October 2008 www.ssd.com

New SEC Enforcement Decision Makes Clear That Director & Officer Questionnaires Should Be Prepared With Care

Update of Forms Also Required by New Exchange Rule

Last month, the Securities and Exchange Commission (SEC) announced its settlement of administrative enforcement proceedings against the former outside director of three public companies who maintained a business relationship with those companies' outside auditor. The director in question had an arrangement with the auditor for all three companies to create audio CDs for business development purposes unrelated to any of the three companies on whose boards the director sat. The director was paid a total of US$377,500 by the outside audit firm in connection with the creation of the CDs.

Although each of the director and officer (D&O) questionnaires that the director was required to complete required disclosure of any relationships between the director and the company's outside auditor, the director chose not to describe the business relationship.

The director had voted to retain the outside auditor for two of the three public companies (and recommended to the shareholders that they ratify that decision) in the company's proxy statement. He also signed two reports on Form 10-K attesting that the auditor was independent. As the audit committee member for one of the public companies, the director shared responsibility for the appointment, compensation and oversight of the company's outside auditor.

The director failed to complete and return the D&O questionnaire for the third public company, but cast a vote to include in that company's proxy statement a recommendation that the company's outside auditor be retained for the following year.

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The SEC found that the conduct described above resulted in violations of the federal securities laws by two of the public companies by impairing the outside auditors' independence and causing the companies to lack independently audited financial statements.

The SEC also found that the conduct resulted in violations by all three of the public companies of the federal proxy rules because their proxy solicitations failed to disclose that one of the directors recommending retention of the outside auditor had a business relationship with that auditor.

The director was found to have personally caused these reported violations and was ordered to cease and desist from causing future violations of the securities laws, and to pay to the SEC a disgorgement fine of US$100,662 (all of his director's compensation from the three public companies for the period in question), together with prejudgment interest of US$23,255.

This very harsh penalty imposed upon the director serves to point out the importance of carefully reviewing and thoughtfully responding to D&O questionnaires.

The SEC has also made the full text of the administrative proceeding available.

Director and Officer Questionnaires Should Now Be Updated

Recently enacted Nasdaq and NYSE modifications to the director independence tests also mandate that companies update and evaluate their D&O questionnaires.

Before these changes, the Nasdaq rules stated that the director of a listed company who accepted, or had a family member who accepted, compensation for the company in excess of US$100,000 during any 12-month period within the preceding three years could not be deemed to be independent (subject to certain exceptions). In August 2008 the SEC approved the amendment to increase the dollar threshold amount to US$120,000.

Similarly, in August 2008, the NYSE filed rule changes (which did not require SEC approval) to amend two of its director independence tests. First, the NYSE increased, from US$100,000 to US$120,000, the amount of director compensation (subject to certain exclusions) that a director or member of a director's immediate family may receive from a listed company in a 12-month period within the prior three years and still be considered independent.

Second, the NYSE amended its auditor affiliation tests to provide that a director may still be considered independent if a member of the director's immediate family currently works for the company's auditor, so long as the family member is not a partner within the auditing firm and does not work personally on the company's

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audit (and has not been such a person within the three preceding years).

CONCLUSION

As companies prepare their D&O questionnaires to incorporate these recent rule changes, they should also consider the SEC's enforcement action and make sure that their questionnaires fully capture all business relationships, and are clear, concise and readily completed. It may also be wise to take steps to sensitize directors to the importance of accurately completing these questionnaires.

For further information on this SEC administrative proceeding and other legal issues related to D&O questionnaires, please contact your principal Squire Sanders lawyer or one of the individuals listed in this Alert.
