement this requirement by adding Item 303(c) to Regulation S-K, requiring a registrant to provide an explanation of its off-balance sheet arrangements in a separately captioned subsection of the "Management's Discussion and Analysis" (MD&A) section in its disclosure documents, including Forms 10-K and 10-Q. The rules also require registrants (other than small business issuers) to provide an overview of certain known contractual obligations in a tabular format. Obligations that must be presented in tabular form include long-term debt, capital lease obligations, operating leases, purchase obligations and other long-term liabilities reflected on the issuer's balance sheet under GAAP. The table must disclose the aggregate amounts of such obligations existing as of the latest fiscal year end balance sheet date coming due within less than one year, within one to three years, within three to five years and after five years. The first three categories of contractual obligations are defined by reference to U.S. GAAP accounting pronouncements. The SEC has stated that a registrant that prepares its financial statements in accordance with non-U.S. GAAP, however, should include in the table contractual obligations that are consistent with the classifications used in the GAAP under which its primary financial statements are prepared.

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[14] Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments, Release Nos. 33-8182, 34-47264 (Jan. 27, 2003), *available at* http://www.sec.gov/rules/final/33-8182.htm.

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The rules include a "definition of 'off-balance sheet arrangements' that primarily targets the means through which companies typically structure off-balance sheet transactions or otherwise incur risks of loss that are not fully transparent to investors."[15] The definition of "off-balance sheet arrangements" employs concepts in accounting literature in order to define the categories of arrangements with precision. The definition includes the following categories of contractual arrangements:

- certain guarantee contracts;
- retained or contingent interests in assets transferred to an unconsolidated entity;
- derivative instruments that are classified as equity; and
- material variable interests in unconsolidated entities that conduct certain activities.

The rules require disclosure of off-balance sheet arrangements that either have, or are reasonably likely to have, a current or future effect that is material to investors. Disclosure is to be made regarding the registrant's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources . That disclosure threshold is "consistent with the existing disclosure threshold under which information that could have a material effect on financial condition, changes in financial condition or results of operations must be included in MD&A."[16]

Disclosure of off-balance sheet arrangements must include material facts and circumstances that provide investors with a "clear understanding" of the company's off-balance sheet arrangements and their material effects. The disclosure must cover the most recent fiscal year, and should discuss changes from the previous year if such a discussion is necessary to an understanding of the disclosure. The following specific disclosures must be made:

- the reasons for using off-balance sheet arrangements;
- the financial importance of off-balance sheet arrangements;
- the magnitude of off-balance sheet arrangements and circumstances that could trigger obligations; and
- the risks of termination of benefits from the arrangements.

The final rules also include a "principles-based requirement" that registrants must provide "such other information that the registrant believes is necessary" for an understanding of its off-balance sheet arrangements and the material effects of these

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[15] *Id.*

[16] *Id.*

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arrangements on its "financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources."

The term "off-balance sheet arrangements" is defined by reference to U.S. GAAP, and the requirement to make the disclosures applies regardless of the GAAP under which an issuer's primary financial statements are presented. The SEC has stated in its release announcing the disclosure requirements that it is not, however, imposing U.S. GAAP on non-U.S. issuers and that a non-U.S. issuer's MD&A disclosure should continue to focus on its primary financial statements, despite the fact that its disclosures regarding its off-balance sheet arrangements are defined by reference to U.S. GAAP. The SEC has also confirmed that the requirements regarding the disclosure of off-balance sheet arrangements do not apply to Form 6-K reports submitted to the SEC by non-U.S. issuers. Consequently, a non-U.S. issuer is not required to update its disclosures regarding off-balance sheet arrangements more frequently than annually unless it files a registration statement with the SEC that includes interim period financial statements.

Off-balance sheet arrangements should be aggregated into groups or categories that provide information in an efficient manner, avoiding unnecessary repetition and the disclosure of immaterial information. Common or similar effects that result from groups of off-balance sheet arrangements must be analyzed in the aggregate if such aggregation increases understanding. The final rules do not require disclosure of preliminary negotiations of off-balance sheet arrangements. Disclosure is required only if a binding definitive agreement is executed or, if there is no such agreement, when settlement of the transaction occurs.

The MD&A discussion of off-balance sheet arrangements need not repeat information provided in the footnotes to the financial statements. Instead, the registrant may make cross-references to specific information in the relevant footnotes. The registrant should integrate the substance of the footnotes into the MD&A discussion so that readers understand the significance of the information that is not included in the body of the discussion.

Registrants are required to comply with the disclosure requirements for off-balance sheet arrangements in Commission filings that are required to include financial statements for the fiscal years ending on or after June 15, 2003. Registrants are also required to comply with the tabular reporting format for selected obligations on Commission filings that are required to include financial statements for the fiscal years ending on or after December 15, 2003. Registrants may voluntarily comply with the new disclosure requirements before the compliance dates.

E. Insider Trades During Pension Fund Blackout Periods

Section 306(a) of the Sarbanes-Oxley Act prohibits directors or executive officers of an issuer from, either directly or indirectly, purchasing, selling or otherwise acquiring or transferring any equity security of the issuer (other than an exempted security) during any pension fund blackout period with respect to such equity security if the director or officer acquired the equity security in connection with his or her service or employment as a director or executive officer.

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In a January 22, 2003 release, the Commission adopted rules to clarify the application of Section 306(a).[10] Known as Regulation Blackout Trading Restriction ("Regulation BTR"), the rules incorporate many of the concepts used in Section 16 of the Exchange Act. Section 306(a) and Regulation BTR took effect on January 26, 2003.

Section 306(a) applies to directors and executive officers of reporting companies (including foreign private issuers, banks and savings associations and small business issuers). The term "director" has the same definition under the Exchange Act rules and the term "executive officer" means "officer" as defined in Section 16(a) of the Exchange Act (as opposed to the definition of "officer" in Rule 3b-2 under the Exchange Act).

Section 306(a) of the Sarbanes-Oxley Act applies to equity securities, but under Regulation BTR, this term also includes derivative securities (as defined in the rules under Section 16 of the Exchange Act relating to equity securities). Regulation BTR also applies to indirect and direct acquisitions and dispositions of equity securities where a director or executive officer has a pecuniary interest in the transaction. The term "pecuniary interest" also has the same meaning it has under the Section 16 rules, thereby including certain acquisitions and dispositions made by family members, partnerships, corporations, limited liability companies and trusts.

Regulation BTR exempts the following transactions:

- acquisitions of equity securities under dividend or interest reinvestment plans;
- purchases or sales of equity securities that satisfy the affirmative defense conditions of Exchange Act Rule 10b5-1(c) (that is, Rule 10b5-1 trading plans);
- purchases or sales of equity securities pursuant to certain employee benefit plans, other than "discretionary transactions" (as defined under the Section 16 rules);
- compensatory grants and awards of equity securities pursuant to programs under which grants and awards occur automatically;
- exercises, conversions or terminations of certain derivative securities which, by their terms, occur only on a fixed date or are exercised, converted or terminated by a counter-party who is not subject to the influence of the director or executive officer;
- acquisitions or dispositions of equity securities involving a bona fide gift or a transfer by will or the laws of descent and distribution;
- acquisitions or dispositions of equity securities pursuant to a domestic relations order;

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[17] Insider Trades During Pension Fund Blackout Periods, Release No. 34-47225 (Jan. 22, 2003), *available at* http://www.sec.gov/rules/final/34-47225.htm.

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- sales or other dispositions of equity securities compelled by the laws or other requirements of an applicable jurisdiction;
- acquisitions or dispositions of equity securities in connection with a merger, acquisition, divestiture or similar transaction occurring by operation of law; and
- increases or decreases in equity securities holdings resulting from a stock split, stock dividend or pro rata rights distribution.

Regulation BTR also specifies the timing and content of an issuer's notice obligations to directors, executive officers and the Commission.

The Section 306(a) statutory prohibition is triggered only if the blackout period lasts more than three consecutive business days and temporarily suspends the ability of at least 50% of the participants or beneficiaries under all individual account plans maintained by the issuer to purchase or sell an interest in issuer equity securities held in an account plan.

Different standards apply to foreign private issuers. Regulation BTR provides that, in the case of a foreign private issuer, the Section 306(a) trading prohibition is only triggered if the 50% test is satisfied and the number of U.S. plan participants subject to the temporary trading suspension is either: (i) greater than 15% of the issuer's worldwide workforce; or (ii) greater than 50,000 in number.

Section 306(a) also provides remedies for violation of the prohibition. An issuer or a security holder of that issuer (on behalf of the issuer) may bring an action to disgorge profits realized by a director or executive officer who trades during a blackout period. Additionally, a violation of the trading prohibition would subject the director or executive officer to possible enforcement action by the Commission.

Pursuant to new Item 11 of Form 8-K, effective March 31, 2003, a registrant is required to file notice of pension fund blackout periods with the SEC on the same day as such notice (as required under Section 306(a)) is transmitted to the registrant's directors and executive officers. From the effective date of Section 306(a), January 26, 2003, to the effective date of the Item 11 disclosure requirement, the SEC allowed registrants to provide the required information under Item 5 ("Other Information") of Form 10-Q or Form 10-QSB in the first quarterly report filed by the registrant after commencement of the blackout period. The interim guidance relating to Item 11 is as follows:

- Registrants should continue to disclose the information required by Item 11 under Item 5 of Form 10-Q or 10-QSB in the first quarterly report filed by the registrant after commencement of the blackout period.
- The text of the disclosure provided under Item 5 of the Form 10-Q or 10-QSB should indicate that the information is being provided under Item 11 of Form 8-K.

The Department of Labor also issued rules regarding pension fund blackout periods on January 24, 2003. New Section 101(i) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), as enacted by the Sarbanes-Oxley Act, requires that written

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notice be provided to participants and beneficiaries of individual account plans of any blackout period during which their right to make investments, obtain loans or obtain distributions may be suspended. The new rules give guidance to plan administrators and participants regarding the requirements for furnishing these notices. They also establish procedures for the assessment of civil penalties by the Department of Labor for failure to comply with the notice requirements.

F. Standards of Professional Responsibility for Attorneys "Appearing and Practicing" before the Securities and Exchange Commission

In a January 29, 2003 release, the SEC issued rules implementing Section 307 of the Sarbanes-Oxley Act, to take effect on August 5, 2003.[18] Section 307 directs the SEC to set forth standards of professional conduct for attorneys "appearing and practicing" before the Commission.

1. Overview

The final rules adopted by the SEC:

- require attorneys to report evidence of misconduct up-the-ladder to an issuer's chief executive officer, chief legal officer and board of directors;
- permit issuers to create a Qualified Legal Compliance Committee ("QLCC") as an alternative procedure for reporting evidence of misconduct;
- set forth circumstances under which an attorney may disclose confidential information to the SEC without the consent of the issuer-client;
- create a safe harbor from private liability for violations of the rules; and
- provide a transition period (180 days) for compliance with the rules.

The rules supplement standards of professional conduct maintained by states and other jurisdictions and are not meant to limit states from imposing additional obligations not inconsistent with the rules. Where state standards conflict with the rules, however, the rules will govern. Preemption of state standards is most likely to arise with respect to disclosure of confidential client information, as discussed below.

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[18] Implementation of Standards of Professional Conduct for Attorneys, Release Nos. 33-8185, 34-47276 (Jan. 29, 2003),*available at* http://www.sec.gov/rules/final/33-8185.htm.

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2. Attorneys Appearing and Practicing Before the SEC

The final rules require attorneys "appearing and practicing" before the SEC in the representation of issuers to report evidence of a material violation of law or breach of fiduciary duty by the issuer, or its agent up-the-ladder, to the chief legal counsel ("CLO") or to both the CLO and the chief executive officer ("CEO"). If the CLO or CEO fail to provide an "appropriate response" to the evidence, the attorney must report the evidence to the audit committee, another independent committee or the full board of directors.

The term "appearing and practicing" is defined to include:

- transacting any business with the SEC, including communications in any form;
- representing an issuer in SEC administrative proceedings or in connection with any SEC investigation, inquiry, information request or subpoena;
- providing advice with respect to the federal securities laws or SEC rules thereunder regarding any document that the attorney has notice will be filed with or submitted to the SEC; and
- advising an issuer as to whether information or a statement, opinion or other writing is required to be filed with or submitted to the SEC.

The rules do not apply to an attorney who engages in the above activities other than in the context of providing legal services to an issuer with whom the attorney has an attorney-client relationship. Thus, attorneys at public broker-dealers and other issuers who are licensed to practice law and who may transact business with the SEC, but who are not in the legal department and do not provide legal services within the context of an attorney-client relationship, are not covered by the rules. The adopting release emphasizes, however, that attorneys need not serve in an issuer's legal department to be covered if they are providing legal services within the context of an attorney-client relationship.

The rules also do not apply to non-appearing foreign attorneys. The term "non-appearing foreign attorney" is defined as an attorney who: (i) is admitted to practice law in a jurisdiction outside the United States; (ii) does not hold himself or herself out as practicing, or giving legal advice regarding, U.S. federal or state law; and (iii) conducts activities that would constitute appearing and practicing before the SEC only incidentally to a foreign law practice or in consultation with U.S. counsel. A foreign attorney must satisfy all three parts of the definition to be excluded from the rules. The rules also contain a provision stating that an attorney practicing outside the United States will not be required to comply with the rules to the extent that compliance is prohibited by applicable foreign law.

Under these new rules, an attorney who is retained or directed by an issuer to investigate evidence of a material violation will be deemed to be "appearing and

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practicing" before the SEC. The rules also relieve attorneys retained or directed to investigate or litigate reports of violations from reporting up-the-ladder under certain circumstances. Specifically, an attorney retained by the CLO to investigate evidence of a material violation is not obligated to report that evidence up-the-ladder if: (i) the attorney reports the results of the investigation to the CLO and the CLO thereafter reports the results to the board, an independent board committee or the QLCC; or (ii) the attorney was retained or directed to assert a colorable defense on behalf of the issuer or the issuer's agent in any investigation or judicial or administrative proceeding relating to the evidence, and the CLO reports the progress and outcome of the proceeding to the board, an independent board committee or the QLCC. Additionally, an attorney retained by a QLCC will not have an obligation to report evidence of a material violation up-the-ladder if the attorney was retained: (i) to investigate such evidence; or (ii) to assert a colorable defense on behalf of the issuer or the issuer's agent in any investigation or judicial or administrative proceeding relating to the evidence.

3. Material Violations

The rules set forth an objective standard for which types of evidence will trigger an attorney's reporting obligations. These obligations will be triggered only if the attorney has "credible evidence" based upon which it would be unreasonable for a prudent and competent attorney not to conclude that it is "reasonably likely" that a material violation has occurred, is occurring or is about to occur. The adopting release indicates that to be "reasonably likely," a material violation must be more than a mere possibility but need not be "more likely than not."

The term "material violation" is defined to include a material violation of U.S. federal or state securities law, a material breach of fiduciary duty or a similar material violation of any U.S. federal or state law. The term "breach of fiduciary duty" refers to any breach of fiduciary or similar duty recognized under an applicable U.S. federal or state statute or at common law, including misfeasance, nonfeasance, abdication of duty, abuse of trust and approval of unlawful transactions.

4. Obligations of Chief Legal Officer

Upon receiving evidence of a material violation, the CLO must initiate an appropriate inquiry into the evidence to determine whether the alleged violation has occurred, is occurring or is about to occur. If the CLO determines that no material violation exists, he or she must notify the reporting attorney and advise him or her of the basis for such determination. Unless the CLO reasonably believes that no material violation exists, however, he or she must take "all reasonable steps" to cause the issuer to adopt an appropriate response, and must advise the reporting attorney of the response.

In lieu of initiating such an inquiry, the CLO may refer a report of evidence to the QLCC (discussed below), but only if the issuer has established the QLCC prior to the report.

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5. Appropriate Response

As noted above, an attorney who does not receive an "appropriate response" from the CEO or CLO after reporting evidence of misconduct will be required to report the evidence to the issuer's audit committee, another board committee consisting solely of directors who are not employed by the issuer or the full board of directors (if the board has no committee consisting solely of directors who are not employed by the issuer). The rules provide that an "appropriate response" is one that leads the reporting attorney to reasonably believe:

- that no material violation has occurred, is occurring or is about to occur;
- that the issuer has adopted appropriate remedial measures to stop ongoing violations, prevent future violations and remedy or otherwise address past violations; or
- that the issuer (with the consent of the board, an independent board committee or the QLCC) has retained or directed an attorney to review the reported evidence and has either (i) substantially implemented any remedial recommendations made by such attorney or (ii) been advised that such attorney may assert a colorable defense on behalf of the issuer or its agent in any investigation or proceeding relating to the reported evidence.

The adopting release states that the factors a reporting attorney might consider in determining whether he or she could "reasonably believe" that an issuer's response was appropriate would include the amount and weight of evidence of a material violation the severity of the apparent material violation, and the scope of the investigation into the report.[19]

6. Qualified Legal Compliance Committee

The rules authorize an issuer to create a QLCC as an alternative procedure for reporting evidence of material violations. This alternative procedure permits, but does not require, an attorney to report evidence of a material violation directly to a QLCC, if the issuer has previously formed such a committee. Under the rules, an attorney who reports evidence to a QLCC will be deemed to have satisfied his or her reporting obligations and will not be required to assess the issuer's response to the evidence.

The rules allow a QLCC to be a separate committee of the issuer's board of directors, or it may be an audit or other standing committee of the board. In any event, the QLCC must consist of at least one member of the issuer's audit committee

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[19] *Id.*

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and two or more additional directors who are not employed by the issuer and who are not, in the case of a registered investment company, "interested persons." The SEC has indicated that it does not intend service on a QLCC to result in increased liability of any member of the board under state law.[20]

The QLCC must adopt written procedures for the confidential receipt, retention and consideration of any report of evidence of a material violation. In addition, the QLCC must have the authority and responsibility to:

- inform the issuer's CLO and CEO of any report of evidence of a material violation;
- determine whether an investigation is necessary and, if so, to: (i) notify the audit committee or the full board; (ii) initiate an investigation; and (iii) retain additional expert personnel as the QLCC deems necessary;
- at the conclusion of any such investigation, : (i) recommend (by majority vote) that the issuer implement an appropriate response, and (ii) inform the CLO, CEO, and board of the results of the investigation and the appropriate remedial measures to be adopted; and
- acting by majority vote, take "all other appropriate action."

Under the rules, although the QLCC must have the authority and responsibility to recommend that an issuer implement an appropriate response, the QLCC is not required to direct the board or the issuer to take action. The QLCC must have the authority, however, to notify the SEC if the issuer fails to implement an appropriate response that the QLCC has recommended.

7. Documentation Requirements

Proposed documentation requirements, which would have imposed mandatory record-keeping obligations upon issuers and attorneys, were eliminated from the final rules. The SEC believes, however, that voluntary documentation of attorney reports and issuer responses may be appropriate in many cases.

8. Issuer as Client

The rules provide that an attorney appearing and practicing before the SEC in the representation of an issuer owes his or her professional and ethical duties to the issuer as an organization, not to the issuer's individual officers, directors or employees. The reference in the proposed rules to an attorney having a duty to act in the "best interests" of the issuer and its shareholders was not included in the final rules.

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[20] *Id.*

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9. Disclosure of Confidential Information

An attorney who has reported evidence of a material violation may use that report (and any response to the report) in connection with any investigation, proceeding or litigation in which the attorney's compliance with the rules is at issue. In addition, the rules provide that an attorney may, without the issuer's consent, reveal to the SEC confidential information related to the representation to the extent that the attorney reasonably believes necessary to:

- prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interests or property of the issuer or investors;
- prevent the issuer, in an SEC investigation or administrative proceeding, from committing perjury or another illegal act that is likely to perpetrate a fraud on the SEC; or
- rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interests or property of the issuer or investors, in furtherance of which the attorney's services were used.

As noted above, the rules are not intended to restrict states from imposing higher obligations not inconsistent with the rules. To the extent that state standards conflict with the rules, however, the rules will govern. This is particularly significant in jurisdictions, such as the District of Columbia, that bar the disclosure of information permitted to be disclosed under the SEC rules.

10. Responsibilities of Supervisory and Subordinate Attorneys

Under the rules, a "supervisory attorney" (including a CLO) must make reasonable efforts to ensure that any subordinate attorney whose actions are supervised or directed by the supervisory attorney conforms to the rules. To the extent that a subordinate attorney appears and practices before the SEC in the representation of an issuer, that attorney's supervisory attorneys should also appear and practice before the SEC. Furthermore, a supervisory attorney is responsible for complying with the rules' reporting requirements when a subordinate attorney has reported evidence of a material violation to the supervisory attorney.

A "subordinate attorney" will be deemed to have complied with the reporting requirements if the subordinate attorney reports to his or her supervisory attorney evidence of a material violation of which the subordinate attorney has become aware. The rules provide, however, that an attorney who appears and practices before the SEC under the direct supervision of a CLO is not considered a subordinate attorney and therefore, must comply with the reporting requirements.

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11. Remedies and Safe Harbor

The rules provide that an attorney who violates the rules will be subject to all civil penalties and remedies available to the SEC under the federal securities laws.

The SEC has included a safe harbor to protect attorneys, law firms and issuers from private liability for violations of the rules. The rules are not intended to, nor do they, create a private right of action based upon compliance or non-compliance with rule provisions.

12. Effective Date

The rules became effective for attorneys and issuers on August 5, 2003.

13. Additional Proposed Rules Regarding Attorney Conduct and "Noisy Withdrawal"

On January 29, 2003, the SEC proposed additional provisions pursuant to Section 307 of the Sarbanes-Oxley Act requiring an attorney to withdraw from representation and notify the SEC if an issuer fails to "appropriately respond" to "evidence of misconduct."[21] The SEC initially proposed to include these "noisy withdrawal" provisions in its rules implementing Section 307 discussed above. Instead, the SEC decided to defer final action on the "noisy withdrawal" provisions, revise the proposed rules to provide an alternative reporting-out approach and extend the comment period for an additional 60 days.

The proposed rules prescribe actions to be taken by an attorney who has not received an appropriate response to his or her report of a material violation. Specifically, where an attorney who has reported evidence of a material violation to the board does not receive an appropriate response in a reasonable time, and the attorney reasonably believes that a material violation <u>is occurring or about to occur</u> and is likely to result in substantial injury to the financial interests or property of the issuer or investors:

- an outside attorney <u>must</u>: (i) withdraw from representing the issuer, indicating that the withdrawal is based on professional considerations; (ii) within one business day, notify the SEC in writing of the withdrawal; and (iii) promptly disaffirm to the SEC any document (or the like) filed with or submitted to the SEC that the attorney prepared or assisted in preparing and that the attorney reasonably believes is or may be materially false or misleading.

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[21] Implementation of Standards of Professional Conduct for Attorneys, Release No. 33-8186 (Jan. 29, 2003), *available at* http://www.sec.gov/rules/final/33-8186.htm.

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- an in-house attorney must: (i) within one business day, notify the SEC in writing that he or she intends to disaffirm a document (or the like) filed with or submitted to the SEC that the attorney prepared or assisted in preparing and that the attorney reasonably believes is or may be materially false or misleading; and (ii) promptly disaffirm to the SEC any such document.

For material violations that already have occurred and are likely to have resulted in substantial injury to the financial interests or property of the issuer or investors, the proposed rules state that:

- an outside attorney who has not received an appropriate response from the board may: (i) withdraw, indicating that the withdrawal is based on professional considerations; (ii) notify the SEC in writing of the withdrawal; and (iii) disaffirm to the SEC any document (or the like) filed with or submitted to the SEC that the attorney prepared or assisted in preparing and that the attorney reasonably believes is or may be materially false or misleading.
- an in-house attorney who has not received an appropriate response from the board may: (i) notify the SEC in writing that he or she intends to disaffirm a document (or the like) filed with or submitted to the SEC that the attorney prepared or assisted in preparing and that the attorney reasonably believes is or may be materially false or misleading; and (ii) disaffirm to the SEC any such document.

An issuer's CLO would be required to inform any attorney retained or employed to replace a withdrawing attorney that the previous attorney's withdrawal was based on professional considerations.

The proposed rules provide that any notification to the SEC prescribed by the rules would not breach the attorney-client privilege. The SEC is inviting comments on any aspect of the proposal, including whether any reporting-out provision should be adopted, whether "noisy withdrawal" should be mandatory in some circumstances and permissive in others and whether it is appropriate to distinguish between ongoing and past violations and between in-house and outside counsel. The SEC is particularly interested in learning how common it is for attorneys to alert their issuer-clients' management or board to evidence of violations, but to then receive either no response or an inappropriate response.

The proposed "noisy withdrawal" rules were heavily criticized by attorneys, issuers, bar associations and others during the SEC's initial comment period. In response to these criticisms, the SEC decided to extend the comment period and propose alternative reporting-out rules, which are designed to eliminate the ethical concerns raised by having attorneys report to the SEC. Under the alternative proposal, the issuer (not the attorney) would be required, within two business days, to disclose on Form 8-K a notification by one of its attorneys of his or her withdrawal for professional considerations (if the attorney is an outside attorney), or failure to

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receive an appropriate response to a report of a material violation (if the attorney is an in-house attorney).

The alternative proposal would eliminate the "noisy withdrawal" provisions and require attorney action only where the attorney reasonably concludes that there is substantial evidence that a material violation is occurring or is about to occur and is likely to cause substantial injury to the financial interests or property of the issuer or investors. In such cases, where the attorney has not received an appropriate response from the board within a reasonable time:

- An outside attorney would be required to withdraw and notify the issuer in writing that the withdrawal is based on professional considerations.
- An in-house attorney would be required to "cease forthwith any participation or assistance" in any matter concerning the violation and notify the issuer in writing that he or she believes the issuer has not provided an appropriate response to the evidence.

As noted above, an issuer receiving notification under these provisions would be required to publicly disclose such notification and the related circumstances on Form 8-K within two business days.

The alternative proposal would require the issuer's CLO to notify any attorney retained or employed to replace an attorney who has given notice to an issuer that the previous attorney has withdrawn for professional considerations or ceased to participate or assist. In addition, the alternative proposal would permit an attorney, if the issuer did not comply with the reporting-out rules, to inform the SEC that he or she had provided the issuer with notice under the rules.

The SEC solicited comments on any aspect of the alternative proposal, including: (i) whether the required attorney determinations are appropriate; (ii) whether failing to apply mandatory withdrawal to past violations adequately protects investors; (iii) whether the alternative proposal is more compatible with existing state standards than the "noisy withdrawal" proposal; and (iv) whether investors and issuers will be adequately protected if the rules contain no reporting-out requirement. In addition, the SEC is seeking comments on whether an issuer should be permitted not to disclose an attorney's notification where a committee of independent directors of the issuer's board determines, based on the advice of disinterested counsel: (i) that the attorney providing the notification acted unreasonably; or (ii) that the issuer has, subsequent to such notification, implemented an appropriate response.

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G. Auditor Workpaper Retention

On January 24, 2003, the Commission issued a release adopting rules to implement Section 802 of the Sarbanes-Oxley Act.[22] Section 802 of the Sarbanes-Oxley Act requires that the SEC promulgate "rules and regulations, as are reasonably necessary, relating to the retention of relevant records such as workpapers, documents that form the bases of an audit or review, memoranda, correspondence, communication, other documents, and records (including electronic records) which are created, sent or received in connection with an audit or review and contain conclusions, opinions, analyses, or financial data relating to such an audit of an issuer of securities . . . ."

These rules require auditors to retain specific information for seven years after completing an audit or review of a registrant's financial statements.

The rules define the documents to be retained to include not only workpapers that support the auditor's conclusions, but also documents that may cast doubts on the auditor's conclusions. As a result, an auditor would be required to retain any documentation that influences the auditor's opinion about accounting and auditing issues.

The rules became effective March 3, 2003. Compliance is required for all audits and reviews completed on or after October 31, 2003.

H. Auditor Independence

In a release dated January 28, 2003, the SEC adopted rules to implement the provisions in Sections 201-206 of the Sarbanes-Oxley Act strengthening auditor independence and requiring revised disclosures to investors about the services provided to issuers by the independent auditor.[23]

The rules list nine non-audit services that, if provided to an audit client, would impair an accounting firm's independence. These nine services are defined as follows:

- bookkeeping or other services related to the accounting records or financial statements of the audit client;
- financial information systems design and implementation;
- appraisal or valuation services, fairness opinions or contribution-in-kind reports;
- actuarial services;

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[22] Retention of Records Relevant to Audits and Reviews, Release Nos. 33-8180, 34 -47241 (Jan. 24, 2003),*available at* http://www.sec.gov/rules/final/33-8180.htm.

[23] Strengthening the Commission's Requirements Regarding Auditor Independence, Release Nos. 33-8183, 34-47265 (Jan. 28, 2003), *available at* http://www.sec.gov/rules/final/33-8183.htm.

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- internal audit outsourcing services;
- management functions or human resources;
- broker or dealer, investment adviser or investment banking services;
- legal services; and
- expert services unrelated to the audit. (Specifically, an accountant is prohibited from providing expert opinions or other expert services to an audit client, or a legal representative of an audit client, for the purpose of advocating that audit client's interests in litigation or in a regulatory or administrative proceeding or investigation. An accountant's independence is not impaired, however, by an accountant providing factual accounts or testimony or explaining the positions taken or conclusions reached during the performance of any service by the accountant.)

Sections 201 and 202 of the Sarbanes-Oxley Act provide that an issuer's audit committee must pre-approve allowable services to be provided by the auditor of the issuer's financial statements. The new rules implement these sections by requiring that the audit committee pre-approve all services. In doing so, the audit committee may establish policies and procedures for pre-approval provided they are consistent with the Sarbanes-Oxley Act, detailed as to the particular service and designed to safeguard the continued independence of the accountant.[24]

The rules also include a de minimis exception for the inadvertent failure to pre-approve non-audit services, which will likely not be useful as this exception requires that non-audit services: (i) do not aggregate to more than five percent of total revenues paid by the audit client to its accountant in the fiscal year when services are provided; (ii) were not recognized as non-audit services at the time of the engagement; and (iii) are promptly brought to the attention of the audit committee and approved prior to the completion of the audit by the audit committee or one or more designated representatives.

The final rules requires disclosure in periodic reports of audit fees and non-audit services approved by the audit committee. In their annual reports, issuers must provide fees paid to the independent accountant for: (i) audit services; (ii) audit-related services; (iii) tax services; and (iv) other services. Additionally, the disclosures must include the audit committee's policies and procedures for pre-approval of services by the independent accountant as well as the percent of fees paid subject to the de minimis exception.

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[24] On August 7, 2003, the office of the Chief Accountant of the SEC issued an FAQ regarding the auditor independence rules. The FAQ is available at http://www.sec.gov/info/accountants/ocafaqaudind080703.htm. The FAQ states that, although the level of detail that is appropriate in a pre-approval policy depends on a company's facts and circumstances, the establishment of monetary limits alone is not sufficient because these limits do not, without more, provide sufficient detail or adequately inform the audit committee.

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Section 201 of the Sarbanes-Oxley Act provides that "a registered public accounting firm may engage in any non-audit service, including tax services," that is not expressly prohibited, after audit committee pre-approval. Accordingly, accountants will be able to continue to provide tax compliance, tax planning and tax advice to audit clients, subject to audit committee pre-approval requirements. There are, however, circumstances in which providing certain tax services to an audit client would impair the independence of an accountant. For example, an auditor would impair its independence by representing an audit client in tax court.

For purposes of the requirements for partner rotation and partner compensation, the rules contain a definition for the new term "audit partner." . An "audit partner" is defined as a partner who is a member of the audit engagement team who has responsibility for decision-making on significant auditing, accounting and reporting matters that affect the financial statements, or who maintains regular contact with management and the audit committee. "Audit partner" includes: (i) the lead and concurring partners as well as partners who serve the client at the issuer level, other than a partner who consults with others on the audit engagement team regarding technical or industry-specific issues; and (ii) the lead partner on subsidiaries of the issuer whose assets or revenues constitute 20% or more of the consolidated assets or revenues of the issuer.

Section 203 of the Sarbanes-Oxley Act specifies that the lead and concurring partner must be subject to rotation requirements after five years. The new rules mandate that the lead and concurring partner rotate after five years and be subject to a five-year "time out" period after rotation. Additionally, certain other significant audit partners will be subject to a seven-year rotation requirement with a two-year time out period.

The new rules also provide that an accountant is not independent if, at any point during the audit and professional engagement period, any audit partner earns or receives compensation based on that partner procuring engagements with the audit client to provide any services other than audit, review or attest services.

Section 206 of the Sarbanes-Oxley Act establishes a one-year cool period before a member of the audit engagement team may accept employment in designated financial or executive positions with an issuer client. The rules, therefore, provide that an accounting firm is not independent if a member of management involved in overseeing financial reporting matters was the lead partner, the concurring partner or any other member of the audit engagement team who provided more than ten hours of audit, review or attest services for the issuer within the one year period preceding the commencement of the audit of the current year's financial statements.

Section 204 of the Sarbanes-Oxley Act requires timely reporting of specific information by accountants to audit committees. Pursuant to this section, the new rules require the accounting firm to report to the audit committee, prior to the filing of its audit report with the Commission: (i) all critical accounting policies and practices used by the issuer; (ii) all material alternative accounting treatments of financial information within GAAP that have been discussed with management, including the ramifications of the use of such alternative treatments and disclosures, and the treatment preferred by the accounting

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firm; and (iii) other material written communications between the accounting firm and management.

In recognition of the fact that some of these provisions may impose an undue burden on certain smaller accounting firms, the new rules provide that firms with fewer than five audit clients and fewer than ten partners may be exempt from the partner rotation and compensation provisions, provided each of these engagements is subject to a special review by the PCAOB at least every three years.

The SEC has also recognized that foreign accounting firms or foreign private issuers may face additional hurdles in implementing these rules. Rules relating to partner rotation and the scope of personnel subject to the "cooling off" period apply to foreign accounting firms. Additional time, however, is afforded to foreign accounting firms with respect to compliance with rotation requirements. The rules also provide guidance on the provision of non-audit services by foreign accounting firms, including the treatment of legal services and tax advice.

The rules became effective May 6, 2003, but contain a transition period (one year, in most cases) for relationships existing prior to May 6, 2003.

I. Standards related to Listed Company Audit Committees

In an April 9, 2003 release, the SEC adopted Exchange Act Rule 10A-3 implementing Section 10A(m)(1) of the Exchange Act, as added by Section 301 of the Sarbanes-Oxley Act.[25] This rule implements the Sarbanes-Oxley Act's requirement that the SEC direct the national securities exchanges and national securities associations to refuse listing of securities of issuers whose audit committees do not comply with the five requirements specified in the Sarbanes-Oxley Act. These five requirements relate to: (i) the independence of audit committee members; (ii) the audit committee's responsibility to select and oversee the issuer's independent accountant; (iii) procedures for handling complaints regarding accounting or auditing matters; (iv) the authority of the audit committee to engage outside advisors; and (v) funding for the outside auditor and any outside advisors engaged by the audit committee. The rule, as adopted in final form, implements all five of these requirements.

1. Definition of Independence

Under Section 301 of the Sarbanes-Oxley Act, listed companies must have audit committees consisting entirely of independent directors. The Act provides that, to be independent, an audit committee member must not accept any "consulting, advisory or other compensatory fee" from the issuer, other than amounts received as compensation for membership on the board of directors, the audit committee or any

[25] Standards Relating to Listed Company Audit Committees, Release Nos. 33-8220, 34-47654 (Apr. 9, 2003), *available at* http://www.sec.gov/rules/final/33-8220.htm.

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other committee. Indirect payments, including payments to a law firm or consulting firm where the director is a partner, would also prevent the individual from being viewed as an independent director. There is no exception in the rules permitting de minimis payments to directors.

In addition, a member of the audit committee may not be an "affiliated person" of the listed company or any subsidiary. The final rules define an "affiliated person" as a person who directly or indirectly controls, is controlled by or is under common control with, the company or a subsidiary. The rules include a safe harbor for persons who are not executive officers of the listed company and who own less than 10 percent of the company's securities. According to the SEC Staff, those who are ineligible to rely on the safe harbor may still rely on a "facts and circumstances" analysis to determine control.

2. Accommodation for New Issuers

The final rules include an accommodation for new public companies. Such companies must have one independent member on their audit committee at the time of listing, a majority-independent audit committee within 90 days after listing and a fully independent audit committee within one year after listing.

3. Accommodations for Holding Companies

In addition, the rules contain an accommodation for holding companies whose directors also serve as directors of a subsidiary. Under the rules, concurrent service on both companies' boards will not preclude a director from serving on either company's audit committee, provided the director is otherwise independent.

4. Accommodations for Foreign Issuers

Given concerns about conflicting regulations and practices in some foreign jurisdictions, the rules include limited exemptions for foreign issuers. First, the rules exempt from the independence requirements certain non-management employees named to the audit committee pursuant to home country "co-determination" and similar requirements. According to the SEC Staff, employees serving on the audit committee under this exemption may not be "executive officers," defined in part as persons with a "policymaking function." Similarly, in accordance with home country requirements, a foreign government representative may serve on the audit committee if he or she is not an executive officer of the issuer and does not receive compensation from the issuer (other than director and committee fees).

Second, the rules include a limited exception from the independence requirements for controlling shareholders of foreign issuers. Specifically, one member of a foreign issuer's audit committee may be a controlling shareholder or shareholder representative, but only if the shareholder or representative does not receive compensation from the issuer, has only observer status on the audit committee and is not an executive officer of the issuer.

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Third, the rules are not intended to conflict with any requirement in an issuer's home jurisdiction that requires shareholders to select, approve or ratify the selection of the independent auditor. In addition, the rules are not meant to conflict with home country requirements relating to shareholder approval of auditor termination and auditor compensation.

Finally, alternative structures, such as boards of auditors and statutory auditors, are permitted to perform auditor oversight functions where such structures are provided for under local law, provided that such auditors are not elected by the issuer's management.

Foreign issuers that are required to disclose whether they have an audit committee financial expert will also be required to disclose whether that individual is "independent" under the applicable SRO listing standard.

Other special provisions for non-U.S. issuers include the following:

- In recognition of the fact that in some countries employee representatives may be required to serve on a company's audit committee as a matter of law or pursuant to an employee collective bargaining agreement, the listing standards may permit an employee of a non-U.S. issuer to serve on the audit committee if that employee is not an executive officer of the issuer and if he or she is elected to the audit committee pursuant to the issuer's governing law or documents, an employee collective bargaining agreement or other home country legal or listing requirements.
- An affiliate of a non-U.S. issuer or a representative of such an affiliate may be permitted to serve as a non-voting observer on the issuer's audit committee provided that he or she is not the chair of the audit committee.
- In a situation in which a non-U.S. government is an affiliate of a non-U.S. issuer, there may be an exemption for a representative of that government to serve on the issuer's audit committee.

A non-U.S. issuer that avails itself of any of the special provisions listed above will be required to disclose that fact in its annual report on Form 20-F and to disclose its assessment of whether reliance on any of the special provisions materially adversely affects the ability of its audit committee to act independently.

In adopting these special provisions, the SEC has noted its authority under the Sarbanes-Oxley Act to grant further relief to non-U.S. issuers in response to, and has indicated its intent to remain sensitive to, future conflicts between non-U.S. corporate governance rules and practices and the listing standards required by Section 301.

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5. Responsibilities of the Audit Committee

The rules provide that a listed company's audit committee must be directly responsible for the appointment, compensation, retention and oversight of the company's independent auditor, and the independent auditor must report directly to the audit committee. SEC Commissioner Harvey Goldschmid has stated that, under the rules, the audit committee is also responsible for firing the independent auditor when appropriate.

Under the rules, the audit committee must establish procedures for:(i) the receipt, retention and treatment of complaints regarding accounting, internal controls and auditing matters, and (ii) the confidential, anonymous submission by employees of the company of concerns regarding accounting and auditing matters. Moreover, the audit committee must have the authority to engage independent counsel and other advisers as it determines necessary to carry out its duties. The listed company must provide appropriate funding, as determined by the audit committee, to compensate the independent auditor and outside advisors.

6. Reporting Requirements

The rules also update existing SEC disclosure requirements relating to audit committees. An issuer must disclose: (i) the use of any exemptions in the rule and its assessment of whether, and how, such exemption may materially adversely affect the ability of their audit committee to act independently and satisfy the other requirements of the rule; (ii) the identification of the audit committee in annual reports; and (iii) disclosures concerning the audit committee's independence in proxy statements. With respect to disclosures contained within a proxy statement, the audit committee must provide a report disclosing whether the audit committee has reviewed the company's audited financial statements with management and discussed various matters with the independent auditors. Issuers must also disclose whether the audit committee is governed by a charter, and if so, must include a copy of the charter as an appendix to the proxy statement at least once every three years. Last, the issuer must disclose whether members of the audit committee are "independent." This latter disclosure requires non-listed companies to choose a definition of "independent" from among those used in the listing standards of the New York Stock Exchange, the NASDAQ Stock Market, and the American Stock Exchange. In all other respects, the rule only affects listed companies.

7. Timing

Domestic listed companies will be required to comply with the new listing standards by the date of their first annual shareholder meeting after January 15, 2004, but, in any event, no later than October 31, 2004. Foreign issuers and small business issuers will be required to comply by July 31, 2005.

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J. Management Assessment of Internal Controls

In a June 5, 2003 release, the SEC adopted rules implementing Section 404 of the Sarbanes-Oxley Act, requiring public companies, other than investment companies, to include a report of management on the company's internal controls over financial reporting in their annual reports on Form 10-K.[26] The rules also require the independent auditor of each public company to issue an attestation report on management's assessment of the company's internal controls, and this attestation report must be included in public companies' annual reports on Form 10-K.

Importantly, the SEC provided an extended transition period, pursuant to which domestic issuers that are subject to the accelerated reporting requirements will not be required to include management's internal control report and the auditor's attestation report until the first annual report on Form 10-K that is filed for fiscal years ending on or after November 15, 2004. Non-accelerated filers must begin to comply with the new requirements beginning with their first fiscal years ending on or after July 15, 2005.

Under the final rules, each annual report on Form 10-K (and foreign company annual reports on Form 20-F or Form 40-F) must include an internal control report setting forth:

- a statement of management's responsibility for establishing and maintaining internal controls and procedures for financial reporting;
- a statement about the effectiveness of the company's internal controls and procedures, based on management's evaluation of those controls and procedures;
- a statement identifying the framework used by management to evaluate the company's internal controls over financial reporting; and
- a statement that the company's independent auditor has attested to, and reported on, management's evaluation of the internal controls and procedures for financial reporting.

The SEC has stated that management's assessment of the effectiveness of the issuer's internal control over financial reporting must be supported by evidence, including documentation to provide reasonable support for: (i) the evaluation of whether the control is designed to prevent or detect material misstatements or omissions; (ii) the conclusion that the tests were appropriately planned and performed; and (iii) the conclusion that the results of the tests were appropriately considered.

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[26] Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reporting, Release No. 33-8238 (June 5, 2003), *available at* http://www.sec.gov/rules/final/33-8238.htm. As part of its guidance with regard to the PCAOB's Auditing Standard No. 2, the SEC has provided additional guidance with regard to internal controls. Please see, *supra*, Section II.A.

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Under the final rules, the SEC defines "internal control over financial reporting" to be:

> A process designed by, or under the supervision of, the registrant's principal executive and principal financial officers, or persons performing similar functions, and effected by the registrant's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:
>
> - pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the registrant;
> - provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the registrant are being made only in accordance with authorizations of management and directors of the registrant; and
> - provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the registrant's assets that could have a material effect on the financial statements.[27]

The definition encompasses the subset of internal controls addressed in the now familiar standards for internal controls over financial reporting set forth in the report of the Committee of Sponsoring Organizations of the Treadway Commission (the "COSO Report"). In this regard, the SEC also indicated that the framework set forth in the COSO Report is an acceptable framework upon which management can base its evaluation of internal controls.

As required under Section 404, the final rules require that public companies include an attestation report from the independent auditor in each annual report on Form 10-K (and foreign company annual reports on Forms 20-F or Form 40-F). On this issue, the SEC indicated that the PCAOB should act soon to provide new standards for procedures related to performing the attestation.

The final rules took a "step back" from the proposed rules on the issue of quarterly certification requirements for internal controls. Specifically, the proposed rules would have required management to perform a quarterly evaluation of the effectiveness of the company's internal controls. Instead, the final rules only require management to determine on a quarterly basis whether there have been any material changes in the company's internal controls and to report any material changes that have occurred.

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[27] *Id.*

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Domestic listed companies that satisfy the SEC's accelerated-filer requirements are required to include management's internal control report and the auditor's attestation report in the first annual report filed for fiscal years ending on or after June 15, 2004. Foreign issuers and small business issuers will be required to include these reports in their first annual report filed for fiscal years ending on or after April 15, 2005. The SEC indicated that it views these extended transition periods to be appropriate because they allow the PCAOB sufficient time to establish the required definitions and standards for attestation, and companies sufficient time to implement the new requirements.

K. Improper Influence on the Conduct of Audits

In a May 20, 2003 release, the SEC issued a final rule implementing Section 303(a) of the Sarbanes-Oxley Act. Section 303 required the SEC to issue rules prohibiting officers and directors of issuers, and others acting under their direction, from improperly influencing the conduct of an audit of the issuer's financial statements.[28] The final rule and the adopting release significantly expand on the text of Section 303. The new rules became effective as of June 27, 2003.

Section 303(a) of the Sarbanes-Oxley Act provides that:

> It shall be unlawful, in contravention of such rules or regulations as the Commission shall prescribe as necessary or appropriate in the public interest and for the protection of investors, for any officer or director of an issuer, or any other person acting under the direction thereof, to take any action to fraudulently influence, coerce, manipulate or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements for that issuer for the purpose of rendering such financial statements materially misleading.

The final rule issued by the SEC under Section 303(a) supplemented the prior Rule 13b2-2. The final rule moved the text of the prior Rule 13b2-2 to Rule 13b2-2(a) and added two new parts as subsections (b) and (c). Subsection (a) of the rule prohibits officers and directors of issuers from falsifying books and records and from making false or misleading statements or omissions to accountants in connection with an audit or the preparation or filing of a report with the SEC.

Subsection (b) implements the Section 303 prohibition with respect to issuers. The first part substantially mirrors the language of Section 303(a), cited above, with a few notable exceptions. The rule provides that:

> No officer or director of an issuer, or any other person acting under the direction thereof, shall directly or indirectly take any action to coerce,

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[28] Improper Influence on Conduct of Audits, Release No. 34-47890 (May 20, 2003), *available at* http://www.sec.gov/rules/final/34-47890.htm.

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> manipulate, mislead or fraudulently influence any independent public or certified public accountant engaged in the performance of an audit or review of the financial statements of that issuer that are required to be filed with the Commission pursuant to this subpart or otherwise if that person knew or should have known that such action, if successful, could result in rendering the issuer's financial statements materially misleading.[29]

The second part of subsection (b) identifies a non-exclusive list of actions that an auditor could be improperly influenced to undertake and that could, if successful, result in rendering the issuer's financial statements materially misleading. For example, the list includes improperly influencing an auditor to issue an unwarranted report on the issuer's financial statements and improperly influencing an auditor not to communicate matters to the issuer's audit committee.

Subsection (c) of Rule 13b2-2, as modified by the final rule applies only to registered investment companies. In addition to implementing the Section 303 prohibition with respect to investment companies, subsection (c) also expressly applies the current Rule 13b2-2 prohibition to investment companies.

The text of the final rule and the adopting release emphasize the SEC's broad view of the scope of Section 303. Most notably:

- The rule does not require specific intent to render the issuer's financial statements materially misleading, nor does it require that an action achieve its desired end or actually result in misleading financial statements. The rule requires only that the person exerting the improper influence "*knew or should have known* that such action, *if successful*, *could* result in rendering the issuer's financial statements materially misleading."
- The SEC interprets the phrase "under the direction of" broadly to include third parties. In addition to employees of the issuer, the SEC could initiate enforcement action under the rule against an issuer's customers, creditors and outside advisers, including accountants, attorneys and financial advisers.
- The rule is not limited to improper influence with respect to the formal audit engagement period of an issuer's current outside auditor. The rule covers any "independent public or certified public accountant" engaged in the "audit or review" of the issuer's financial statements. The SEC interprets the phrase "engaged in the performance of an audit or review" broadly to encompass not only the formal engagement period, but also any time prior to or after such period where the accountant is called upon to make decisions or judgments about the financial statements, such as a decision to issue a consent to the use of prior years' audit reports.

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[29] *Id.*

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The final rule addresses intent in two places. First, the rule requires that the person exerting improper influence "knew or should have known" that his or her actions, if successful, could result in rendering the financial statements materially misleading. Here, the final rule departs from the text of Section 303 by using "knew or should have known," a negligence standard, in place of the statutory "for the purpose of" language, which would require specific intent. Thus, the SEC will not be required to show that a person's actions were intended to render the issuer's financial statements materially misleading, but only that the person knew, or was negligent in not knowing, that his or her actions could achieve that result. The distinction is illustrated by an example in the adopting release:

> For example, if an officer of an issuer coerces an auditor not to conduct certain audit procedures required by generally accepted auditing standards ("GAAS") because the officer wants to conceal his embezzlement of funds from the issuer, then it is possible that his actions might not be found to be for the "purpose of rendering the financial statements misleading." If that officer, however, knew or should have known that not performing the procedures could result in the auditor not detecting and seeking correction of material errors in the financial statements, then we believe the officer's conduct should be subject to the rule.[30]

Second, the rule requires that the person "coerce, manipulate, mislead or fraudulently influence" an auditor. Here, the SEC has re-ordered the text of Section 303 to place "fraudulently influence" after "coerce, manipulate, mislead" rather than at the beginning of the list. This change emphasizes the SEC's position that "fraudulently" modifies "influence" and not "coerce, manipulate or mislead." Thus, the SEC has eliminated any additional scienter requirement that may have been required with respect to charges of coercing, manipulating or misleading. Explaining this change, the SEC states that coerce and manipulate "imply pressure, threats, trickery, intimidation or some other form of purposeful action," and therefore, no further modifier is necessary. Further, the adopting release states that causing misleading statements to be made to an auditor is already prohibited by current Rule 13b2-2, and therefore, attaching "fraudulently" to "mislead" would heighten the standard required by existing law, and undercut the rule's objective to enhance investor confidence in the audit process.

The adopting release contains a non-exclusive list of types of conduct that the SEC believes could constitute improper influence if the other requirements of the rule are met (*i.e.*, that the person knew or should have known that the action, if successful, could result in rendering the issuer's financial statements materially misleading), including:

- offering or paying bribes or other financial incentives, including offering future employment or contracts for non-audit services;

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[30] *Id.*

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- providing an auditor with an inaccurate or misleading legal analysis;
- threatening to cancel or canceling existing non-audit or audit engagements if the auditor objects to the issuer's accounting;
- seeking to have a partner removed from the audit engagement because the partner objects to the issuer's accounting;
- blackmailing; and
- making physical threats.

Additionally, the final rule makes clear that actions do not have to be successful in meeting their objective to be improper under the rule, nor must they actually result in the financial statements being rendered materially misleading. Rather, the rule requires only that the action, if successful, could have led to that result.

The final rule covers actions by officers, directors and "any other person acting under the direction thereof." The rule does not define "direction," but the adopting release makes clear that the SEC interprets the term to encompass a broad range of behavior that could reach persons beyond those under the supervision or control of an officer or director. Such persons "might include not only the issuer's employees, but also. . . customers, vendors or creditors . . . [or] partners or employees of the accounting firm (such as consultants or forensic accounting specialists retained by counsel for the issuer) and attorneys, securities professionals or other advisers." Thus, the SEC may initiate action under the rule against such third parties "who participate in an effort to improperly influence the auditor when those third parties knew or should have known that the effect of their conduct would be to render an issuer's financial statements materially misleading."[31] For example, the SEC could take action against an attorney who, at the request of an officer, prepares a misleading legal analysis that is relied upon by the company's auditor in making a decision relevant to the company's audit.

In response to comment letters expressing concern that including third parties within the ambit of the rule would produce a "chilling effect" on communications between an issuer's auditor and third parties, the SEC comments in the adopting release that it does not intend "to hold any party accountable for honest and reasonable mistakes or to sanction those who actively debate accounting or auditing issues." The adopting release states that third parties should, however, "exercise reasonable attention and care in those communications." Further, the SEC declined to follow the suggestion offered by some commentators, which would have required that a third party act at the specific instruction or direction of an officer or director to come within the scope of the rule.

The final rule is directed at improperly influencing an "independent public or certified public accountant" who is "engaged in the performance of an audit or review of the financial

[31] *Id.*

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statements of that issuer that are required to be filed with the Commission." Once accounting firms are registered with the PCAOB established by the Sarbanes-Oxley Act, the terms "independent public or certified public accountant" will cover registered public accounting firms and persons associated with such a public accounting firm, as defined in the Sarbanes-Oxley Act.

The SEC interprets the phrase "engaged in the performance of an audit or review" broadly, to apply to all accountants engaged in auditing or reviewing an issuer's financial statements or issuing attestation reports to be filed with the SEC. The SEC's position is that the phrase encompasses the formal audit engagement period and "any other time the auditor is called upon to make decisions or judgments regarding the issuer's financial statements." This includes the negotiation period prior to formal retention of the auditor, such as by making hiring contingent upon limiting the scope of the audit, and later periods, when a former auditor of the company is asked to consent to the use of prior years' audit reports. Further, the rule is not limited to an issuer's annual financial statements, but also includes improperly influencing an auditor during the review of interim financial statements.

The rule identifies a non-exclusive list of actions that could, if successful, result in rendering an issuer's financial statements materially misleading. An officer or director could improperly influence an accountant within the meaning of the rule by coercing, manipulating, misleading or fraudulently influencing an auditor:

- to issue a report on an issuer's financial statements that is not warranted in the circumstances, due to material violations of generally accepted accounting principles, generally accepted auditing standards or other professional or regulatory standards;
- not to perform an audit, review or other procedures required by generally accepted auditing standards or other professional standards;
- not to withdraw an issued report; or
- not to communicate matters to an issuer's audit committee.

Officers, directors and their advisers should also be aware of the following with respect to the final rule and the adopting release:

- Section 303(b) of the Sarbanes-Oxley Act provides the SEC with sole civil enforcement authority with respect to Section 303 and any rule or regulation issued under the provision, thereby precluding a private right of action.
- There is no exemption or qualification in the final rule limiting its application to foreign private issuers.
- A violation of the rule is an "illegal act" within the meaning of Section 10A(b) of the Exchange Act, and therefore, must be reported by auditors under that section. Attorneys also should be aware that evidence of a violation of the final rule may be reportable under Section 307 of the Sarbanes-Oxley Act if it amounts to "evidence of a material violation," as defined in the SEC's rules under Section 307.

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- The SEC states its position that Exchange Act Rule 3b-2, which includes within the definition of "officer" a company's "president, vice president, secretary, treasurer or principal financial officer, comptroller or principal accounting officer, and any person routinely performing corresponding functions," also covers "those who set corporate governance policies and legal policies for an issuer."
- For purposes of Rule 13b2-2, the definition of "issuer" in Section 3 of the Exchange Act is applicable, and not the narrower definition of that term contained in the Sarbanes-Oxley Act. With limited exceptions, the Exchange Act definition covers any person who issues or proposes to issue securities. Thus, the Section 303 prohibition applies to any person who issues or proposes to issue securities whose financial statements are required to be filed with the SEC.

L. Certification of Filings with the SEC and Disclosure Controls and Procedures

1. Section 906 Certification of Periodic Reports

The Sarbanes-Oxley Act contains two divergent certification provisions, each requiring CEOs and CFOs of public companies to certify certain matters in periodic reports filed with the SEC. These requirements are in addition to the certification requirements which the SEC imposed on the CEOs and CFOs of 947 large public companies pursuant to the investigative order described above. One of the new certification provisions, contained in Section 906 of the Sarbanes-Oxley Act, was immediately effective, and thus, applies to periodic reports filed by every domestic or foreign issuer on or after July 30, 2002. The Section 906 certification was enacted under the criminal mail fraud statute and the SEC is currently discussing its application with the Department of Justice.

a. Filings Subject to the Section 906 Certification Requirement

Section 906 applies to each "periodic report" containing financial statements filed with the SEC on or after July 30, 2002. Thus, the certification requirement applies to each Form 10-K and Form 10-Q filed by a company subject to Section 13(a) or 15(d) of the Exchange Act, as well as to Forms 20-F filed by foreign issuers. The certification is required to be made by the CEO and the CFO, or the persons holding equivalent positions.

Section 906 does not apply to Forms 8-K or Forms 6-K, since these reports are viewed as current reports and Section 906 applies only to "periodic reports," such as quarterly and annual reports. In its release adopting rules relating to certifications under Section 302 of the Sarbanes-Oxley Act, the SEC confirmed that Forms 8-K and Forms 6-K are not "periodic reports"

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subject to certification requirements.[32] The SEC has also recently provided guidance that suggests that Section 906 does not apply to Forms 11-K.[33]

Many companies whose equity securities are closely held file periodic reports, as a result of having issued debt securities in an offering that was registered under the Securities Act. These companies are required, under Exchange Act Section 15(d), to file periodic reports covering the fiscal year in which that registration statement becomes effective. Thereafter, the companies typically continue to file periodic reports with the SEC pursuant to an undertaking in the indenture, even though Section 15(d) states that the duty to file such reports is "automatically suspended" as to any subsequent fiscal year if at the beginning of the fiscal year there are less than 300 holders of the debt securities.[34] Because the Sarbanes-Oxley Act applies only to an issuer whose securities are registered under Section 12 of the Exchange Act or to an issuer that "is required to file reports under Section 15(d)," there is a strong argument that a company that is not required to file under Section 15(d), but which has chosen to do so, is not subject to Section 906, or to other provisions of the Sarbanes-Oxley Act. The same analysis, however, may not apply to other aspects of the Sarbanes-Oxley Act and, in particular, to the Section 302 certification. The 906 certifications apply to "periodic reports," as opposed to Section 302, which applies to "each annual and quarterly report filed or submitted." This "filed or submitted" language under Section 302, coupled with the fact that Section 302 applies to "each company filing periodic reports under Section 13(a) or 15(d)," may provide a hook for the SEC to require "voluntary" 15(d) filers to submit the 302 certifications, even if those voluntary filers do not have to submit 906 certifications, which are applicable to "issuers," a defined term not used in the lead-in to Section 302. Because the Section 302 certifications appear in the filings, one can well imagine the

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[32] Certification of Disclosure in Companies' Quarterly and Annual Reports, Release Nos. 33-8124, 34-46427 (Aug. 29, 2002), *available at* http://www.sec.gov/rules/final/33-8124.htm ("SEC Release No. 33-8124").

[33] At the Association of Corporate Counsel annual conference in October 2003, Paula Dubberly, Associate Director of the SEC's Division of Corporation Finance, announced that the SEC, the Department of Justice and members of the President's Corporate Fraud Task Force recently completed discussions and jointly concluded that Section 906 of the Sarbanes-Oxley Act does not apply to Forms 8-K, 6-K and 11-K.

[34] An informal interpretation by the SEC Staff indicates that the provision under Section 15(d) of the Exchange Act, stating that a company is not required to file reports under Section 15(d) during any year (except for the fiscal year in which the registration statement became effective) if the company has fewer than 300 security holders of record at the beginning of such fiscal year, is not conditioned upon the company filing a Form 15 to deregister pursuant to Rule 15d-6.

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SEC also taking the position that a "voluntary" Form 10-K or 10-Q must fully comply with the content and format requirements applicable to those forms.

b. What the Section 906 Certification Should State

The certification should state that: (i) the periodic report containing the financial statements fully complies with the requirements of Section 13(a) or 15(d) of the Exchange Act; and (ii) the information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer.

The Sarbanes-Oxley Act imposes criminal penalties if the CEO or CFO certifies the statement "knowing" that the periodic report does not comport with the requirements set forth in the statement, and imposes greater penalties if the officer's act is also "willful."

c. The Ramifications of an Executive's Inability to Make the Certification

Because the certification can give rise to criminal liability, where an executive believes that the required statement would not be true, he or she should consult with counsel. The fact that a CEO or CFO believes he or she is unable to make the certification will likely be viewed as material information, resulting in the company's need to consider whether it should publicly disclose in the periodic report that one or both of its executives are unable to provide the certification, together with the reasons for their inability to provide the certification.

It is unclear whether there is any penalty for failing to file the certification. Section 3(b)(1) of the Securities Act provides:

> A violation by any person of this Act . . . shall be treated for all purposes in the same manner as a violation of the [Exchange Act] or the rules and regulations issued thereunder, consistent with the provisions of this Act, and any such person shall be subject to the same penalties, and to the same extent, as for a violation of that Act or such rules or regulations.

Section 906, however, is contained in a part of the Sarbanes-Oxley Act entitled the "White-Collar Crime Penalty Enhancement Act of 2002," so it is unclear whether Section 3(b) applies to this Act-within-an-Act. It is also unclear whether the Sarbanes-Oxley Act provides a civil remedy for failure to file the certification.

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d. How the Section 906 Certification Should be Submitted to the SEC

In a June 5, 2003 release, the SEC adopted rules requiring issuers to furnish the 906 certifications as an exhibit to periodic reports.[35] The rules amend Item 601 of Regulations S-B and S-K to add the 906 certifications as exhibit 32. Corresponding amendments were adopted for companies subject to the Investment Company Act. The rules confirm that a 906 certification may take the form of a single certification signed by the issuer's chief executive officer and chief financial officer. The rules were effective for the Forms 10-Q filed on August 15, 2003.

Because Section 906 requires the certification to "accompany" a filing, as opposed to being included in the filing (the language used for the other certification provision contained in Section 302 of the Sarbanes-Oxley Act), the Sarbanes-Oxley Act does not on its face require the Section 906 certification to be filed with the SEC. In this regard, the rules, as adopted, require issuers to "furnish," rather than "file," the 906 certifications. The "furnished" certifications would not be subject to liability under Section 18 of the Exchange Act and would not be subject to automatic incorporation by reference into an issuer's Securities Act registration statements. The SEC, however, has also amended the Exchange Act rules to mandate that companies submit the 906 certifications, with the result that the failure to do so would constitute a violation of the Exchange Act.

e. Increased Liability as a Result of Section 906

It is unclear whether a Section 906 certification will result in increased liability outside of the context of a criminal action brought by the U.S. Attorneys office under Section 906 for submitting or willfully submitting a certification on a periodic report that the executive knows does not satisfy the standard set forth in the Sarbanes-Oxley Act.

Whether Section 906 certifications lead to increased liability under the foregoing or other theories will, of course, take a number of years to determine and will depend on judicial interpretations. It may be that the certifications will not result in litigation or liability at a company in circumstances where the company would not otherwise have that exposure due to some underlying inaccuracies in a periodic report.

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[35] Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reporting, Release No. 33-8238 (June 5, 2003), *available at* http://www.sec.gov/rules/final/33-8238.htm ("SEC Release No. 33-8238").

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2. Section 302 Certification of Periodic Reports

Section 302 of the Sarbanes-Oxley Act requires a more extensive mechanism for certification of periodic reports by CEOs and CFOs. As directed by Section 302(a) of the Sarbanes-Oxley Act, the SEC adopted rules, which became effective on August 29, 2002, imposing new obligations relating to certification of SEC filings on both principal executive and financial officers and companies.[36] The SEC amended the rules regarding Section 302 certifications slightly in its June 5, 2003 release.[37]

The new rules require CEOs and CFOs to certify financial and other information contained in quarterly and annual reports. The rules also require CEOs and CFOs to certify that:

- they are responsible for establishing, maintaining and regularly evaluating the effectiveness of disclosure controls and procedures;
- they have made certain disclosures to the auditors and the audit committee of the board about the internal controls; and
- they have included information in the quarterly and annual reports about their evaluation and whether there have been significant changes in the internal controls or in other factors that could significantly affect internal controls subsequent to the evaluation.

The SEC also adopted rules that implement certain aspects of the statements required to be made in the CEO and CFO certifications. These include:

- rules requiring companies to maintain 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;
- rules requiring an evaluation of the effectiveness of these controls and procedures on a quarterly basis;
- rules requiring disclosure of the CEO's and CFO's conclusions about the effectiveness of these controls and procedures in the body of the Form 10-K and Form 10-Q; and
- rules requiring companies to disclose significant changes in their internal controls.

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[36] SEC Release No. 33-8124.

[37] SEC Release No. 33-8238.

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These rules codify the significantly increased focus on CEO and CFO involvement with, and accountability for, their company's public disclosures. Following recent corporate scandals in which senior officers testified that they delegated all responsibility for financial and other disclosures to others in management, Congress and the SEC have made it clear that they view such abdication to be inappropriate. While CEOs and CFOs continue to be able to involve and rely on others involved in the disclosure process, in order to make the mandated certifications, CEOs and CFOs will need to be directly involved each quarter in reviewing SEC filings and in monitoring the processes that generate the information required to be disclosed in those filings.

a. Requirements for Section 302 Certification

Sample certifications for Form 10-K and Form 10-Q are included as part of the SEC's rule release. As discussed below, it is important that the text of the certification not vary in any respect from the format required for the particular filing. Under the certifications, each CEO and CFO is required to certify the following items in each covered filing:

1. He or she has reviewed the report.

2. 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.[38]

3. 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 company as of, and for, the periods presented in the report (emphasis added).[39]

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[38] Note that this statement reflects the anti-fraud disclosure standard embodied in existing Exchange Act Rule 12b-20.

[39] Note that the term "fairly present" is intended by the SEC as a broader representation than the term "fairly presents in accordance with U.S. GAAP." The representation applies to the financial statements (including footnote disclosure), selected financial data, Management's Discussion and Analysis and other financial information included in a filing. The "fairly presents" standard requires an assessment of overall material accuracy and completeness that includes an assessment of whether the accounting principles selected are appropriate under the circumstances, whether the disclosure is informative and reasonably reflects the underlying

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4. He or she and the other certifying officers:

   - have designed such disclosure controls and procedures to ensure that material information is made known to them, particularly during the period in which the periodic report is being prepared;
   - have designed such internal controls over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP;
   - have evaluated the effectiveness of the disclosure controls and procedures as of a date within 90 days prior to the filing date of the report; and
   - have disclosed any change in internal control over financial reporting that occurred during the most recent quarter that has materially affected, or is reasonably likely to affect, the overall internal reporting.

5. He or she and the other certifying officers have disclosed to the auditors and to the audit committee:

   - all significant deficiencies in the design or operation of internal controls which could adversely affect the company's ability to record, process, summarize and report financial data, and have identified for the auditors any material weaknesses in internal controls; and
   - any fraud, whether or not material, that involves management or other employees who have a significant role in the internal controls.

As discussed below, the SEC amended Forms 10-Q and 10-K to impose affirmative obligations on companies regarding maintenance of "disclosure controls and procedures" and to require the disclosures referenced

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transactions and events and whether any additional disclosure is necessary to provide investors with a materially accurate and complete picture of the company's financial condition, results of operation and cash flows. It is important to note that the SEC has repeatedly stated that compliance with U.S. GAAP may not of itself provide sufficient disclosure to avoid misleading investors. *See In re Caterpillar, Inc.*, SEC Release No. 34-30532 (Mar. 31, 1992), and *In re Edison Schools, Inc.*, SEC Release No. 34-45925 (May 14, 2002). Significantly, however, the SEC confirmed that the certification requirements are not intended to change existing disclosure standards.

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in point 4 of the certifications regarding the officers' assessments of both disclosure controls and internal financial reporting controls.

b. Who is Subject to the Certification Requirements?

1. Reporting Companies

All companies registered under Section 12 of the Exchange Act or that are required to file reports under Section 15(d) of the Exchange Act are subject to the certification rules. The SEC release adopting the certification rules provides slightly different rules for certifications by registered investment companies and for issuers of asset-backed securities.

2. Foreign Private Issuers

The certification requirements clearly apply to all foreign private issuers that file reports under Section 13(a) or 15(d) of the Exchange Act, except those foreign private issuers that furnish materials to the SEC pursuant to Rule 12g3-2(b).

3. Voluntary Filers

Many companies whose equity securities are closely held file periodic reports, as a result of having issued debt securities in an offering that was registered under the Securities Act. These companies are required under Exchange Act Section 15(d) to file periodic reports covering the fiscal year in which that registration statement becomes effective. Thereafter, many companies continue to file periodic reports with the SEC pursuant to an undertaking in the indenture, even though Section 15(d) states that the duty to file such reports is "automatically suspended" as to any subsequent fiscal year if at the beginning of the fiscal year there are less than 300 holders of the debt securities.

(a) Certification Requirement under Section 906

Section 906 of the Sarbanes-Oxley Act requires an *issuer* to make certain certifications in their periodic reports. Section 2(a)(7) of the Sarbanes-Oxley Act defines "issuer" to mean an issuer whose securities are registered under Section 12 of the Securities Act or that is required to file reports under Section 15(d) of the Exchange Act.[40]

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[40] *See* Section 2(a)(7) of the Sarbanes-Oxley Act. Notably, the Sarbanes-Oxley Act defines "issuer" more narrowly to include only a subset of those defined as issuers under Section 3(a)(8)

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Thus, it appears that a company that is not required to file under Section 15(d), but which files reports voluntarily or pursuant to an indenture covenant, is not subject to the certification requirements of Section 906.

(b) Certification Requirement under Section 302

Section 302 of the Sarbanes-Oxley Act, in contrast, requires each company filing periodic reports under Section 13(a) or 15(d) of the Exchange Act to make the required certifications. Congress' decisions to use the more narrowly defined term "issuer" in Section 906 and the broader term "company" in Section 302 arguably reflect an intent to apply the certification requirements of Section 302 more broadly. Thus, under rules of statutory construction, Section 302 may be interpreted to apply to more companies than does Section 906, bringing voluntary filers within its scope.

New Rule 13a-14 states that "each report … filed on Form 10-Q, Form 10-QSB, Form 10-K, Form 10-KSB, Form 20-F or Form 40-F" must contain the certification. It has long been the SEC Staff's position that voluntary filers cannot choose to comply with only select provisions of the forms. SEC Staff interpreting the certification requirements have also been informing callers of the Staff's view that Section 302 certifications are required for voluntary filers. Further, bond indentures often require the issuer to file periodic reports "as if" they were subject to Section 13(a) or 15(d). Accordingly, we recommend that voluntary filers include the certifications and begin the process of establishing, documenting and evaluating their disclosure controls and procedures in order to meet the Section 302 certification requirements. While it may be possible for a voluntary filer to exit the reporting system by filing a Form 15, companies considering such action should review the language of their indentures to determine whether that action is permissible.

c. What Reports are Subject to the Certification Requirements?

The new certification requirements apply to each annual or quarterly report filed under either Section 13(a) or 15(d) of the Exchange Act (e.g. reports on Forms 10-K, 10-Q, 20-F and 40-F). To the extent that information required in a Form 10-K is provided in another document, such as the proxy

[Footnote continued from previous page]
of the Exchange Act. Section 3(a)(8) of the Exchange Act defines "issuer" as any person who issues or proposes to issue any security.

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statement, the certification covers such information.[41] Current reports, such as reports on Forms 6-K and 8-K, are not subject to the certification requirements applicable to periodic reports.[42] In addition, the SEC specifically excluded reports on Form 11-K from the new certification requirements of Section 302.

d. Questions about the Certification Requirements

1. Format and Location of CEO and CFO Certifications

A separate Rule 13a-14 certification must be provided for each CEO and CFO. The SEC amended Forms 10-K and Forms 10-Q, and the other forms which require certifications, to provide for the certifications to appear immediately following the signature section.

The SEC has adopted amendments to the certifications required by Section 302 to facilitate investors' ability to locate the certifications within the company reports.[43] The new rules require a company filing periodic reports under Section 13(a) or 15(d) of the Exchange Act to file 302 certifications as an exhibit to the periodic reports. The rules amend Item 601 of Regulations S-B and S-K to add the 302 certifications to the list of required exhibits as new Item 31, and should be effective for filings made in mid-August 2003.

2. Changes to the Certificates

The SEC has said that the required certification must be in the exact form set forth in the amended forms and may not be altered in any way, "even if the change would appear to be inconsequential in nature." It is important to note that the language of the certification differs depending on what report is being filed. For example, the language required for an annual filing on Form 10-K differs from the language required for a quarterly filing on Form 10-Q. Therefore,

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[41] The SEC has requested comment on whether certifications should be required with respect to proxy statements and Exchange Act registration statements. Thus, further rulemaking may be forthcoming on the scope of the certification requirements.

[42] The SEC adopting release makes clear that a report on Form 8-K and a foreign company report on Form 6-K is a current report, as opposed to periodic report, for purposes of the new certification requirements of Section 302, as well as for the purpose of Section 906. *See* Section II.B.2 of SEC Release No. 33-8124.

[43] SEC Release No. 33-8238.

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companies should carefully check that their officers are submitting the correct form of certification with a particular filing.

3. Signatures and Powers of Attorney

A CEO or CFO is not permitted to have the certification signed on his or her behalf pursuant to a power of attorney or other form of confirming authority. Clients are advised to coordinate the certification process in advance of filing deadlines to avoid logistical difficulties in collecting signatures. Companies are required to retain the original certifications, which their CEO and CFO signed at the time they authorized their signatures to be typed onto the certification being filed via EDGAR, but companies are not required to file original signed copies of the certifications with the SEC. The certification requirement does not alter the current signature requirements for quarterly and annual reports, and the signatures appearing on the certifications are subject to the same rules and procedures for EDGAR filings.

e. Disclosure Controls and Procedures vs. Internal Controls

The language of the certifications distinguishes between two types of controls: "internal controls over financial reporting" and "disclosure controls and procedures." In the SEC's view, the concept of internal controls addresses a company's controls and procedures for financial reporting purposes that are currently required to be in place under Section 13(b) of the Exchange Act (the Foreign Corrupt Practice Act books and records provisions) and that are addressed in AICPA standards.[44]

Pursuant to Section 404 of the Sarbanes-Oxley Act, the SEC has adopted rules, in addition to those required under the Section 302 certifications, requiring annual assessments of internal controls and certain disclosures related thereto.[45] While Section 404 of the Sarbanes-Oxley Act requires implementation of only an annual review of internal controls, the rules, as adopted, require quarterly certification, but only of the fact that no major changes have taken place that have materially and adversely affected, or

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[44] *See* AICPA Professional Standards, AU Section 319.06, which provides the following definition of internal controls: "Internal controls is a process … designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations and (c) compliance with applicable laws and regulations."

[45] SEC Release No. 33-8238.

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will likely materially and adversely affect, an issuer's internal controls over financial reporting.

The SEC specifically intended the new concept of disclosure controls and procedures "to cover a broader range of information than is covered by an issuer's internal controls related to financial reporting."[46] The new term adds an important element that extends beyond financial controls to require a greater involvement of the company's business and legal officers. While the certifications require the CEO and CFO to state their responsibility for establishing and maintaining disclosure controls, as a practical matter, we expect that these officers will work closely with other senior company officials, including the general counsel, to confirm that controls and procedures are in place to make certain that *all* information required to be disclosed, not just financial information, is properly disclosed. These disclosure controls and procedures must be put in place as a method to assure that such information is collected, communicated to senior management, evaluated and disclosed in a timely manner.

f. What are Disclosure Controls and Procedures?

The SEC adopted new Rule 13a-14(c) to define "disclosure controls and procedures" as controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports filed under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.[47] Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in its Exchange Act reports is accumulated and communicated to the issuer's management, including its principal executive and financial officers, as appropriate to allow timely decisions regarding required disclosure. Importantly, although the certification requirements currently apply only to periodic reports such as Forms 10-K and Forms 10-Q, disclosure controls and procedures are required to address all required SEC disclosures, including proxy statements and Forms 8-K. It should be noted that, in its proposal to expand and accelerate reporting on Form 8-K, the SEC included a safe harbor provision for failing to satisfy the accelerated Form 8-K reporting requirements conditioned upon, among other things, the company's

[46] *See* SEC Release No. 33-8124, at Section III. B.

[47] In adopting this definition, the SEC imposed a stricter standard on companies than is provided for with respect to CEOs and CFOs under the Sarbanes-Oxley Act, as the language of the CEO and CFO certifications on disclosure controls includes a materiality standard established by Congress.

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maintenance of sufficient procedures to provide reasonable assurances that the company is able to collect, process and disclose the information required to be disclosed by Form 8-K within the specified time period.

In adopting the new rules, the SEC did not prescribe any particular controls or procedure to be used by companies. Instead, the SEC indicated it expects each company to develop a process that is consistent with its business and internal management and supervisory practices.

g. New Disclosure Items for Forms 10-Q and Forms 10-K: Controls and Procedures.

1. Required Disclosure

The SEC also adopted a variety of rules and disclosure requirements that impose duties on companies in support of the CEO and CFO certification process. New Rule 13a-15(a) requires that companies maintain disclosure controls and procedures, and Rule 13a-15(b) addresses the evaluation of these controls and procedures.[48] Specifically, Rule 13a-15(b) requires a company's management, including the CEO and CFO, to supervise and participate in the evaluation of the effectiveness, design and operation of the company's disclosure controls and procedures. This evaluation must take place within 90 days prior to filing of a report requiring the new certifications. Thus, the CEO and CFO will need to conduct a quarterly assessment of the company's disclosure controls and procedures.

Form 10-Q and Form 10-K have been amended to include new Items 4 and 14, respectively. These items, named "Controls and Procedures," refer to new Item 307 of Regulation S-K. Item 307(a) requires disclosure of the conclusions reached by the CEO and CFO, following their Rule 13a-15(b) evaluation of the effectiveness of the company's disclosure controls and procedures. An issue arises as to the appropriate language for the disclosure required under Item 307(a), given that the CEO and CFO certification itself contains a materiality qualification with respect to the design of disclosure procedures and controls, whereas Rule 13a-15(a) imposes on companies a responsibility to maintain disclosure controls without regard to the materiality of the information being reported. While the issue is not clear, we believe that the Item 307(a) disclosure may contain a

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[48] Corresponding provisions were adopted under new Rule 15d-15 for companies filing under Section 15(d).

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materiality reference, in order to conform the disclosure to the language contained in the CEO's and CFO's certification.

New Item 307(b) requires disclosure of any significant changes in a company's internal controls, or in other factors that could significantly affect these controls, subsequent to the date the internal controls were last evaluated by the CEO and CFO.

2. Transition Issues

For companies other than registered investment companies, "accelerated filers," as defined in Exchange Act Rule 12b-2, as of the end of its first fiscal year ending on or after June 15, 2004, must begin to comply with the management report on internal control over financial reporting disclosure requirements in its annual report for that fiscal year. Companies that are not accelerated filers as of the end of its first fiscal year ending on or after June 15, 2004, including foreign private issuers, must begin to comply with the annual internal control report for its first fiscal year ending on or after April 15, 2005. Companies must begin to comply with the requirements regarding evaluation of any material change to its internal control over financial reporting in their first periodic report due after the first annual report required to include a management report on internal control over financial reporting.

Companies may voluntarily comply with the new disclosure requirements before the new compliance dates become effective. With regard to Section 302 and 906 certifications, companies have been required to comply with the new exhibit requirements in quarterly, semi-annual or annual report due on or after August 14, 2003.

To account for the differences between the compliance date of the rules relating to internal control over financial reporting and the effective date of changes to the language of the Section 302 certification, a company's certifying officers may temporarily modify the content of their Section 302 certifications to eliminate certain references to internal control over financial reporting until the compliance date.

M. Section 16 Amendments

The Sarbanes-Oxley Act amended and restated Section 16(a) of the Exchange Act to require executive officers, directors and greater than 10% stockholders ("insiders") to file Section 16 transaction reports "before the end of the second business day following the day on which the subject transaction has been executed." The Sarbanes-Oxley Act authorized the SEC to exempt transactions from the two business day reporting requirement if it determines

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that reporting within that time is not "feasible." In addition, the SEC's general exemptive and rulemaking authority under Section 16(a) was not affected by the Sarbanes-Oxley Act.

The amendment to Section 16(a) became effective on August 29, 2002. On August 27, 2002, the SEC adopted final rules to address the amendments to Section 16(a).[49] Under these rules, the new reporting requirements apply to transactions occurring on or after August 29, 2002.

1. Section 16(a) Reporting Changes

Under the SEC's final rules, the Section 16 reporting rules have been amended as follows:

a. Form 4 Reporting of Transactions between the Company and the Insider.

Transactions between an insider and the company (or an employee benefit plan) that are exempt from Section 16(b) liability, but that were previously required to be reported on Form 5, are now reportable on Form 4. As a result, the following transactions are subject to two-business-day reporting:

- Grants, awards and other acquisitions from the issuer that satisfy the requirements of Rule 16b-3(d). This category includes stock option grants, restricted stock grants and acquisitions of stock units under non-tax qualified deferred compensation plans.
- Dispositions to the issuer that satisfy the requirements of Rule 16b-3(e). This category includes shares delivered to the company to pay tax withholding amounts or an option exercise price, options surrendered to the company in an option repricing and sales of shares to a company.
- Discretionary transactions that satisfy the requirements of Rule 16b-3(f). A "discretionary transaction" is a participant-directed movement of a portion of his or her account balance into or out of a company stock fund under a deferred compensation plan. The term does not include transactions made in connection with the plan participant's death, disability, retirement or termination of employment, or that are required to be provided under IRS regulations. Discretionary transactions may occur in a tax-qualified plan, such as a 401(k) plan, or in a non-tax qualified plan, such as a SERP or a directors' fee deferral arrangement. As

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[49] Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Release No. 34-46421 (Aug. 27, 2002), *available at* http://www.sec.gov/rules/final/34-46421.htm.

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discussed below, the SEC provided a limited extension of time for Form 4 reporting of discretionary transactions.

b. Accelerated Reporting of Transactions on Form 4.

All Forms 4 are due on the second business day after an applicable transaction is executed, subject to two narrow exceptions. As a result, in addition to the transactions described above, stock option exercises and open market purchases and sales are subject to two business-day reporting.

The SEC has provided a limited extension of time for Form 4 reporting for "discretionary transactions" and for transactions pursuant to Rule 10b5-1(c) trading plans, provided that, in both cases, the insider does not select the date the transaction is to occur. Under the limited extension, the two-business-day deadline is counted from a "deemed" transaction date, which is the earlier of the date the insider receives notice that the transaction was executed and the third business day after the date the transaction is executed. Consequently, the latest a Form 4 can be timely filed for these transactions is on the fifth business day after the transaction. Insiders should note, however, that the extended time period for these transactions is not available if the insider has selected the date for transaction execution. For example, if an insider establishes a Rule 10b5-1(c) trading plan that provides for a sale on the first business day of each month, the insider has selected the date of the transaction and the limited extension is not available. If an employee benefit plan operates such that a discretionary transaction occurs on a date determined by the day the insider provides instructions authorizing the transaction, as opposed to being executed on a date selected in the discretion of the plan administrator, the insider arguably has selected the date for execution of the transaction, and consequently, the limited filing extension would not be available. In these circumstances, the insider will need to receive information from the plan administrator to complete and file a Form 4, reporting the transaction within the normal two-business-day deadline.

c. Other Reporting Exemptions Will Continue.

All pre-existing exemptions from Section 16 transaction reporting continue to be available. Consequently, as before, insiders are not required to report the following transactions:

- acquisitions under tax-conditioned plans that satisfy the requirements of Rule 16b-3(c), including: (i) purchases that occur pursuant to stock allocations under ERISA profit-sharing plans and employee stock ownership plans ("ESOPs"); (ii) purchases that occur pursuant to payroll deductions under 401(k) plans; (iii) excess benefit plans that provide only for benefits or contributions in excess of certain limits imposed on tax-qualified plans; and (iv) employee stock purchase plans that satisfy Section 423 of the

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Internal Revenue Code and similar plans that are not tax qualified but satisfy certain coverage and participation requirements;

- forfeiture or expiration of stock options or restricted stock;
- acquisitions pursuant to dividend reinvestment plans, other than purchases that result from a discretionary contribution to such plans;
- stock splits, stock dividends and distributions of stock purchase rights;
- transfers pursuant to divorce decrees and domestic relations orders;
- changes in the form of ownership that do not affect the insider's pecuniary interest in the shares, such as changes from indirect to direct ownership;
- transactions following termination of insider status, if the insider has not effected a matchable transaction during the previous six months while still an insider; or
- transactions effected in a fiduciary capacity as a guardian, executor or receiver during the twelve months following the insider's appointment to such position.

d. Form 5 Reporting of Other Transactions.

A few categories of transactions remain eligible for reporting annually on Form 5. Consequently, as before, insiders can use Form 5 to report the following transactions:

- acquisitions or dispositions of shares through gifts or inheritance; and
- "small" acquisitions, meaning purchases aggregating less than $10,000, provided that the transactions are not transactions with the company or an employee benefit plan described in Rule 16b-3(d) or (f), which, as addressed above, are now subject to two-business-day reporting. (A common example of small transactions that remain eligible for Form 5 reporting are acquisitions under dividend reinvestment arrangements sponsored by brokerage firms when a company itself does not offer a reinvestment plan. Note, however, that if the $10,000 threshold is exceeded, a Form 4 to report the transactions must be filed within the new two-business-day deadline.)

In addition, Form 5 continues to be available for year-end disclosure of late transaction reports.

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e. Form 3 and Form 5 Reporting.

The Sarbanes-Oxley Act did not change the filing deadlines for Form 3. For persons who become insiders after a company's initial public offering, a Form 3 is due within 10 days (not business days) after the person becomes a Section 16 insider. When companies initially go public, Forms 3 are due on the effective date of a company's registration under Section 12. The Sarbanes-Oxley Act also does not address the timing of Form 5 filings, and the SEC has retained the deadline it originally developed for that form (i.e., 45 days after the end of the company's fiscal year).

f. Reporting Holdings.

Form 4 continues to require "end of period" holdings to be reported, but the SEC has clarified that each Form 4 must report the person's holdings after giving effect to the transaction reported on the form. As in the past, a Form 4 is not required to reflect the effect of a transaction that is not reported on the Form 4 and that has not previously been reported on an insider's holdings, such as the effect of a gift or a discretionary transaction that has not yet been reported, and need only reflect the effect of non-reportable transactions, such as purchases under 401(k) payroll contributions and dividend reinvestment plans, as of the most recently available statement.

g. Form 8-K Reporting.

In the release adopting the new rules, the SEC indicated that it will not pursue its proposal to require that companies disclose insiders' stock transactions on a Form 8-K.

2. Section 16 Reporting Changes

Neither the Sarbanes-Oxley Act nor the SEC rules changed any of the pre-existing exemptions from liability under Section 16(b). Thus, any transaction that is exempt from reporting and any transaction that is exempt under a 16(b) rule, such as Rule 16b-3, is not subject to potential matching for purposes of determining short-swing liability.

3. Mandated Electronic Filing and Website Posting for Section 16 Reports

In a May 7, 2003 release, the SEC adopted rules requiring electronic filing and website posting of forms filed under Section 16(a) of the Exchange Act, reporting

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corporate insiders' ownership and transactions in company securities.[50] These rules implement Section 403 of the Sarbanes-Oxley Act and complement the accelerated two-day reporting requirement adopted by the Commission in August 2002. Mandatory electronic filing and website posting requirements became effective on June 30, 2003, a month earlier than required under the Sarbanes-Oxley Act.

Directors, executive officers and 10% owners of a class of securities (collectively, "Insiders") are required to file Forms 3, 4 and 5 ("Section 16 Reports") pursuant to Section 16(a) of the Exchange Act and the rules thereunder. Forms 4 are generally required to be filed within two business days after a reportable transaction. The new rules (i) require Insiders to file all Section 16 Reports electronically and (ii) require issuers to post Section 16 Reports on their websites by the end of the business day following the filing date. A company can satisfy the website posting requirement by linking to filings on the SEC's EDGAR database or to other third-party databases if certain conditions are satisfied.

Since June 30, 2003 and pursuant to the new rules:

- The deadline for electronic filing of Section 16 Reports has been extended from 5:30 p.m. Eastern Standard Time on the date on which a Section 16 Report is due to 10:00 p.m. Eastern Standard Time. Thus, if a Form 4 is filed electronically before 10:00 p.m. EST on its due date, it will be treated as timely filed. (This extended filing deadline will not be available for other SEC filings, such as Forms 8-K, Forms 10-K and Forms 10-Q, or for registration statements. Although those reports can currently be submitted electronically between 5:30 and 10:00 p.m. EST, they are not deemed to be filed until the next business day.)
- For a period of one year, companies are not required to report an Insider's late Section 16 Report filings in their Forms 10-K or proxy statements, if the Section 16 Report is filed only one day late.
- Insiders or issuers who encounter technical difficulties in filing Section 16 Reports are not able to file a Form TH, which provides an automatic deadline extension, for late Section 16 Reports. Instead, they need to request that the Commission adjust the filing date under Rule 13 of Regulation S-T, if they can demonstrate that they meet the requirements for an adjusted filing date to the Commission staff.

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[50] Mandated Electronic Filing and Website Posting for Forms 3, 4 and 5, Release No. 33-8230 (May 7, 2003), *available at* http://www.sec.gov/rules/final/33-8230.htm. In order to satisfy the website posting requirement, the SEC has revised its EDGAR company search web page to allow issuers to link only to the Section 16 forms. The SEC has also issued an FAQ on electronic filing, *at* http://www.sec.gov/divisions/corpfin/sec16faq.htm. Finally, the SEC has provided additional tips for using the new system, *at* http://www.Section16.net.

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The Commission has developed special features for the EDGAR filing system that will facilitate electronic filing of Section 16 Reports. Under the new EDGAR filing system for Section 16 Reports, Insiders can type Section 16 transaction data into an on-line template, add any applicable attachments and file the Report. The system is currently operational to make actual electronic filings of Section 16 Reports. Since the June 30, 2003 effective date, Insiders have been required to file Section 16 Reports through the new EDGAR filing system. In addition, a number of vendors have announced that they are developing filing programs that will interface with the new EDGAR filing system for Section 16 Reports.

N. Consensus Outline on Interpretive Issues under Section 402 of the Sarbanes-Oxley Act

Section 402 of the Sarbanes-Oxley Act generally prohibits public companies from extending credit in the form of a personal loan to any executive officer or director. Section 402, however, contains substantial ambiguities, is the subject of limited legislative history and has not been the subject of any official guidance. In particular, the Sarbanes-Oxley Act does not mandate that the SEC adopt rules implementing or clarifying Section 402, and it appears that the SEC will not provide guidance on many of the issues arising under Section 402 in the near future.[51]

On October 15, 2002, 25 leading law firms, including Gibson, Dunn & Crutcher LLP, released a consensus outline which sets forth the law firms' views regarding a number of activities that, in the absence of contrary official guidance, should be considered "permissible" under Section 402.[52]

The outline lists some of the factors that were considered in support of each conclusion, although each firm that joined in issuing the outline does not necessarily concur in all aspects of these analyses or give all aspects of the analyses equal weight. In addition, the outline reflects that some factual situations are less certain than others. Because the outline is intended to set forth guiding principles and not to provide legal advice on any particular fact pattern, companies should continue to consult counsel as to the applicable analyses, risks and alternatives available for particular situations. It also is important to note that the consensus outline does not mean that any of the situations addressed is free from risk under 402, as the SEC could always provide guidance that takes a contrary position, either through rulemaking, no-action interpretation or enforcement actions.

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[51] At the American Bar Association Spring Meeting in Los Angeles, California on April 4 and 5, 2003, Alan Beller, Director of the Division of Corporate Finance of the SEC, stated that the Staff is not inclined to issue guidance on Section 402.

[52] Consensus Outline, *Sarbanes-Oxley Act: Interpretive Issues under Section 402—Prohibition of Insider Loans* (Oct. 15, 2002), *available at* http:// www.gibsondunn.com/practices/publications/detail/id/766/?pubItemId=6371.

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Finally, it should be noted that a number of the situations addressed in the consensus outline continue to involve sensitive policy issues. One such area is the issue of "cashless" option exercises. When evaluated in light of the actual mechanics involved and the abuses that lead to Section 402, we believe that many cashless exercise arrangements should not be viewed as involving a prohibited extension of credit by either the company or the brokerage firm. Additionally, these programs should not be seen as inconsistent with the spirit of the Sarbanes-Oxley Act, since they were often implemented, and at times even mandated, by companies for their executives and non-executives alike, not to provide credit, but rather to simplify or outsource option plan administration.[53] Nevertheless, while we hope that the consensus outline will be a helpful reference for analysis of the issues that arise under Section 402, we also understand that some companies may wish to continue to evaluate whether alternative approaches are available for various arrangements to avoid Section 402 issues.

The outline advises the use of customary principles of statutory construction to interpret Section 402. Furthermore, the outline focuses on the definition of a personal loan, which must take the form of a loan, rather than a mere extension of credit. The loan must be personal, as well. For example, a loan whose primary purpose is to advance the business of the issuer would probably not be considered a personal loan.

Specific situations discussed in the outline, and generally thought to be permissible include:

- Advances of cash, in accordance with company policy, to cover reimbursable travel expenses because the advance serves a primary business purpose.
- Personal use of a company credit card, with a requirement for reimbursement because the use of the company card serves a primary business purpose.
- Personal use of a company car, with a requirement for reimbursement because the use of the car serves a primary business purpose.
- The advancement of relocation payments because the payment serves a primary business purpose.
- Payment of stay and retention bonuses subject to repayment because the payment serves a primary business purpose.

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[53] *But see* IRS Memorandum, March 14, 2003. The IRS has taken the administrative position that companies may pay the required withholding tax within one day of the settlement of the sale, as long as the settlement takes place within three days of the exercise of the options. Since the general SEC guidelines require broker-dealer trades to settle within three days, and since most trades settle within the three day window, this position substantially moots interpretive questions about whether a loan to an executive arises from an employer advancing the withholding taxes in a cashless option exercise.

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- Indemnification advances, where repayment is required under certain circumstances, because the advances do not take the form of a loan, nor are the payments necessarily "personal."

- Deferred compensation because the payments are, if anything, an extension of credit from the officer to the issuer.

- Leveraged co-investment in a limited partnership or other entity that will own actual investment assets. Depending on the terms of the loan, and whether the loan is to the individual or the entity, this situation may pose greater risk for a Section 402 violation.

- Tax indemnity payments to overseas-based executive officers because the payments are not in the nature of a loan.

The following situations discussed in the outline involve "arranging" issues. According to the Sarbanes-Oxley Act, an issuer may not arrange a personal loan for an executive. The outline recognizes that issuers will almost certainly assist in facilitating certain loans, but contemplates that "arranging" a loan is a more substantial level of participation in the loan. Similarly, the outline recognizes that there are situations in which the issuer will have arranged some aspect of the loan, but should not be considered to have "arranged" the loan itself. An example of this would be loans from a 401(k) plan, where the issuer has arranged the benefit program, but is not involved in the loan from the program. These arranging situations include:

- Loans from a parent company, who is not an issuer, to an officer of an issuer subsidiary. The permissibility of the loan turns on whether the subsidiary has arranged the loan.

- Loans from a 401(k) plan—the loan is from the plan and not the issuer, and while the issuer has arranged the plan, it should not be considered to have arranged the loan.

- Loans from annuities or other broad-based employee benefit programs—the loan is from the program, and not the issuer.

- Cashless option exercises involve both personal loan issues and arranging issues. Any benefits or extensions of credit granted to the officer are not generally in the form of a loan. Additionally, the transaction is usually available to all employees of the option plan.

Certain situations are permissible due to exceptions or grandfather provisions:

- Securities related loans, other than margin loans subject to the specific exemption—Section 402 allows certain margin loans pursuant to Section 7 of the Exchange Act.

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- Drawdowns on committed lines and maintaining demand loans after July 30, 2002—grandfather clauses allow drawdowns on credit lines committed before July 30, 2002 and maintenance of demand loans extended before July 30, 2002.

- Forgiveness of grandfathered loans—forgiveness of a loan constitutes the discharge of a loan and, as such, would not be a "material modification" prevented by the statute.

- Modification favorable to the issuer—because of the purpose of the statute, a modification, such as an increase in interest rate, should not be considered a material modification.

O. Additional Provisions

As discussed above, many of the provisions in the Sarbanes-Oxley Act have already been addressed by the SEC Staff by way of final or proposed rules, many of which have been previously discussed in this outline. Nevertheless, each of the Sarbanes-Oxley Act provisions require close scrutiny by public companies, and some require more immediate attention than others. The following is a summary of additional Sarbanes-Oxley provisions that companies should be aware of.

1. Corporate Responsibility

The Sarbanes-Oxley Act also contains the following provisions regarding corporate responsibility and corporate governance:

a. Disgorgement of Certain Executive Compensation upon Financial Statement Restatements: Section 304

- This provision requires that CEOs and CFOs disgorge bonuses, other incentive- or equity-based compensation and profits on sales of issuer securities where an accounting restatement is required due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws as a result of misconduct. Disgorgement is required for such compensation received or profits realized during the 12-month period following the first public issuance or filing with the SEC (whichever occurs first) of a document embodying the noncompliant report. The SEC may exempt any person from the application of this provision as it deems necessary and appropriate.
- This provision became effective immediately upon enactment. Note that there is no deadline by which the SEC must adopt exemptions.

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b. **Officer and Director Bars: Sections 305 and 1105**

- Section 305 changes the standard governing judicial imposition of officer and director bars in SEC actions under Section 21(d)(2) of the Exchange Act and Section 20(e) of the Securities Act from "substantial unfitness" to "unfitness."
- Section 1105 amends Section 21C of the Exchange Act and Section 8A of the Securities Act to add new provisions giving the SEC authority to bar in an administrative cease and desist proceeding an individual who has violated Section 10(b) of the Exchange Act or Section 17(a)(1) of the Securities Act (anti-fraud provisions), or rules or regulations thereunder, from acting as an officer or director of a public company in an administrative cease and desist proceeding, if the person's conduct demonstrates unfitness to serve as an officer or director of a public company.
- Both sections became effective immediately upon enactment.

c. **Statute of Limitations for Securities Fraud: Section 804**

- This provision amends 28 U.S.C. § 1658 to extend the statute of limitations for private rights of action involving claims of fraud, deceit, manipulation or contrivance in the contravention of a regulatory requirement concerning the securities laws to the earlier of: (i) two years after discovery of the facts constituting the violation; or (ii) five years after such violation.
- This provision applies to proceedings commenced on or after the date of enactment.

d. **Whistleblower Protection: Section 806**

- This provision amends federal criminal law to prohibit public companies and their employees, contractors, subcontractors or other agents from discriminating in the terms and conditions of employment with respect to employees who: (i)provide information or make a complaint regarding conduct of the employee "reasonably believes" constitutes a securities violation or securities fraud; or (ii) file or participate in proceedings related to fraud against shareholders.
- An employee may seek relief under this provision by filing a claim with the Occupational Safety and Health Administration ("OSHA") (within the Department of Labor) within 90 days after the date of the violation, or, if a decision is not rendered by the Secretary of Labor within 180 days, by bringing an action for de novo review in the federal district court of jurisdiction. Before conducting an investigation, the Department must be satisfied that the complaint makes a prima facie showing that the protected

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conduct was a contributing factor in an adverse employment action taken by the employer.

- Following an investigation, the Department will issue its findings and a preliminary order, often directing immediate reinstatement, if: (i) there is "reasonable cause" to believe that the employee's protected conduct was a contributing factor to the adverse personnel action alleged in the complaint; and (ii) the employer has not demonstrated by clear and convincing evidence that it would have taken the same unfavorable action in the absence of that behavior. Alternatively, if these elements are not satisfied, the Department will issue a preliminary order dismissing the complaint. The "clear and convincing" standard employers must meet to avoid liability is higher than the discrimination standards under most anti-retaliation provisions, including those contained in Title VII of the Civil Rights Act of 1964.
- Potential relief includes reinstatement, back pay with interest and compensation for special damages, such as attorneys' fees and other litigation costs. Employers, and in some cases individuals, found to have retaliated against a whistleblower may be subject to administrative, civil and criminal sanctions. The Act thus confronts corporate officers and managers with the prospect of being sued in their individual capacity and even serving prison time for personnel decisions they have made.
- The Act protects a whistleblower even if his or her report of wrongdoing is incorrect, provided that the whistleblower reasonably believed that what he or she reported constituted a violation. This means that a company may still *lose* a Sarbanes-Oxley whistleblower case, despite being able to prove that a complainant's understanding of an SEC rule was mistaken, and thus, the allegation was unwarranted.
- It is expected that plaintiffs may seek to use the whistleblower provisions of Sarbanes-Oxley as the predicate for state law claims for wrongful termination in violation of public policy. If viable, such claims will result in exposure to the full range of tort damages, including punitive damages in states where such damages are available. One potential issue is whether or not a federal court action, limited to the remedies set forth in the statute, is the exclusive remedy for retaliation against whistleblowers that would not be actionable absent the Sarbanes-Oxley Act. In some states, including California, it has been held that retaliation claims are actionable in public policy wrongful termination actions, even where the statute sets forth a procedure for agency investigation and action.
- This provision became effective immediately upon enactment.

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e. Retaliation Against Informants: Section 1107

- This provision amends 18 U.S.C. § 1513 (retaliation against a witness, victim or informant) to provide for fines and imprisonment of up to 10 years for anyone who "knowingly, with the intent to retaliate," takes any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any federal offense.
- This provision became effective immediately upon enactment.

2. Disclosure Requirements

While most of the disclosure provisions of the Sarbanes-Oxley Act have been addressed by the SEC, it is important to note that Section 408 of the Sarbanes-Oxley Act requires the SEC to review the disclosures of public companies on a regular and systematic basis. At the very least, the disclosures of public companies must be reviewed once every three years. The provision became effective immediately upon enactment of the Sarbanes-Oxley Act.

3. Auditor and Accounting Provisions Related to Review of SEC Filings

The Sarbanes-Oxley Act also contains the following auditor and accounting related provisions:

a. Oversight Board: Title I

- This provision establishes a new regulatory body, the PCAOB, to oversee the audit of public companies and companies offering securities to the public, and related matters, subject to oversight by the SEC.[54]

b. Auditor Qualifications: Registration, Oversight and Independence: § 102; Title II

- This provision requires firms that audit the financial statements of an issuer that has filed a registration statement under the Securities Act or that is registered under Section 12 or 15 of the Exchange Act to be registered with, and subject to oversight by, the PCAOB. These firms are required to be registered within 180 days after the SEC has determined that the PCAOB is functional, or within 180 days of April 25, 2003, the date the SEC issued an order stating the

[54] See *supra* Section II.A.

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PCAOB had satisfied the requirements of Section 101(d) of the Sarbanes-Oxley Act.

- The Sarbanes-Oxley Act further regulates and redefines the relationship between a registered public accounting firm and its audit clients:[55]
  - **Non-Audit Services, Section 201:** This provision amends Section 10A of the Exchange Act to prohibit registered public accounting firms from providing eight categories of non-audit services to their audit clients, including financial information systems design and implementation, valuation services and internal audit outsourcing services. The PCAOB may, subject to SEC review, exempt any person, issuer, accounting firm or transaction from this provision on a case-by-case basis.
  - **Audit Committee Pre-Approval of Auditor Services, Section 202:** This provision amends Section 10A of the Exchange Act to require audit committee pre-approval of all services provided by an issuer's outside auditor, subject to a de minimis exception. The audit committee may delegate pre-approval authority to one or more members of the audit committee, and pre-approvals for audit-related services may be made in connection with approval of the audit engagement. Pre-approval of non-audit services to be performed by the issuer's auditor must be disclosed in periodic reports.
  - **Audit Partner Rotation, Section 203:** This provision amends Section 10A of the Exchange Act to provide that the lead (or coordinating) audit partner and the reviewing audit partner of the registered public accounting firm cannot perform audit services for the same issuer for more than five consecutive fiscal years.
  - **Auditor Communication With Audit Committee, Section 204:** This provision amends Section 10A of the Exchange Act to require that registered public accounting firms timely report to audit committees on critical accounting policies and practices, alternative treatments of financial information that have been discussed with management and other material written communications with management.

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[55] *See* discussion *supra* Section III.H. The SEC has adopted rules implementing Sections 201-206 of the Sarbanes-Oxley Act.

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- **Restrictions on Employment of Auditor Personnel, Section 206:** This provision amends Section 10A of the Exchange Act to prohibit registered public accounting firms from providing audit services to issuers whose CEO, CFO or chief accounting officer, or any person serving in an equivalent position, was employed by the audit firm and participated in the issuer's audit in any capacity within one year of audit initiation.

- While the effective date is not specifically described in the Sarbanes-Oxley Act, these provisions are not effective until after the PCAOB is operational and the auditing firm has qualified as a "registered public accounting firm."

IV. Adopted and Proposed Changes to Proxy Rules

In response to recommendations in a July 2003 report of the Division of Corporate Finance entitled "Review of the Proxy Process regarding the Nomination and Election of Directors" (the "Staff Report"), the SEC has in recently proposed or approved several new rules or amendments to the current rules relating to shareholder access to certain proxy materials, expanded disclosure regarding board nominating committees and new disclosure concerning shareholder communications with directors.

A. Shareholder Access to Proxy Materials

In a release dated October 14, 2003, the SEC proposed amendments to its proxy rules that have the potential to dramatically change the way corporate directors are nominated and elected by permitting large shareholders and shareholder groups to place some nominees for director in company proxy materials under certain circumstances.[56] The proposal, known as "shareholder access," would implement controversial recommendations of the Staff Report. The Staff Report recommended, among other things, requiring conditional shareholder access to a company's proxy materials for the purpose of nominating candidates for election as director. Many companies have argued that if the final rules are adopted as proposed, then shareholder access could produce "special interest" directors and could turn director elections into costly proxy contests, resulting in a substantial disruption of corporate affairs and discouraging qualified individuals from serving on corporate boards. Questions have also been raised about the SEC's statutory authority to act in this area and the proposal's compliance with rulemaking requirements.

The proposed rules raise a number of significant issues for public companies, several of which we highlight below. The comments received on these issues are likely to have a substantial impact on any final rules adopted by the SEC.

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[56] Security Holder Director Nominations, Release No. 34-48626 (Oct. 14, 2003), *available at* http://www.sec.gov/rules/proposed/34-48626.htm.

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1. Overview

The proposed rules would require companies to include shareholder nominees for director in company proxy materials if one of two triggers is present: (i) more than 35 percent of shares voted are "withhold" votes for a director, or (ii) a proposal made by a more than one percent shareholder to activate shareholder access receives a majority vote. Once shareholder access is triggered in one of these ways, any group comprised of the holders of more than five percent of the company's stock would be able to place up to three director nominees (depending on the size of the board) in the company's proxy statement and on the company's proxy card for two years. As proposed, the triggers would be applicable beginning with annual meetings held after January 1, 2004. In other words, if the rules are adopted as proposed, the occurrence of one or both of the triggers at a company's 2004 annual meeting could activate shareholder access for that company's 2005 and 2006 meetings.

2. Applicability

The proposed rules would apply to all companies that are subject to the SEC's proxy rules, including operating companies and investment companies, unless applicable state law prohibits a company's shareholders from nominating a candidate or candidates for election as a director. Where state law permits companies to prohibit shareholder nominations through provisions in a company's certificate or articles of incorporation or bylaws, shareholder access would not be available to shareholders of a company that included such a provision in its certificate or articles of incorporation or bylaws.

The SEC is seeking comment on whether the proposed rules should apply only to accelerated filers (generally, those with an aggregate market value of $75 million or more) and investment companies. The proposing release also solicits comment on whether the rules should exempt companies that implement all shareholder proposals that receive majority votes in a given year, or companies that agree not to exclude from their proxy materials any shareholder proposal submitted by an eligible shareholder.

3. Triggering Events

The SEC has indicated that the proposed rules are intended to focus on companies where there are criteria showing that the proxy process may be ineffective. As proposed, shareholder access would be available only upon the occurrence of one or both of the following triggers:

- at least one of the company's director nominees receives "withhold" votes from more than 35 percent of the votes cast at an annual meeting at which directors are elected; or
- a shareholder proposal to activate shareholder access (a "direct access" shareholder proposal) is submitted by a shareholder or group of

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shareholders holding more than one percent of the company's voting securities for one year and receives a majority of the votes cast.

The SEC is soliciting comment on a possible third trigger for shareholder access, based on a company's failure to implement a majority-vote shareholder proposal. Specifically, a company would be subject to shareholder access if:

- a shareholder proposal, other than a direct access shareholder proposal, is submitted by a shareholder or group of shareholders holding more than one percent of the company's voting securities for one year and receives a majority of votes cast; and
- the company's board of directors fails to implement the proposal by the 120th day before the one-year anniversary of the date the company releases its proxy statement in connection with the previous year's annual meeting.

The proposing release raises several issues regarding how to define "implementation" under the possible third trigger.

4. Disclosure of Triggering Events

The proposed rules would require a company to identify in its proxy materials any shareholder proposal that would, if adopted, be a shareholder access triggering event. For example, a company that receives a direct access shareholder proposal from a qualifying shareholder (one holding more than one percent of the company's voting securities for one year) would be required to disclose that fact in its proxy materials. In the proposing release, the SEC recommends that companies consider making such disclosure pending final action on the proposal (*i.e.*, before final shareholder access rules are adopted) and implies that failure to do so may be a violation of Rule 14a-9 of the Exchange Act, which prohibits false and misleading statements in proxy materials.

The proposed rules also would require new disclosures in a company's annual report on Form 10-K and quarterly reports on Form 10-Q.[57] In addition to the current requirement that a company disclose the results of voting on matters submitted to a shareholder vote, the company would be required to disclose that it is subject to the shareholder access procedure as a result of the vote, if applicable, and state the date by which shareholders must submit any nominations for director using shareholder access.

The proposed shareholder access procedure is separate from, and in addition to, the procedures set forth in Exchange Act Rule 14a-8 and a company's advance notice bylaw provisions. Accordingly, if the shareholder access rules are adopted as proposed, companies will need to pay close attention to the requirements and filing

[57] Registered investment companies would provide the additional disclosure on Form N-CSR.

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deadlines under the shareholder access rules, Rule 14a-8 and company bylaw provisions.

5. Submission of Nominees

Once triggered, shareholder access would be available for any annual meeting or special meeting of shareholders held within two years after the triggering event. To be eligible to submit a nomination under the proposed rules, a shareholder or group of shareholders must represent that they:

- beneficially own, either individually or as a group, more than five percent of the company's voting securities for at least two years;
- intend to continue to own those securities through the date of the subject election of directors;
- are eligible to report beneficial ownership on Exchange Act Schedule 13G, rather than Exchange Act Schedule 13D (meaning that the nominating shareholders must represent that they did not acquire the company's securities with the purpose or the effect of changing or influencing control of the company); and
- have filed an Exchange Act Schedule 13G (or amendment thereto) reporting beneficial ownership, including a certification that they meet the rules' ownership criteria.

In addition, the nomination must be consistent with applicable law and regulation, including state and federal law, and the nominating shareholder or shareholder group must represent that the nominee meets the objective criteria for "independence" of the applicable rule of a national securities exchange (*e.g.*, the New York Stock Exchange) or national securities association (*e.g.*, the NASDAQ Stock Market). To the extent that a rule imposes an independence standard that requires a subjective determination by the board (for example, requiring that the board affirmatively determine that a director has no material relationship with the company, as proposed by the NYSE), this element would not need to be satisfied.

The proposed rules also provide that the nominating shareholder or shareholder group must not have certain specified relationships with the nominee. First, the nominee must not be a nominating shareholder or an immediate family member of a nominating shareholder or any member of the nominating shareholder group. Second, the nominee (or any member of the nominee's immediate family) must not have been an employee of the nominating shareholder or shareholder group, nor accepted any consulting, advisory or other compensatory fee from the nominating shareholder or shareholder group or any affiliate, during the then-current calendar

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year or the immediately preceding calendar year.[58] Third, the nominee must not be an executive officer of an affiliate of the nominating shareholder or shareholder group, nor a director of the nominating shareholder or shareholder group or of any affiliate. Fourth, the nominee must not control the nominating shareholder or any member of the shareholder group. Finally, neither the nominee nor the nominating shareholder or shareholder group may have a direct or indirect agreement with the company regarding the nomination.

Under the proposed rules, a company subject to shareholder access would be required to include in its proxy materials only a specified number of shareholder nominees for director, determined by the number of directors serving on the company's board of directors:

- If the company's board has eight or fewer members, then the company would be required to include one shareholder nominee.
- If the company's board has nine to 19 members, then the company would be required to include up to two shareholder nominees.
- If the company's board has 20 or more members, then the company would be required to include up to three shareholder nominees.[59]

Where more than one shareholder or shareholder group is eligible to place a nominee or nominees in a company's proxy materials, the company would be required to include the nominee or nominees of the shareholder or shareholder group with the largest beneficial ownership.

6. Notice by Nominating Shareholders

The proposed rules would require nominating shareholders or shareholder groups to provide notice to the company of their intent to require that the company include their nominee(s) on the company's proxy card, no later than 80 days before the date that the company mails its proxy materials. This notice, which would be filed with the SEC, would be required to include representations concerning the nominating shareholder's eligibility and the nominee's candidacy, independence and relationships with the nominating shareholder (as described above) and:

- a copy of the Schedule 13G filed by the nominating shareholder or shareholder group;

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[58] As noted here, the proposed rules provide a limited look-back for certain nominee/nominating shareholder relationships. In this regard, the rules differ from the proposed NYSE and NASDAQ independence standards, which require companies to look back three years when evaluating a director's independence.

[59] Companies with classified boards of directors would be subject to special standards, set forth in proposed Rule 14a-11(d)(2).

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- a statement from the nominee that the nominee consents to be named in the company's proxy statement and, if elected, to serve on the company's board of directors;
- disclosure about the nominee complying with the requirements of Item 7(a), (b) and (c) of Exchange Act Schedule 14A (identifying the nominee, describing certain legal proceedings related to the nominee, and describing the nominee's transactions and relationships with the company);
- if not included in the Schedule 13G, the following information with regard to each nominating shareholder or member of the shareholder group: (1) name and business address; (2) principal occupation or employment; (3) beneficial ownership; and (4) criminal convictions and involvement in other legal proceedings;[60]
- the methods by which the nominating shareholder or shareholder group may solicit shareholders, including any website address on which the nominating shareholder or shareholder group may publish soliciting materials; and
- certain additional information if the company is an investment company.

7. Requirements for Companies that Receive a Shareholder Nominee

Upon receiving a shareholder nominee for director, a company would be required to determine whether the nominee and the nominating shareholder or shareholder group have satisfied each of the requirements in the proposed rules (described above). If so, the company must include the name of the nominee on the company's proxy card.

In addition, the company would be required to include the following information in its proxy materials: (1) a statement from the nominee that the nominee consents to be named in the proxy statement and, if elected, to serve on the company's board; (2) disclosure about the nominee's transactions and relationships with the company and a description of certain legal proceedings related to the nominee; (3) address, ownership and other specified information about the nominating shareholder or shareholder group; (4) the methods by which the nominating shareholder or shareholder group may solicit shareholders, including the website address on which the nominating shareholder or shareholder group may publish soliciting materials; and (5) certain other information if the company is an investment company.

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[60] Where the nominating shareholder is an entity, the required disclosure would be provided with regard to the control persons of the entity.

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Finally, if the company includes a statement supporting its own nominee(s) or opposing the shareholder nominee (other than a mere recommendation to vote in favor of or withhold votes from specified candidates), then the company also must include, at the election of the nominating shareholder or shareholder group, a statement of support for the shareholder nominee, not to exceed 500 words.

If the company determines that it need not include the shareholder nominee in its proxy materials (because, for example, the nominating shareholder or shareholder group has not complied with the requirements set forth in the rules), then it would be required to notify the nominating shareholder or shareholder group of its determination, no less than 30 days before the one-year anniversary of the date the company released its proxy statement in connection with the previous year's annual meeting. The company also would be required to include disclosure about this determination in its proxy materials. The SEC is soliciting comment on whether a company's determination not to include a shareholder nominee should be subject to review by the SEC or its staff, or whether the SEC should make an explicit statement regarding review by the courts.

8. Relationship to Other Securities Law Provisions

The proposed rules provide that a nominating shareholder or shareholder group would not be deemed an "affiliate" of the company solely by virtue of having used the shareholder access procedure to nominate a director. In addition, the proposed rules provide an exemption from certain of the SEC's proxy rules for shareholders to communicate for the limited purpose of forming a shareholder group to nominate a director (once shareholder access is triggered) without filing a proxy statement.

The SEC also is proposing to exempt from its proxy rules, under certain conditions, solicitations by or on behalf of a nominating shareholder or shareholder group in support of a nominee placed on the company's proxy card. Finally, the proposed rules would amend Exchange Act Rule 16a-1(a)(1), the rule that defines who is a ten percent owner for purposes of Exchange Act Section 16, to exclude a nominating shareholder group.

9. Liability

In the proposing release, the SEC indicates its intent that a nominating shareholder or shareholder group be liable for any false or misleading statements in the notice provided to the company by the shareholder or group, including statements required to be repeated in the company's proxy materials. The proposed rules expressly provide that the company would not be responsible for such disclosure. Moreover, information provided to the company by a nominating shareholder or shareholder group and included in the company's proxy materials would not automatically be incorporated by reference into the company's other SEC filings.

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B. Enhanced Nominating Committee Disclosures

In a November 24, 2003 release, the SEC approved new rules that amend the proxy rules to expand disclosure related to the operation of board nominating committees.[61] The purpose of the rules regarding enhanced disclosure relating to nominating committee activities is to provide information to enable shareholders to evaluate a company's board of directors and nominating committee. The final rules amend Schedule 14A under the Exchange Act to require discussion of the following items in a company's proxy statement:

- whether the company has a standing nominating committee and, if not, why not and who determines nominees for director;
- whether the nominating committee has a charter and where the charter is available (either on the company's website or in its proxy statement);
- whether members of the nominating committee are independent;
- whether the company considers candidates for director put forward by shareholders and, if so, the material elements of its process for considering such candidates;
- the procedures for shareholders to submit candidates for director (any changes to such procedures must be disclosed in the company's periodic reports);
- any minimum qualifications that the company seeks for director nominees;
- the company's process for identifying and evaluating candidates to be nominated for director;
- a statement regarding the "category" of person(s) who recommended each new nominee approved by the nominating committee for inclusion on the company's proxy card (categories include shareholders, non-management directors, the CEO, other executive officers, third-party search firms and "other");
- whether the company pays any third party a fee to assist in the process of identifying or evaluating candidates; and
- whether the company has rejected director candidates put forward by a shareholder or group of shareholders who beneficially owned more than five percent of the company's stock for at least one year at the time of the recommendation and, if so, the names of the nominating shareholder(s)

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[61] Disclosure Regarding Nominating Committee Functions and Communications between Security Holders and Boards of Directors, Release No. 33-8340 (Nov. 24, 2003), *available at* http://www.sec.gov/rules/final/33-8340.htm.

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and the candidate (provided that both the shareholder and the candidate affirmatively consent to being so named).

C. Disclosure Regarding Shareholder Communications with Directors

In a November 24, 2003 release, the SEC also approved final rules to amend Item 22 of Schedule 14A under the Exchange Act to require disclosure concerning shareholder communications with directors.[62] The final rules also amend Schedule 14A to require disclosure of the following information in a company's proxy statement:

- a statement as to whether the board has a process for shareholders to communicate with the board and, if not, why not; and
- if the board has such a process:
    - a description of the manner in which shareholders may communicate with the board and, if applicable, with individual directors;
    - a description of the company's process (if any) for determining which communications will be relayed to directors; and
    - whether the board has a policy with respect to directors' attendance at the annual meeting of shareholders and information regarding directors' attendance at the previous year's annual meeting.

V. Corporate Governance

A. Approval of Changes to the Listing Standards of the Major Securities Markets

In the summer of 2002, both the NYSE and the Nasdaq proposed significant changes to their respective corporate governance listing standards. Initially, both organizations submitted their proposals to the SEC in August 2002 for final approval. The proposals of both organizations were amended a number of times and put out for public comment in March 2003. In late June 2003, the SEC approved, on a fast track basis, proposals for both organizations relating to shareholder approval of equity compensation plans. On November 4, 2003, the SEC approved the final rule proposals for both the NYSE and the Nasdaq.[63]

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[62] *Id.*

[63] NASD and NYSE Rulemaking: Relating to Corporate Governance, Release No. 34-48745 (Nov. 4, 2003), *available at* http://www.sec.gov/rules/sro/34-48745.htm.

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1. The New York Stock Exchange

With limited exceptions, domestic companies must comply with the new listing standards by the earlier of their first annual meeting after January 15, 2004, or October 31, 2004.[64] Companies with classified boards generally will have until their second annual meeting after January 15, 2004 (but not later than December 31, 2005). The approved standards include changes in the following areas:[65]

a. Board Independence

- The board must have a majority of independent directors. Companies have until the earlier of their first annual meeting after January 15, 2004, or October 31, 2004, to comply with the new independence rule[66] and are required to publicly disclose when they have achieved majority independence.
- Controlled companies, in which more than 50 percent of the voting power is held by an individual, group or another company, rather than the public, need not meet this board independence requirement.
- For a director to be deemed "independent," the board must affirmatively determine that the director has no material relationship with the listed company other than service as a director.
- The basis for board determinations that a relationship is not material must be disclosed in the company's proxy statement or, if the company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC. The board may adopt and disclose categorical standards to assist it in making independence determinations, and may make a general disclosure if a director meets these standards. Any determination of independence for a director who does not meet the standards must be specifically explained.

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[64] The NYSE has published a set of FrequentlyAsked Questions on its web site at http://www.nyse.com/pdfs/section303Afaqs.pdf.

[65] The final NYSE listing standards are available at http://www.nyse.com/pdfs/finalcorpgovrules.pdf.

[66] Companies listed on the NYSE in conjunction with an initial public offering would have 12 months to comply with the independence requirements. Such companies would have to comply with all other listing requirements at the time of being listed.

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- A three-year "cooling off" or "look-back" period applies, during which the following are not considered independent:[67]

  (i) a director who is an employee, or whose immediate family member[68] is an executive officer, of the listed company.

  (ii) a director who receives, or whose immediate family member receives, more than $100,000 per year in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service)

  (iii) a director who is employed, or whose immediate family member is employed, as an executive officer of another company where any of the listed company's present executives serves on that company's compensation committee.

  (iv) a director who is affiliated with or employed by, or whose immediate family member is affiliated with or employed in a professional capacity by, a present or former internal or external auditor of the company.

  (iv) a director who is employed, or whose family member is employed, as an executive officer of another company where any of the listed company's present executives serve on that company's compensation committee.

  (vi) a director who is an executive officer or an employee, or whose immediate family member is an executive officer, of a company that makes payments to, or receives payments from, the listed company for property or services in an amount which, in any single fiscal year, exceeds the greater of $1 million, or two percent of such other company's consolidated gross revenues.[69]

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[67] In order to facilitate a smooth transition to the new independence standards, the NYSE will phase in the "look-back" provisions" by applying only a one-year look-back for the first year after adoption of these standards. The three-year look back for the first year after adoption of these new standards will begin to apply only from and after November 4, 2004.

[68] Immediate family members include a person's spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law and anyone, other than an employee, who lives in the same home.

[69] Charitable organizations shall not be considered "companies" for purposes of this provision, provided however that a listed company shall disclose in its annual proxy statement, or if the

[Footnote continued on next page]

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b. Executive Sessions of the Board/Presiding Director

- Non-management directors must meet at regularly scheduled executive sessions without management. The NYSE guidance also suggests that the independent directors of a board should meet in executive sessions as well.
- A director must be designated to preside at executive sessions, although there is no requirement to designate a single director who will preside at all sessions. If one director is chosen, the director's name must be disclosed in the proxy statement. Alternatively, a company may disclose the procedure by which a presiding director is selected. In any case, companies must disclose the means by which stockholders and employees may communicate with the presiding director or the non-management director.

c. New Requirements for Audit Committee Members and Audit Committees

- Audit committees must have a minimum of three financially literate members.
- Audit committees must be composed entirely of independent directors.
- The audit committee must have a written charter that addresses the committee's purpose, specific responsibilities enumerated by the NYSE and an annual performance evaluation.
- The purpose of the audit committee, at minimum, must be to prepare the report included in the annual proxy statement and to assist in board oversight of:

  (i) the integrity of the company's financial statements;

  (ii) compliance with the legal and regulatory requirements;

  (iii) the outside auditor's qualifications and independence; and

  (iv) performance of the company's internal audit function and of the outside auditor.

- The audit committee must perform additional substantive responsibilities, which must be set forth in its charter. The audit committee must:

[Footnote continued from previous page]
listed company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC.

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(i) obtain and review, at least annually, a report by the outside auditor describing the auditor's internal quality control procedures and all relationships between the auditor and the company;

(ii) discuss the annual audited financial statements and quarterly financial statements with management and the outside auditor, including the company's MD&A disclosures;

(iii) discuss earnings releases, and financial information and earnings guidance provided to analysts and rating agencies;

(iv) discuss the company's policies on risk assessment and management;[70]

(v) periodically meet separately with management, internal auditors and the outside auditor;

(vi) have sole authority to retain and terminate the outside auditor, including sole authority to approve all audit engagement fees and terms;

(vii) review with the outside auditor any audit problems or difficulties and management's response;

(viii) set clear hiring policies for employees or former employees of the outside auditors; and

(ix) report regularly to the board of directors;

(x) have the authority, without seeking board approval, to obtain advice and assistance from outside legal, accounting or other counsel or consultant;

(xi) review any difficulties encountered in the course of its audit work and management's response with the outside auditor;

(xii) clarify hiring policies for employees or former employees of the outside auditor; and

(xiii) report regularly to the board of directors.

- Each listed company must have an internal audit function.
- In accordance with Section 301 of the Sarbanes-Oxley Act, an audit committee must establish procedures for the receipt, retention and treatment of complaints by the listed company's employees regarding auditing matters, internal controls and accounting.

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[70] The rules recognize that it is the job of the company's CEO and senior management to assess and manage the company's exposure to risk. The rules indicate, however, that the audit committee must discuss guidelines and policies to govern the process by which senior executive officers accomplish these tasks.

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d. Nominating/Corporate Governance and Compensation Committees

- Companies must have a nominating/governance committee as well as a compensation committee.
- Each committee must be composed entirely of independent directors and must have a written charter. Controlled companies need not meet the independence requirement for these committees.
- Companies must fully comply with the independence requirement by the earlier of their first annual meeting after January 15, 2004, or October 31, 2004.
- Companies may allocate the responsibilities of the nominating and compensation committees to committees of their own denomination, however, regardless of the name, the committees must still be composed entirely of independent directors.
- The charter of the nominating/corporate governance committee should address: (i) committee member qualifications, appointment and removal; and (ii) committee structure, operations and reporting to the board.
- The nominating/corporate governance committee must have a written charter that identifies the committee’s purpose, which, at minimum, must be to: (i) identify individuals qualified to become board members and recommend that the board select these nominees; and (ii) develop and recommend a set of corporate governance principles to the board.
- The charter for the nominating/corporate governance committee must set forth the committee’s goals and responsibilities, which, at minimum, must reflect the board’s criteria for selecting new directors and oversight of evaluation of the board and management.
- The charter for the nominating/corporate governance committee must provide for an annual evaluation of the committee.
- The compensation committee charter should address: (i) committee member qualifications, appointment and removal; and (ii) committee structure, operations and reporting to the board.
- The compensation committee must have a written charter that identifies the committee’s purpose, which, at minimum, must be to: (i) discharge the board’s responsibility relating to compensation of executives; and (ii) produce an annual report on executive compensation for inclusion in the annual proxy statement.
- The charter for the compensation committee must also set forth the committee’s duties and responsibilities, which, at minimum, must be to:

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    - review corporate goals and objectives, relative to executive compensation, evaluate CEO performance in light of these corporate objectives, and have the sole authority to set CEO compensation based on achievement of the objectives;
    - make recommendations to the board regarding equity and incentive-based compensation plans; and
    - make recommendations to the board with respect to non-CEO compensation plans.

- The compensation committee charters must provide for an annual evaluation of the committee.
- Although not mandatory, the NYSE advises that the nominating/corporate governance committee and the compensation committee should have sole authority, without requiring full board action, to retain and terminate outside advisors, such as search firms used to identify director candidates and compensation consultants.

e. CEO Certification

The CEO must certify annually to the NYSE that the company has complied with NYSE listing standards. The CEO must also promptly notify the NYSE after any executive officer becomes aware of any material non-compliance with any provision of the proposed listing standards.

f. Corporate Governance Principles

- Companies must adopt a set of corporate governance principles and post these principles on their websites.
- The corporate governance guidelines must address:

  (i) director qualification standards;

  (ii) director responsibilities;

  (iii)director access to management and, when necessary and appropriate, to independent advisors;

  (iv)director compensation, including general principles for determining the form and amount of director compensation and for reviewing those principles;

  (v) director orientation and continuing education;

  (vi) management succession; and

  (vii) an annual performance evaluation of the board to determine how effectively the board and its committees are functioning.

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g. Codes of Business Conduct and Ethics

- Companies must adopt and disclose, including by posting on their websites, a code of business conduct and ethics for directors, officers and employees. The code must require that any waivers of compliance with the code for directors or executive officers be made only by the board or a board committee and that such waivers be promptly disclosed to shareholders. The code must also contain compliance standards and procedures that ensure prompt and consistent action against violations of the code.
- A code of business conduct and ethics should address: conflicts of interest; corporate opportunities; confidentiality; fair dealing with the company's customers, suppliers, competitors and employees; protection and proper use of company assets; compliance with laws, rules and regulations, including laws on insider trading; and reporting illegal or unethical behavior.

h. CEO Certification of Compliance with Listing Standards and Penalties for Violations

- The CEO of each listed company must certify annually to the NYSE that he or she is not aware of any violation by the company of the NYSE's corporate governance listing standards. The NYSE certification, and any CEO/CFO certifications required to be filed with the SEC regarding the quality of the company's public disclosure, must be disclosed in the company's annual report.
- NYSE may issue public reprimand letters to listed companies that violate listing standards. This proposal would take effect immediately following SEC approval.

i. Foreign Issuers

Listed foreign private issuers must comply with the listing standards applicable to audit committees. However, foreign private issuers would not be required to comply with any additional NYSE independence standards and could instead disclose, in a brief, general summary, significant ways in which their corporate governance practices differ from those of domestic companies listed on the NYSE.

j. Websites

Companies must post charters for the nominating/ governance committee, compensation committee, audit committee and other important committees, along with corporate governance guidelines and codes of conduct, on their websites.

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k. NYSE Reprimand Letter

The NYSE may issue a public reprimand letter to any listed company that it determines has violated a NYSE listing standard regardless of type of security listed or country of incorporation. Repeat offenders, may be suspended or delisted.

l. Shareholder Approval of Equity Compensation Plans

Shareholders must vote to approve or disapprove all equity compensation plans, except employment inducement option plans, option plans acquired through mergers and certain tax-qualified option plans such as ESOPs and 401(k)s.

2. Nasdaq

Companies are required to implement the new Nasdaq listing standards, with certain exceptions, upon their next annual meeting occurring after January 15, 2004, but no later than October 31, 2004. The Nasdaq rule changes address:

a. Board Independence

- A company's board of directors must be composed of a majority of independent directors.
- The independent directors must meet regularly in "executive sessions." Companies would have to comply with this requirement by the next annual meeting occurring after January 15, 2004, but no later than October 31, 2004.
- The following persons are not considered independent directors:

  (i) a director who is employed by the company or by any parent or subsidiary of the company;

  (ii) a director who accepted or who has a family member who accepted any payments from the company or any parent or subsidiary of the company in excess of $60,000, other than for compensation for board or board committee service, payments arising solely from investments in the company's securities, compensation paid to a family member who is a non-executive employee of the company or a parent or subsidiary of the company, benefits under a tax-qualified retirement plan, or non-discretionary compensation, or loans permitted under Section 13(k);

  (iii) a director who is a family member of an individual who is employed by the company or by a parent or subsidiary of the company as an executive officer;

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(iv) a director who is, or has a family member who is, a partner in, or a controlling shareholder or an executive officer of, any organization to which the company made, or from which the company received, payments for property or services that exceed 5% of the recipient's consolidated gross revenues of that year, or $200,000, whichever is more, other than payments arising solely from investments in the company's securities, or payments under non-discretionary charitable contribution matching programs;

(v) a director of the listed company who is, or has a family member who is, employed as an executive officer of another entity where any of the executive officers of the listed company serve on the compensation committee of such other entity;

(vi) a director who is, or has a family member who is, a current partner of the company's outside auditor who worked on the company's audit; or

(vii) in the case of an investment company a director who is an "interested person" of the company as defined in section 2(a)(19) of the Investment Company Act of 1940, other than in his or her capacity as a member of the board of directors of any board committee.

- Controlled companies are exempt from the requirements for a majority independent board.

b. Strengthen the Role of Independent Directors in Compensation and Nomination Decisions

- Each issuer must certify that it has adopted a formal written charter or board resolution, as applicable, addressing the nominations process and such related matters as may be required under the federal securities laws.
- A nominations committee that is "independent" for purposes of the requirement relating to independent director approval of director nominations may have a single non-independent director under certain circumstances. If the nominations committee has at least three members, one director who does not meet the Nasdaq definition of "independent director" and who is not a current officer or employee of the company, or a family member of such a person, can serve on the committee for no more than two years, if: (i) the board determines that the individual's membership on the committee is required by the best interests of the company; and (ii) the company discloses the nature of the relationship and reasons for the determination in its proxy statement. Controlled companies are exempt from this provision.
- If a company does not rely on the foregoing exception and the nominations committee has at least three members, one director

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who owns 20% or more of the company's common stock or outstanding voting power and who does not meet the Nasdaq definition of "independent director" may serve on an independent nominations committee, if the board determines that the individual's membership on the committee is required by the best interests of the company and the company discloses the nature of the relationship and reasons for the determination in its proxy statement. Controlled companies are exempt from this provision.

- Director nominations must be approved by either a majority of the independent directors or an independent nominations committee.
- A compensation committee that is "independent" for purposes of the requirement relating to independent director approval of executive compensation may have a single non-independent director under certain circumstances. If the compensation committee has at least three members, one director who does not meet the Nasdaq definition of "independent director" and who is not a current officer or employee of the company, or a family member of such a person, can serve on the committee for no more than two years, if: (i) the board determines that the individual's membership on the committee is required by the best interests of the company; and (ii) the company discloses the nature of the relationship and reasons for the determination in its proxy statement. Controlled companies are exempt from this rule requirement.
- CEO compensation and other executive officer compensation must be approved by either an independent compensation committee or by a majority of independent directors in an executive session. The CEO may be present at a meeting where other executive officer compensation is approved.

c. Audit Committees

- The audit committee must have a written charter that addresses its purpose and certain authorities and responsibilities mandated under the Sarbanes-Oxley Act. Companies must comply with the audit committee charter requirement by the company's first annual meeting after January 15, 2004, but no later than October 31, 2004.
- The audit committee must review and reassess the adequacy of the written charter on an annual basis.
- The audit committee must have at least three members, each of whom must:

  (i) meet the Nasdaq definition of "independent director";

  (ii) meet the criteria for independence set forth in SEC rules under Section 301 of the Sarbanes-Oxley Act;

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(iii) not have participated in the preparation of the financial statements of the company or any current subsidiary of the company at any time during the past three years; and

(iv) be able to read and understand fundamental financial statements at the time of joining the committee.

- A non-independent director may, subject to an "exceptional and limited circumstances" exception, serve on the audit committee for up to two years, although such person must still satisfy the audit committee independence requirements of the Sarbanes-Oxley Act. The company must disclose the nature of the relationship and the reasons for the determination that such relationship is in the best interests of the company in its proxy statement.
- The audit committee charter must set forth the committee's purpose of overseeing the company's accounting and financial reporting processes and the audits of the financial statements.
- The audit committee charter must set forth, and the audit committee must perform, the responsibilities required in Exchange Act Rule 10A-3(b)(2-5), which include:

(i) pre-approve all services and permissible non-audit services, as set forth in Section 202 of the Sarbanes-Oxley Act;

(ii) have the sole authority to hire, fire and determine the compensation of the company's outside auditors;

(iii) have the authority to engage and determine funding for outside advisors, as set forth in Section 301 of the Sarbanes-Oxley Act; and

(iv) have the responsibility to establish procedures for complaints relating to auditing and accounting matters, as set forth in Section 301 of the Sarbanes-Oxley Act.

- Audit committees are required to have the authority to consult and retain legal counsel and other appropriate experts.
- Consistent with the Sarbanes-Oxley Act, a member of the audit committee may receive no compensation from the corporation other than that for board and committee service .
- Companies who file reports under Regulation S-B must meet the audit committee standards of all other issuers.
- Audit committees must review and approve all related-party transactions.
- Companies must disclose the receipt of an audit opinion with a going concern qualification.

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- The audit committee must establish procedures for the confidential and anonymous receipt and treatment of complaints by the issuer.
- If a listed issuer fails to comply with the audit committee composition requirements, because an audit committee member ceases to be independent for reasons outside the member's reasonable control, the audit committee member could remain on the committee until the earlier of the issuer's next annual shareholders meeting or one year from the occurrence of the event that caused the failure to comply with the requirements; and if an issuer fails to comply with the audit committee composition requirements due to one vacancy on the audit committee, and the aforementioned cure period is not otherwise being relied upon for another audit committee member, the issuer would have until the earlier of the next annual shareholders meeting or one year from the occurrence of the event that caused the failure to comply with this requirement.
- Current Nasdaq rules requiring one member of the audit committee to have experience through employment, education or otherwise will remain the same.

d. Non-U.S. Companies

- Nasdaq has the ability to provide exemptions to foreign issuers, except to the extent that such exemptions would be contrary to the federal securities laws.
- Non-U.S. companies will be required to disclose any exemptions to corporate governance requirements at the time they are received, and on an annual basis thereafter.
- Non-U.S. companies will be required to file all interim reports filed in the company's home country, and the filing of at least a semi-annual report with the SEC and Nasdaq, accompanied by an English translation.

e. Codes of Conduct

- All companies must have a publicly available code of conduct, which must at least address conflicts of interest and compliance with applicable laws, rules and regulations.
- The code of conduct should also describe an appropriate compliance mechanism and must disclose any waivers granted to executive officers and directors. Waivers may only be granted by independent directors and must be promptly disclosed on Form 8-K.

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- The code of conduct must contain all of the elements required by Section 406 of the Sarbanes-Oxley Act and the SEC's implementing rules. These rules are described below.

f. Penalties for Corporate Governance Violations

- A company can be delisted for making a material misrepresentation or omission to Nasdaq.
- A company's re-listing application can be denied if Nasdaq finds that the company has violated its corporate governance standards during the period in which the delisting appeal is pending.
- Companies will be permitted to disseminate material via Regulation FD-compliant methods of disclosure, such as conference calls, press conferences and web casts, instead of solely by press release. The public must be given adequate notice and granted access.

g. Equity Based Compensation Plans

- Shareholders must vote to approve all stock option plans and all material modifications of such plans.
- Nasdaq would retain the existing exception that allows companies to provide inducement grants to new executive officers, but any such grants would have to be approved by an independent compensation committee or a majority of the independent directors.
- Certain tax-qualified plans, such as ESOPs and plans that merely provide a convenient way to purchase shares on the open market or from the issuer at fair market value, will be exempt, as will the assumption of pre-existing grants in connection with a merger or acquisition.
- Existing option plans are unaffected, unless a material modification is made to the plan.
- The amended rules regarding shareholder approval of equity compensation plans were approved by the SEC on June 30, 2003, and became effective upon SEC approval.[71]

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[71] Self-Regulatory Organizations; New York Stock Exchange, Inc. and National Association of Securities Dealers, Inc.; Order Approving NYSE and Nasdaq Proposed Rule Changes and Nasdaq Amendment No. 1 and Notice of Filing and Order Granting Accelerated Approval to NYSE Amendments No. 1 and 2 and Nasdaq Amendments No. 2 and 3 Thereto Relating to Equity Compensation Plans, Release No. 34-48108 (June 30, 2003).

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B. Other Corporate Governance Proposals

A number of independent organizations have also published suggested guidelines for enhanced corporate governance.

The Business Roundtable published its *Principles of Corporate Governance* in May 2002. *Principles of Corporate Governance* can be found at http://www.businessroundtable.org/pdf/704.pdf. *Principles of Corporate Governance* provided a set of guiding principles intended to assist corporate management and boards of directors in their individual efforts to implement corporate governance best practices. Many of the proposals in *Principles of Corporate Governance* were included in the standards adopted by the NYSE and the Nasdaq.

In November 2003, the Business Roundtable also published *Executive Compensation: Principles and Commentary*, which provides more detailed guidance with regard to designing, implementing and overseeing executive compensation programs. *Executive Compensation: Principles and Commentary* is available at http://www.businessroundtable.org/pdf/ExecutiveCompensationPrinciples.pdf.

In April 2004, the Business Roundtable published The Nominating Process and Corporate Governance Committees: Principles and Commentary, which provides a guide of best practices for companies' director nomination process. The publication also provides guidance with regard to the expanding role of the corporate governance committee in shaping the company's overall governance policies and procedures. The Nominating Process and Corporate Governance Committees: Principles and Commentary is available at http://www.businessroundtable.org/pdf/20040421002CorpGovComm.pdf.

On March 31, 2003, the American Bar Association's Task Force on Corporate Responsibility released its Report on Corporate Responsibility, which is available at http://www.abanet.org/buslaw/corporateresponsibility/final_report.pdf. The report makes a number of recommendations for corporate governance of public companies as well as for attorneys in representing companies on corporate governance matters. The changes to the model rules of attorney conduct were approved at the ABA's 2003 annual meeting.

VI. Staff Accounting Bulletins

A. Introduction

As expressed in speeches by former SEC Chairman Arthur Levitt and former SEC Chief Accountant Lynn Turner , the SEC has focused on accounting issues in response to "new services and new technologies . . . creating new questions and challenges that must be addressed."[72] Staff Accounting Bulletins are intended to address attempts by companies to

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[72] Arthur Levitt, Quality Information: The Lifeblood of Our Markets, Remarks of the Chairman at the Economic Club of New York (Oct. 18, 1999),

[Footnote continued on next page]

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disclose the value of assets that are increasingly intangible and for which there is not sufficient guidance in the traditional financial reporting model. In addition to the guidance already provided by recent Staff Accounting Bulletins, the SEC has looked at accounting issues in connection with internet activities[73] and international accounting standards,[74] and has proposed new rules to provide better disclosure regarding such accounting areas as changes in valuation and loss accrual accounts.[75]

B. Staff Accounting Bulletin No. 103: Update of Codification of Staff Accounting Bulletins

On May 9 2003, the SEC released Staff Accounting Bulletin No. 103 in order to make the Staff's interpretive guidance consistent with current accounting and auditing guidance and with SEC rules.[76] While offering relatively little new guidance, per se, the bulletin represents the first comprehensive recodification of the Staff Accounting Bulletins in more than 20 years. The recodification addresses, among other topics, financial statements, business combinations, senior securities, equity accounts and revenue recognition. Many of the changes rescind material no longer needed because of changes in authoritative accounting standards and new SEC rules. As a result of the recodification, the entire SAB codification will now be available on the SEC website.[77]

C. Staff Accounting Bulletin No. 104: Revenue Recognition

On December 17, 2003, the SEC released Staff Accounting Bulletin No. 104, revising or rescinding portions of the interpretative guidance included in Topic 13 of the codification of staff accounting bulletins in order to make the Staff's interpretive guidance consistent with

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[Footnote continued from previous page]
http://www.sec.gov/news/speech/speecharchive/1999/spch304.htm; Lynn Turner, Reflections on Times Past, Times to Come, Remarks at the 10th Annual Conference on Financial Reporting,University of California at Berkeley (Nov. 5, 1999), http://www.sec.gov/news/speech/speecharchive/1999/spch322.htm.

[73] Letter from Lynn E. Turner, Former Chief Accountant, to the Financial Accounting Standards Board (Oct. 18, 1999), *available at* http://www.sec.gov/info/accountants/staffletters/calt1018.htm.

[74] International Accounting Standards, Release Nos. 33-7801, 34-42430 (Feb. 16, 2000), *available at* http://www.sec.gov/rules/concept/34-42430.htm.

[75] Supplementary Financial Information, Release Nos. 33-7793, 34-42354 (Jan. 27, 2000), *available at* http://www.sec.gov/rules/proposed/34-42354.htm.

[76] Staff Accounting Bulletin: No. 103 Update on Codification of Staff Accounting Bulletins, Release No. SAB 103 (May 9, 2003), *available at* http://www.sec.gov/interps/account/sab103.htm.

[77] The codification is also found at Part 211 of Title 17 of the Code of Federal Regulations.

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current accounting and auditing guidance and SEC rules.[78] The principal revisions rescind material no longer necessary because of private sector developments in U.S. generally accepted accounting principles and new SEC rules.[79] Additionally, the bulletin rescinds the Revenue Recognition in Financial Statements Frequently Asked Questions and Answers document issued in conjunction with Topic 13 and incorporates selected portions of that document into Topic 13.

VII. Other SEC Rule Changes or Items of Note

A. Other Changes in SEC Rules

1. Accelerated Reporting Requirements for Form 10-K and Form 10-Q

In a September 5, 2002 release, the SEC approved the adoption of the proposed rules to accelerate the filing deadline for annual and quarterly reports under the Exchange Act, with a three-year phase-in period.[80] Pursuant to the new rules, for many companies, Forms 10-K must be filed within 60 days of fiscal year-end and Forms 10-Q must be filed within 35 days of quarter-end. As noted below, however, there is a three-year transition period for the implementation of the new rules.

The accelerated filing requirements are being phased in over three years (which began at December 31, 2002), according to the following schedule:

- For fiscal years ending on or after December 15, 2003, the filing period will be shortened to 75 days after the fiscal year end. For fiscal years ending on or after December 15, 2004, the filing period will be further shortened to 60 days after the fiscal year end. Thereafter, the reporting period will continue to be 60 days after the fiscal year end.
- For fiscal years ending on or after December 15, 2003, the filing period will remain 45 days after the end of the quarter. For fiscal years ending on or after December 15, 2004, the filing period will be shortened to 40 days after the end of the quarter. For fiscal years ending on or after December 15, 2005, the filing period will be further shortened to 35 days after the

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[78] Staff Accounting Bulletin No. 104: Revenue Recognition, Release No. SAB 104 (December 17, 2003), *available at* http://www.sec.gov/interps/account/sab104rev.pdf.

[79] Specifically, many of the revisions relate to EITF Issue 00-21, *Revenue Arrangements with Multiple Deliverables*.

[80] Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access, Release Nos. 33-8128, 34-46464 (Sept. 5, 2002), *available at* http://www.sec.gov/rules/final/33 - 8128.htm.

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end of the quarter. Thereafter, the reporting period will continue to be 35 days after the fiscal quarter ends.

Companies are subject to the accelerated reporting requirements if they: (i) have a domestic public float of at least $75 million; (ii) have been a reporting company for 12 months; and (iii) have previously filed at least on report with the SEC.

Based on comments made by the SEC Staff at the open meeting in which the rules were adopted, it appears that financial statements of subsidiaries that are not themselves subject to the accelerated filing requirements will not have to be included in the parent company's periodic reports on the accelerated schedule and may be filed by amendment at a later date. The accelerated filing deadlines do not apply to foreign private issuers.

2. New Rules on Website Access to SEC Reports

A new provision, impacting companies that do not provide access to their SEC filings through company websites, became effective on November 15, 2002. The rule requires companies that are subject to the accelerated filing requirements for Forms 10-K and Forms 10-Q(generally, companies that are eligible to use Form S-3[81])to disclose whether they provide access to their SEC filings through their website in any Form 10-K filed for a fiscal year ending after December 15, 2002.

Specifically, under new Item 101(e) of Regulation S-K, each such company must disclose:

- the company's website address, it if has one;
- whether the company makes available, free of charge, on or through its website (if it has one) its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC;[82]

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[81] "Accelerated filers" are companies that: (i) have a common equity float of $75 million; (ii) have been subject to Section 13(a) or 15(d) reporting requirements for at least one year; (iii) have filed at least one annual report pursuant to Section 13(a) or 15(d); and (iv) are not eligible to use Forms 10-KSB and Forms 10-QSB.

[82] The SEC has indicated that it expects companies to post their filings on their website on the same day they are filed. *See id.*

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- if the company does not make its filings available in this manner, the reasons it does not do so, including, where applicable, that it does not have an Internet website; and

- if the company does not make its filings available in this manner, whether the company will voluntarily provide electronic or paper copies of its filings free of charge upon request.

The rule allows companies to provide website access to their Exchange Act reports in a number of ways. For example, companies may establish hyperlinks to the reports via the SEC's website. Other options available to companies include posting hypertext links to other third-party services or posting PDF files of the reports. The SEC release also instructs companies to provide a hyperlink directly to their reports, or to a list of their reports, instead of just providing a hyperlink directly to the home page or general search page of the SEC or other third-party service.

Although compliance with the disclosure requirement began with annual reports on Form 10-K filed for fiscal years ending on or after December 15, 2002, the disclosure relates to the company's practice during the period covered by the report.

3. Amendments to Rule 10b-18 and Disclosure of Section 12 Stock Repurchases

The SEC's amendments to Rule 10b-18, which generally became effective for U.S. issuers' quarterly reports on Form 10-Q filed for periods ending on or after March 15, 2004, created new disclosure requirements for all issuer repurchases, including repurchases that fall within the Rule 10b-18 safe harbor.[83] Under these new rules, which are stated in Item 703 of Regulations S-K and S-B, issuers must disclose all open market and private repurchases of registered equity securities that occurred during the previous fiscal quarter (or for Forms 10-K and 10-KSB, the fourth quarter); or in the case of closed-end funds, the preceding semi-annual period; or for foreign issuers, on a yearly basis in annual report Form 20-F. Specifically, issuers must disclose, for each month in the quarter, (1) the total number of shares purchased, (2) the average price paid per share, (3) the number of shares purchased as part of a publicly announced repurchase plan and (4) the maximum number of shares that may yet be purchased under the plans or programs. Finally, the amended rules require footnote disclosure of the principal terms of publicly announced repurchase programs.

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[83] The SEC's Division of Market Regulation has issued an FAQ with regard to the Rule 10b-18 amendments. The FAQ is available at http://www.sec.gov/divisions/marketreg/r10b18faq0504.htm.

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The new disclosures in Item 703 apply only to repurchases of Section 12 registered securities. Thus, the SEC has determined that the Item 703 table need not report the following:

- forfeiture of restricted stock units when vesting conditions are not satisfied. The forfeitures are not reported because they are not a repurchases.
- purchases of securities that may be converted into Section 12 registered securities but are not currently Section 12 registered, including repurchases of convertible debt that is not Section 12 registered
- option exchange programs because options are not Section 12 securities
- cash settlement of restricted stock units because the restricted stock units are not registered under Section 12
- net settlement of restricted stock units if the number of shares actually issued upon vesting is reduced by the number necessary to pay taxes. The restricted stock units held back by the issuer are not Section 12 registered securities. In contrast, net settlement of restricted stock is reportable under Item 703 as a repurchase if the stock is treated as outstanding prior to vesting (e.g., has voting rights) and the stock is a Section 12 registered security.

The impact of these disclosure requirements on equity securities transferred in connection with employee benefit plans is still evolving. The SEC requires different treatment for two types of "cashless" exercises of employee stock options. If an individual exercises options and the issuer withholds shares to either pay the exercise price or pay withholding taxes ("net exercises"), the shares withheld are not reportable under the amended rule. In contrast, if an individual pays the exercise price or withholding taxes by delivering to the issuer shares the individual already owns (a "stock-for-stock" or "stock swap" exercise), then the repurchase of shares by the issuer must be reported in the Item 703 disclosure table.

Additionally, stock repurchases by an employee benefit plan, including a 401(k) plan, may be reportable if the plan is an affiliated purchaser, as defined in Rule 10b-18(a)(3). Under that rule, an "affiliated purchaser" is: (i) a person acting, directly or indirectly, in concert with the issuer for the purpose of acquiring the issuer's securities; or (ii) an affiliate who, directly or indirectly, controls the issuer's purchase of such securities, whoses purchases are controlled by the issuer or whose purchases are under common control with those of the issuer. It further states that an "affiliated purchaser" does not include a broker, dealer or other person solely by reason of such broker, dealer or other person effecting Rule 10b-18 purchases on behalf of the issuer or for its account and does not include an officer or director of the issuer solely by reason of that person's participation in the decision to authorize Rule 10b-18 purchases by or on behalf of the issuer.

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B. The California Corporate Disclosure Act

California corporations, and corporations qualified to do business in California whose shares are publicly traded, will be subject to additional information filing requirements under new California legislation, which became effective January 1, 2003.[84] The new legislation, the California Corporate Disclosure Act (the "Corporate Disclosure Act"), makes significant additions to the information previously required to be filed with the California Secretary of State under Sections 1502 and 2117 of the California Corporations Code, and increases the frequency of the filings from every two years to every year.

The Corporate Disclosure Act applies to each "publicly traded company" that is either a California corporation or qualified to do business in California. "Publicly traded company" is defined by the Corporate Disclosure Act as a company whose securities are listed or admitted to trading on a national or foreign securities exchange, or are the subject of two-way quotations, such as bid and ask prices, that are regularly published by one or more broker-dealers in the National Daily Quotation Service or a similar service. The National Daily Quotation Service has not existed for years, but the provision was probably intended to refer to the Electronic Quotation Service of Pink Sheets LLC, which traces its roots back to the National Daily Quotation Service. Parent corporations not incorporated or qualified to do business in California, but doing business in California through subsidiaries are apparently not required to make the filings under the Corporate Disclosure Act. Their subsidiaries are also not required to make the filings if their securities are not publicly traded.

Although the subject matter of the new disclosures is similar to what is already required to be filed with the SEC by companies reporting under the Exchange Act, apparently little attempt was made to coordinate the two disclosure requirements. Thus, compliance with the California requirements will require more than a mere "cut and paste" from information required to be prepared for filing or already filed with the SEC. Further, due to the differences in the disclosure requirements, officers' and directors' questionnaires, typically relied upon in preparing Exchange Act filings, will have to be revised if they are to be relied upon for the California filing.

The California Secretary of State has published a new form for publicly traded companies on which the information must be filed.[85] The Secretary of State is required to

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[84] As of May 2003, the AICPA estimates that more than a dozen states are contemplating new or additional legislation regarding financial disclosure and accounting reform. *See* http://www.aicpa.org/download/statelegis/state_acctg_reform_legislation.pdf.

[85] The new form, entitled Corporate Disclosure Statement, is a supplement to a modified version of the previously required Statement Information, both of which have to be filed. The forms can be downloaded from the California Secretary of State's web site, *at* http://www.ss.ca.gov/business/corp/corp_soinfo.htm.

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make the disclosed information "available and open" to the public and, by December 31, 2004, to provide access to the information by means of an on-line database.

The information filed under the Corporate Disclosure Act by a California corporation must be certified by the corporation as being true and correct. Interestingly, there is no corresponding certification provision in the statute for filings by non-California corporations qualified to do business in California, but the Secretary of State's form for non-California corporations calls for such a certification. The information required to be disclosed is:

- Auditor and Non-Audit Services. The name of the independent auditor used by the corporation and a description of any "other services" (presumably non-audit services) performed for the corporation during the previous 24 months by the independent auditor or certain of its affiliates, and the date of the "last report" prepared by the auditor (presumably, the last audit report). A copy of the report is required to be attached to the statement of information filed with the Secretary of State. Remarkably, there is no express requirement that the related financial statements be filed, and the Secretary of State is accepting filings without them.
- Directors' and Executive Officers' Compensation. The annual compensation paid to each member of the board of directors and each executive officer. The compensation disclosed must include the number of shares or options to purchase shares "that were not available to other employees." The meaning of "not available to other employees" is not clear, although the intention could have been to exclude broad-based stock purchase plans where directors and executive officers are treated on an equal basis with employees. The Secretary of State's form defines "compensation" as including wages, salaries, bonuses, commissions and "other forms of monetary remuneration" (in addition to the options and shares referred to above). The form indicates that the period for which compensation should be disclosed is the "previous twelve months or last fiscal year" (presumably at the option of the filer). The reference to options presumably refers to options granted during the reporting period, although it could include options which become exercisable because of service during the reporting period. Likewise the term "shares" probably refers to shares issued during the reporting period, perhaps including shares issued upon exercise of previously granted options, and could include previously granted restricted shares as to which the restrictions lapse due to service during the reporting period.
- Definition of "Executive Officer." "Executive officer" is defined in the Corporate Disclosure Act as each of the five most highly compensated officers, "excluding any officer who is not a director." This definition differs from that set forth in the SEC's Rule 405 under the Securities Act, and the comparable Rule 3b-7 under the Exchange Act, where the term refers to the president, any vice-president in charge of a principal business unit, division or function, any officer who performs a policy making function, or any other person who performs similar policy-making

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functions. The federal definition expressly includes executive officers of subsidiaries who perform policy-making functions for the parent.

- In the typical situation where the chief executive officer is also a director, it is unclear under the Corporate Disclosure Act whether the number of other officers included in the definition is reduced to four or whether another officer's compensation must be added. It would probably be prudent, however, to interpret "executive officer" as including each of the five most highly compensated officers who is not a director.

- Loans to Directors. A description of any loans made to a director "at a preferential rate" during the preceding 24 months, including the amounts and terms of the loans. Interestingly, loans to executive officers are not covered. The phrase "preferential rate" could prove a significant loophole, as there appears to be no legislative history to interpret it. The intention could have been, however, to exclude only those loans made by corporations that lend money in the ordinary course of their business, if the loans to directors were made at the rate made available to others. Such treatment would be similar to the treatment in federal Sarbanes-Oxley Act, which completely prohibits personal loans to directors and executive officers, but has an exclusion for certain kinds of issuers that extend credit in the ordinary course of their business, provided the credit is extended to the director or executive officer on market terms or on terms no more favorable than those offered to the general public. It is also interesting that, in the Corporate Disclosure Act, "preferential" relates only to the rate and not to the other terms or the loan amounts.

- Bankruptcy. A statement indicating whether any bankruptcy was filed by the corporation, its executive officers or members of the board of directors within the preceding 10 years. Read literally, the disclosure requirement does not include cases of involuntary bankruptcy or other kinds of insolvency or receivership proceedings.

- Fraud Convictions. A statement indicating whether any member of the board of directors or any executive officer of the corporation was "convicted of fraud" during the previous 10 years. Again, read literally, the language does not include judgments in civil actions or orders or decrees in regulatory proceedings. "Fraud" may be interpreted, however, to include crimes involving any kind of deliberate deception, false or misleading disclosure or failure to disclose.

- Securities Laws Violations. A statement indicating whether the corporation violated any federal securities laws or any security or banking provision of California law in the previous ten years for which the corporation was found liable in any action before a court, regulatory agency or self-regulatory organization in which a judgment of over $10,000 was entered. Interestingly, this provision relates only to the corporation and not to directors, executive officers or entities with which

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they are or have been associated. The statute would require disclosure of such a judgment even if vacated or reversed on appeal.

The information required by the Corporate Disclosure Act must be filed each year by a California corporation during the calendar month in which its original articles were filed, or in any of the preceding five calendar months. The filing period is the same for a non-California corporation qualified to do business in California, except that the period is measured from the month in which the corporation filed the forms prescribed by the Secretary of State to qualify to do business in California. This means that corporations have some control over the timing of the filing, and that those with filing deadlines within the first five months after the end of their fiscal years have some control over what information will be disclosed. For example, for a company that was incorporated in April 1995, has a fiscal year ending December 31 and files on April 2, 2004, the information filed would relate to the audit report for 2003 (under normal circumstances), compensation of directors and executive officers for 2003 and loans made to directors during the 24-month period from April 1, 2002 to March 31, 2004. However, if the corporation chose to file its information statement on December 1, 2003, it would be providing information about the audit report for 2002, compensation for 2002 and loans made during the period from December 1, 2001 to November 30, 2003.

The preceding example assumes that the reference to loans made "during the previous 24 months" refers to calendar months preceding the calendar month of filing, although that is not clear from the legislation. The other possible meaning would be the 24 months preceding the date of filing. For example, for a filing at the close of business on April 5, 2003, the 24-month period might be from April 5, 2001 to April 4, 2003. In the absence of any authoritative clarification, it would be prudent to be over-inclusive, and to use the 24 calendar months preceding the calendar month of filing plus any intervening subsequent days in the month of filing, although that would require disclosure that is current as of the date of filing. A similar problem exists in determining the 10-year periods for which bankruptcies, fraud convictions and judgments under securities and banking laws must be disclosed.

Another problem with the reporting period under the Corporate Disclosure Act is that a corporation might be required to disclose information in its California filing before the information becomes publicly available through filings under the Exchange Act. Absent unusual circumstances, this will be true for disclosure of compensation by corporations required to file in California in the first few months after the end of their fiscal years because the SEC document that includes compensation information will typically not yet have been filed. Under circumstances where material information is first being disclosed in the California filing, the corporation would have to consider filing a current report on Form 8-K with the SEC to ensure widespread public disclosure.

If any of the disclosed information changes, the corporation is permitted, but not required, to file a current statement containing all of the required information. While it is arguable that corporations should make current filings to prevent information previously filed from being inaccurate or misleading, presumably the statement speaks only as of the date it is filed and the statute appears to expressly preclude any requirement of updating, with one exception described below. Also, current information that is material may be publicly

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available through press releases and filings under the Exchange Act. If the name or address of the designated agent for service of process changes, a current statement is required as to all of the information referred to above, and not just the information regarding the agent. Therefore, a new filing could be triggered by events outside of the corporation's control, such as a change of address of its agent for service of process.

In addition to the current filing fee of $20, the Corporate Disclosure Act imposes a new filing fee of $5.00 and provides that one-half of the $5 will be deposited into the new Victims of Corporate Fraud Compensation Fund, to be administered by the California Secretary of State and to provide restitution to victims of corporate fraud. The other half is to be used to further the disclosure provisions of the Corporate Disclosure Act, including the development and maintenance of the on-line database to be established by the Secretary of State.

C. Employee Stock Options

1. Disclosure of Equity Compensation Plan Information

On December 21, 2001, the SEC adopted amendments to its disclosure requirements relating to equity compensation plans to require additional information to be provided in annual reports filed on Forms 10-K and 10-KSB, and in proxy and information statements when the company is submitting a compensation plan for shareholder approval.[86] The SEC's amendments to its equity compensation plan information disclosure rules were prompted, at least in part, by a concern that as the use of equity compensation, particularly stock options, continues to grow, and as companies issue more shares of stock to their employees, the ownership interests of current shareholders may become diluted. Because the distribution of additional shares may result in a significant reallocation of ownership between existing shareholders and management and employees, the SEC believed that investors have a strong interest in understanding companies' equity compensation programs and that therefore, additional, and more clear, disclosure was necessary.

a. Content of the Disclosure

The amended disclosure requirements apply to all equity compensation plans in effect as of the end of a company's last completed fiscal year that provide for the award of company stock or options, warrants or rights to purchase stock.[87] An equity compensation plan is "in effect" as long as securities remain available for future issuance under the plan, or as long as previously granted options, warrants or rights remain outstanding. Disclosure

[86] Disclosure of Equity Compensation Plan Information, Release Nos. 33-8048, 34-45189 (Dec. 21, 2001), *available at* http://www.sec.gov/rules/final/33-8048.htm.

[87] *Id*.

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is required regardless of whether the plan participants are company employees, including officers, or non-employees, such as directors, consultants, vendors, or customers. Under the amended disclosure requirements, public companies must disclose, in tabular format:

- the number of securities to be issued upon the exercise of any outstanding options, warrants and rights;
- the weighted-average exercise price of such outstanding options, warrants and rights; and
- the number of securities remaining available for future issuance under equity compensation plans, excluding those securities reflected above.

The above information must be divided into two categories, based on whether or not the compensation plan was approved by shareholders. Within these two categories, information may be aggregated; it is not necessary to disclose information on a plan-by-plan basis. Information regarding individual equity compensation arrangements and "assumed" plans (i.e., cases in which the company assumed an equity compensation plan in connection with a merger, consolidation, or other acquisition and will be making subsequent grants and awards under this plan) also must be included in the disclosure, in the appropriate category.[88] In the case of individual options, warrants and rights that are assumed, companies must disclose the number of shares underlying the assumed options, warrants and rights, and the related weighted-average exercise price information on an aggregated basis in a footnote to the table.

If any plan included in the table is a so-called "evergreen plan," containing a formula that automatically increases the number of shares available for issuance by a percentage of the number of shares outstanding, the company also must describe this formula in a footnote to the table.[89]

In addition, for each compensation plan that was adopted without shareholder approval, companies must provide a brief narrative description of the material features of the plan. Companies may satisfy this disclosure requirement by cross-referencing to the financial statement footnote disclosures required by Statement of Financial Accounting Standard No. 123 ("Standard 123") containing the relevant information.[90] The cross-reference

[88] *Id.*

[89] *Id.*

[90] *Id.*

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should identify the specific plan or plans in the Standard 123 disclosure that were not approved by shareholders, as companies are not required to distinguish between shareholder approved and non-shareholder approved plans in their Standard 123 disclosures.

b. Location of the Disclosure

The amendments require the table to be included in a company's annual report on Form 10-K each year. In addition, it must be included in a proxy statement when a company is submitting a compensation plan for shareholder approval. To avoid redundancy, the amendments permit companies that are required to include the information in both a Form 10-K and in a proxy statement to satisfy their Form 10-K disclosure requirements by incorporating the information by reference to their definitive proxy statements (if that proxy statement involves the election of directors and is filed not later than 120 days after the end of the fiscal year covered by the Form 10-K). The disclosure is not required in Securities Act registration statements.

c. When Disclosure is Not Required

The disclosure requirements do not apply to plans that issue warrants or rights to all shareholders on a pro rata basis or to any qualified employee benefit plan.

d. Filing of Non-Shareholder Approved Plans

The amendments also revise the exhibit requirements contained in Item 601 of Regulation S-K to require companies to file with the SEC a copy of any non-shareholder approved equity compensation plan in which any employee participates, unless the plan is immaterial in amount or significance.[91] Existing non-shareholder approved plans are subject to this requirement, and copies of such plans must be filed as an exhibit to the Form 10-K for the company's first fiscal year ending on or after March 15, 2002.

e. Guidance for Companies

- First, companies should gather the required information regarding all equity compensation plans. Companies should note that the SEC considers both individual arrangements and assumed plans to be subject to the disclosure rules. Individual arrangements are "plans" that apply to only one person within the company, for

[91] *Id*. at 23.

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example, a corporate officer. Assumed plans are those that a company acquired in connection with a merger, consolidation, or other form of acquisition. Information regarding both individual arrangements and assumed plans is to be aggregated with the information pertaining to other equity compensation plans, and divided into the two categories of shareholder approved and non-shareholder approved.

- Second, companies should review the required information and prepare a mock-up of the table, as it would appear in an annual report or a proxy statement. This step will provide companies with a concrete image of how shareholders will be presented with the information.
- Third, based on the mock-up of the table, companies should consider how shareholders will perceive their plans, and whether it is in their best interests to modify or terminate any plans before disclosure is required. Note that disclosure is required with respect to any compensation plan "in effect" as of the end of the company's last completed fiscal year. As mentioned earlier, a plan is "in effect" as long as securities remain available for issuance under the plan, or as long as options, warrants or rights previously granted under the plan remain outstanding.

2. Repricing of Stock Options

The SEC has informally stated that it believes that exchange offers involving option repricings may involve a tender offer subject to Rule 13e-4 as well as Regulation 14E, and may require the filing of a Schedule TO-I at the time the exchange offer commences. On March 21, 2001, the Division of Corporate Finance issued an exemption order under the Exchange Act for issuer exchange offers that are conducted for compensatory purposes.[92] The order exempts such exchange offers, typically stock option exchange offers, from the "all holders" and "best price" provisions reflected in Rules 13e-4(f)(8)(i) and (ii) of the Exchange Act, as long as all of the following conditions are met:

- the issuer is eligible to use Form S-8, the options subject to the exchange offer were issued under an employee benefit plan as defined in Rule 405 under the Securities Act, and the securities offered will be issued under such an employee benefit plan;
- the exchange offer is conducted for compensatory purposes;

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[92] Exemptive Order (Mar. 21, 2001), *available at* http://www.sec.gov/divisions/corpfin/repricing.htm.

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- the issuer discloses the essential features and significance of the exchange offer in the offer to purchase, including risks that option holders should consider in deciding whether to accept the offer; and
- except as exemption in the order, the issuer complies with Rule 13e-4.

In its interpretive guidance with respect to the exemptive order,[93] the Division also stated that such disclosure should contain financial information about the issuer, which is generally material to the investment decision of the option holder, but that such financial information may be in summary form if the issuer incorporates its financial statements by reference. The Division has taken the position that a tender offer is involved unless the offer is limited to executive or senior officers of the issuer, the exchange is a privately negotiated compensation arrangement, and the exchange only involved the lowering of the option exercise price of outstanding stock options with no other changes, or such change can be unilaterally effected without option holder consent.

3. Registration under Section 12(g)

Many issuers that granted stock options to employees in anticipation of an initial public offering and that subsequently failed to go public now find themselves confronting the registration requirements of Section 12(g) of the Exchange Act. Section 12(g) requires any issuer having 500 or more holders of record of a class of equity securities, and more than $10 million in assets at the end of its most recent fiscal year to register the class of equity securities. Under the Exchange Act, the definition of "equity securities" includes options.[94] Consequently, for issuers that granted options to 500 or more employees, the prospect of registration has caused concern. Although these issuers have no public investors, and no market for trading the options or the underlying stock, upon registration under Section 12(g), these issuers would become subject to the reporting requirements of the Exchange Act and must furnish the same disclosures as any publicly-held company. These disclosures would include annual and quarterly reports, including audited financial statements. In addition, registration under Section 12(g) would place other burdens on these issuers. Registration would, among other things, subject the issuer's stockholders to Section 13(d) of the Exchange Act, regarding the reporting of ownership above 5%, and would also subject the issuer to the proxy rules under the Exchange Act.

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[93] DIVISION OF CORPORATION FINANCE, SECURITIES AND EXCHANGE COMM'N, CURRENT ISSUES AND RULEMAKING PROJECTS QUARTERLY UPDATE (Mar. 31, 2001), *available at* http://www.sec.gov/divisions/corpfin/cfcrq032001.htm.

[94] Section 3(a)(11) of the Exchange Act defines "equity security" to include any warrant or right to subscribe for or purchase any stock or similar security.

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On March 29, 2001, the SEC's Division of Corporation Finance revised and loosened the conditions that issuers must satisfy in order to obtain relief from registering employee stock options under Section 12(g).

In the past, the SEC had granted no-action relief to issuers who would otherwise have been required to register because they had more than $10 million in assets and 500 or more employees who held stock options, provided that the following conditions were met:

- options would be granted under a stock option plan only to employees;
- options would be granted without consideration, and at fair market value exercise prices, for the purposes of incentivizing employees to work to improve share value;
- holders of options would be under no obligation to exercise options and options would not become exercisable until a future public offering or at some other relatively distant date;
- options would be non-transferable;
- the issuer would have the right to cancel options under various circumstances in return for a cash payment based on an annual appraisal of the underlying common stock, but there would be no other market or methodology by which an option holder could receive anything of value for an option prior to its exercise, and accordingly no trading interest in the options would exist;
- the issuer would undertake to provide option holders with certain material information about the options; and
- the no-action relief requested would be limited to options granted under the stock option plan.[95]

In its March 31, 2001 quarterly update to its Current Issues and Rulemaking Projects Outline,[96] the Division of Corporation Finance indicated that it would relax

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[95] *See* Mitchell Int'l Holding, Inc., SEC No-Action Letter, 2000 SEC No-Act LEXIS 1033 (Dec. 27, 2000); General Roofing Services, Inc., SEC No-Action Letter, 2000 SEC No-Act LEXIS 496 (Apr. 13, 2000); Kinkos, Inc., SEC No-Action Letter, 1999 SEC No-Act LEXIS 928 (Nov. 30, 1999); WRQ, Inc., SEC No-Action Letter, 1997 SEC No-Act LEXIS 1100 (Dec. 31, 1997); BSG Corp., SEC No-Action Letter, 1995 SEC No-Act LEXIS 617 (Aug. 1, 1995); Superior Services, Inc., SEC No-Action Letter, 1994 SEC No-Act LEXIS 374 (Mar. 18, 1994); Starbucks Corp., SEC No-Action Letter, 1992 SEC No-Act LEXIS 483 (Apr. 2, 1992).

[96] DIVISION OF CORPORATION FINANCE, SECURITIES AND EXCHANGE COMM'N, CURRENT ISSUES AND RULEMAKING PROJECTS QUARTERLY UPDATE (Mar.31, 2001), *available at* http://www.sec.gov/divisions/corpfin/cfcrq032001.htm.

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the conditions for relief from registration in several ways. Issuers must still apply to the SEC for no-action relief from the registration requirements of Section 12(g), but they may either satisfy the conditions listed above or provide more disclosure to option holders, but satisfy the conditions subject to the following modifications:

- the options can be immediately exercisable;
- former employees may retain their vested options;
- the options may be transferable upon the employee's death or disability;
- the stock received upon exercise of the options may not be transferable except back to the issuer or in the event of the employee's death or disability; and
- consultants may participate in an option plan if they would be able to participate under Securities Act Rule 701.

An issuer may only take advantage of these relaxed conditions if it provides its employee option holders with the same level of information that would be available if the issuer were in fact subject to the reporting requirements of the Exchange Act. This information includes the information that would be found in an initial registration statement, annual and quarterly reports, including audited annual financial statements and unaudited quarterly financial statements prepared in accordance with GAAP. The preparation of equivalent disclosure will impose substantial costs on issuers and may necessitate the disclosure of financial and proprietary information to employee option holders .[97]

4. Accounting for Stock Based Compensation

In March 2004, the Federal Accounting Standards Board ("FASB") issued an exposure draft with regard to the accounting treatment of equity based compensation plans.[98] The exposure draft would amend FASB Statement No. 123, Accounting for Stock-Based Compensation to require companies to recognize the cost of stock-based compensation for employee services. More frankly, the exposure draft would

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[97] In most cases, issuers that are in this situation will have issued more than $5 million in options during the applicable 12-month periods under Rule 701 of the Securities Act. Consequently, even in the absence of the more onerous disclosure requirements imposed by the SEC, Rule 701 requires that the issuer distribute the financial information required by Part F/S of Form 1-A to option holders. Such information, however, while still raising the same issues about disclosure of proprietary information, would not have to be audited, nor would it have to be accompanied by all of the other information required in annual and quarterly reports.

[98] *Share-Based Payment—An Amendment of Statements No. 123 and 95*, available at http://www.fasb.org/draft/ed_intropg_share-based_payment.shtml.

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eliminate the "intrinsic value" method for accounting for stock options currently allowed and require companies to expense most stock option plans.

Companies would be required to measure the cost of the stock based compensation on the grant date of the equity instrument. The cost would then be recognized over the vesting period of the instrument. No compensation cost would be registered for instruments that do not vest.

The cost of employee services would be measured initially at fair value of liabilities and would be re measured subsequently at each reporting date through the settlement date of the instrument. The fair value at the grant date would be measured using an option pricing model, such as the Black-Scholes method. If a stock based award is modified over the vesting period, the company would also need to recognize any difference equal to the excess of the fair value of the modified stock award.

Employee stock purchase plans that grant employees additional rights or benefits over other holders of the same class of securities as well as plans that do not allow participation by all employees would also need to be recognized as costs under the exposure draft.

Companies would also be required to provide additional disclosure, as necessary, in the notes to their financial statements to provide users of the financial statements information necessary to understand the nature of the stock based compensation and how the stock based compensation affects the overall financial statements.

The exposure draft is an effort to both simplify U.S. GAAP and to converge U.S. GAAP with international accounting standards. The International Accounting Standards Board, whose standards are followed by a number of countries around the world, requires a company to expense stock based compensation. The exposure draft is also in response to growing concern in the United States that the intrinsic value method does not accurately reflect the cost of stock based compensation on a company's financial statements. The new rules would eliminate alternative disclosure methods for stock based compensation and provide more comparable financial statements among different companies.

The public comment period on the exposure draft ended on June 30, 2004. The FASB is currently reviewing public comments on the draft and expects to issue a final set of standards on stock based compensation in the fourth quarter of 2004.

D. Selected SEC Enforcement of Regulation FD

The SEC has issued a number of decisions enforcing Regulation FD, focusing on: (i) selective intentional disclosures by an issuer to securities professionals and other “enumerated persons” that differ from its disclosures to the public; and (ii) the distinction between intentional and unintentional selective disclosures.

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1. Selective Intentional Disclosures to Enumerated Persons

In *In re Raytheon Co. and Franklyn A. Caine*,[99] the SEC found that Raytheon Co. ("Raytheon") and its CFO, Franklyn Caine, violated Regulation FD by selectively providing Raytheon's quarterly earnings guidance to sell-side equity analysts and failing to simultaneously disclose the same information to the public. In February 2001, Raytheon disclosed only its annual earnings estimates and failed to disclose that, according to the estimates, the bulk of its earnings would accrue in the second half of the year. However, Mr. Caine later disclosed Raytheon's quarterly earnings estimates to selected analysts in a series of "one-on-one calls," causing each of the analysts to lower first quarter earnings estimates for Raytheon. As a result, Raytheon's own estimates "beat the Street" in the first quarter of 2001. The SEC determined that this disparate distribution of information was a violation of both Section 13(a) of the Exchange Act and Regulation FD, and issued, as part of a negotiated settlement, cease and desist orders against Raytheon and Mr. Caine prohibiting further violations.

Similarly, in *In re Siebel Systems, Inc.*,[100] the SEC found that the CEO of Siebel Systems, Inc. ("Siebel") had selectively made optimistic business disclosures at an invitation-only conference hosted by Goldman Sachs. These disclosures contrasted sharply with a public announcement made by Siebel weeks earlier. In that previous announcement, Siebel had disclosed that it was experiencing an "exceptionally soft market" and anticipating a "tough" quarter. The Commission found that the CEO was aware, prior to the conference, that the attendees included broker-dealers, investment advisers, investment companies and institutional shareholders, and that the information provided at the conference was based on internal information that would not be web-cast or otherwise disseminated to the public. Accordingly, the SEC concluded that the conference disclosures were material "selective disclosures [that] benefited those investors at the conference who 'were privy to the information beforehand [and] were able to make a profit or avoid a loss' and disadvantaged those who were kept in the dark."[101] Finding that the disparate distribution of information was a violation of both Section 13(a) of the

[99] Order Instituting Public Cease and Desist Proceedings, Making Findings, and Imposing a Cease and Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934, Release No. 34-46897 (Nov. 25, 2002), *available at* http://www.sec.gov/litigation/admin/34-46897.htm.

[100] Order Instituting Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease and Desist Order, Release No.34 46896 (Nov. 25, 2002), *available at* http://www.sec.gov/litigation/admin/34-46896.htm.

[101] *Id.*

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Exchange Act and Regulation FD, the SEC issued a cease and desist order prohibiting further violations as part of a settlement with Siebel.[102]

The SEC also issued a report in which it found that Motorola, Inc. ("Motorola") violated Regulation FD after one of its senior officials selectively told sell-side analysts in one-on-one communications that Motorola's sales and orders were down by 25% even though Motorola had previously disclosed publicly that its sales and orders were simply experiencing "significant weakness."[103] Despite these findings, the Commission failed to pursue an enforcement action against Motorola because of its "good faith reliance" on its in-house counsel's legal advice that the disparity in information was not material for purposes of Regulation FD. Although no enforcement action was taken, the SEC issued the report to "remind issuers of their obligations under Regulation FD not to selectively disclose material and nonpublic information to securities professionals."[104] Further, the Commission warned that "senior officials of issuers should be particularly cautious during private conversations with analysts" and "may not use 'code' words" to explicitly avoid imparting material nonpublic information.[105]

More recently, on September 9, 2003, the SEC announced it had settled a Regulation FD complaint against Schering-Plough Corporation.[106] The SEC had charged that former Schering-Plough chairman and chief executive officer had met privately a number of times during September and October of 2002 with different analysts and portfolio managers at institutional investment firms, which were among Schering-Plough's largest investors. At these meetings, Kogan disclosed "through spoken language, tone, emphasis and demeanor" material negative, non-public

[102] On June 29, 2004, the SEC again charged Siebel with violating Regulation FD in connection with the release of certain material non-public information in one-on-one meetings with institutional investors. In its complaint, the SEC also charged Siebel with a failure to maintain adequate disclosure controls and procedures. The case is currently pending.

[103] Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: Motorola, Inc., Release No. 46898 (Nov. 25, 2002), *available at* http://www.sec.gov/litigation/investreport/34-46898.htm.

[104] *Id.*

[105] *Id.*

[106] SEC Files Settled Regulation FD Charges Against Schering-Plough Corporation and its Former Chief Executive, Litigation Release No. 18330 (Sep. 9, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr18330.htm.

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information regarding Schering-Plough's earnings estimates.[107] The private meetings caused a sell-off of Schering-Plough stock by the investors. In the midst of the sell-off, the SEC alleged that Kogan held a private meeting with approximately 25 analysts where he told them that Schering-Plough's earnings estimates for 2003 would be "terrible."[108] After this meeting, Schering-Plough issued a press release that provided earnings estimates for 2002 and 2003 that were materially below analysts' previous estimates for the company. Schering-Plough did not admit or deny the SEC's charges, but consented to the entry of a final judgment that would require it to pay a $1 million civil penalty. Kogan also agreed to pay a $50,000 civil penalty.

2. Intentional v. Unintentional Disclosures

In *In re Secure Computing Corp. & John McNulty*,[109] the SEC found that while initial material and nonpublic disclosures regarding a manufacturing agreement made by John McNulty, CEO of Secure Computing Corp. ("Secure"), were unintentional, later material nonpublic disclosures about the same agreement made in a conference call with institutional investors after Mr. McNulty had learned the information was confidential *were* intentional and required Secure to issue a simultaneous public disclosure of the information. Secure issued a press release divulging the nonpublic information nearly three hours after the intentional nonpublic disclosure and after the close of the market that day. The SEC, however, found that this release did not comply with Regulation FD's requirement of simultaneous public disclosure, and that it violated both Regulation FD and Section 13(a) of the Exchange Act. Subsequently, as part of a settlement with Mr. McNulty and Secure, the SEC issued a cease and desist order prohibiting further violations of Section 13(a) of the Exchange Act and Regulation FD.

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[107] *Id.*

[108] *Id.*

[109] Order Instituting Cease-and-Desist Proceedings, Making Findings, and Imposing a Cease-and-Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934, SEC Release No. 34- 46895 (Nov. 25, 2002), *available at* http://www.sec.gov/litigation/admin/34-46895.htm.

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