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## Nasdaq Amends Proposed Rules on Corporate Governance

In October 2003, The Nasdaq Stock Market, Inc. (“Nasdaq”) submitted to the Securities and Exchange Commission (the “SEC”) amended corporate governance rule proposals applicable to Nasdaq-listed companies.<sup>1</sup> The amended rule proposals reflect modifications from previous proposals in response to comments from the public and the SEC Staff and to conform to the requirements of the Sarbanes-Oxley Act of 2002 (the “Sarbanes-Oxley Act”) and SEC rulemaking thereunder.

### Effective Dates/Transition Periods

Under the amended rule proposals, Nasdaq-listed companies will have until the earlier of their first annual shareholders’ meeting after January 15, 2004, or October 31, 2004, to comply with the rules regarding board independence and independent committees.<sup>2</sup> The rules do not expressly address whether the new proxy statement disclosure requirements regarding director independence will apply to the 2004 proxy statement (which is filed with the SEC and mailed to shareholders prior to the annual meeting). Accordingly, absent specific guidance from Nasdaq, companies will need to consider, in the spirit of the rules and good corporate governance practices, whether to include such disclosures. The rules relating to codes of conduct are effective six months after SEC approval of the proposed rules. The rules relating to audit committee review and approval of related party transactions become effective on January 15, 2004.

With the exception of the audit committee, if timely compliance with the rules would require a company with a staggered board to replace a director not scheduled to stand for election until a later date, the rules provide that the director may continue in office until the second annual meeting after January 15, 2003, but no later than December 31, 2005.

Foreign private issuers will have until July 31, 2005 to come into compliance with Nasdaq’s corporate governance standards. Foreign private issuers may apply for exemptions from the standards, other than the standards relating to audit committees mandated by the Sarbanes-Oxley Act, in which case disclosure of any such exemptions must be included in filings made on or after January 1, 2004.

### Executive Summary

The rules, if approved in their present form, will:

- Require listed companies to have a majority of independent directors, tighten the standards for qualifying as an “independent” director and require regularly scheduled meetings of the independent directors;

<sup>1</sup> The Nasdaq proposed rules are available at [www.nasdaq.com/about/ProposedRuleChanges.stm](http://www.nasdaq.com/about/ProposedRuleChanges.stm).

<sup>2</sup> Small business issuers will have until July 31, 2005 to come into compliance with these rules.

- Require that compensation of executive officers (including the CEO) of listed companies be determined, or recommended to the board for determination, either by a majority of independent directors or a compensation committee comprised solely of independent directors;
- Require director nominees of listed companies to be selected, or recommended to the board for selection, either by a majority of independent directors or a nominations committee comprised solely of independent directors, and require listed companies to adopt a charter or board resolution addressing the nominations process;
- Impose more stringent standards of independence for audit committee members and require audit committees to assume increased authority and responsibilities;
- Require the audit committee or another independent body of the board of directors of listed companies to review and approve all related party transactions;
- Require each listed company to adopt and disclose a code of conduct applicable to all directors, officers and employees;
- Require written notification to Nasdaq upon any material non-compliance with these corporate governance listing standards; and
- Require foreign private issuers to disclose any exemptions to Nasdaq's corporate governance requirements at the time of their first U.S. listing and annually thereafter, as well as any alternative measures taken in lieu of the waived requirements.

### **Applicability of the Rules**

The rules apply to all companies listing securities on the Nasdaq National Market and the Nasdaq SmallCap Market, other than limited partnerships. Limited exemptions exist for controlled companies<sup>3</sup>, management investment companies registered under the Investment Company Act of 1940, asset backed issuers, passive issuers organized as trusts or other unincorporated associations and cooperatives that do not have a publicly traded class of common stock. Foreign private issuers may obtain exemptions from the rules, other than the standards relating to audit committees mandated by the Sarbanes-Oxley Act, where the rules conflict with applicable law or generally accepted business practices of the foreign private issuer's home country.

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<sup>3</sup> A "controlled company" is a company of which more than 50% of the voting power is held by an individual, a group or another company. In order for a group to exist for purposes of this rule, the shareholders must have publicly filed a notice that they are acting as a group (e.g. a Schedule 13D). Controlled companies are exempt from the requirement to have a majority of independent directors, and are exempt from the requirements relating to the compensation of officers and the nominations of directors. A controlled company taking advantage of any of these exemptions must disclose the basis for the determination that it is a controlled company in its annual proxy statement.

## Summary of the Rules

### BOARD INDEPENDENCE

The rules require that a majority of the directors of a listed company be independent. An independent director means a person, other than an officer or employee of the company or any of its subsidiaries or any other individual having a relationship, which, in the opinion of the company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director. Nasdaq has clarified that a director's ownership of listed company stock, by itself, does not preclude a board determination of independence.

In addition to the foregoing, the rules mandate that certain relationships preclude a finding of independence. Specifically, the following persons are not independent:

- A director who is, or at any time during the past three years was, employed by the company or by any parent or subsidiary<sup>4</sup> of the company;
- A director who accepted, or who has a family member<sup>5</sup> who accepted, any payments from the company or any parent or subsidiary of the company in excess of \$60,000 during the current or any of the past three fiscal years, other than the following:
  - > 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) of the Securities Exchange Act of 1934, as amended (the "Exchange Act");
- A director who is a family member of an individual who is, or at any time during the past three years was, employed by the company or by any parent or subsidiary of the company as an executive officer;
- 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

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<sup>4</sup> The Nasdaq commentary states that references to "parent or subsidiary" are intended to cover entities the company controls and consolidates with the company's financial statements as filed with the SEC (but not if the company reflects such entity solely as an investment in its financial statements).

<sup>5</sup> The rules define "family member" as a person's spouse, parents, children and siblings, whether by blood, marriage or adoption, or anyone residing in such person's home. This was modified from an earlier proposal that defined "family member" as any person who is a relative by blood, marriage or adoption or anyone residing in such person's home.

made, or from which the company received, payments for property or services<sup>6</sup> in the current or any of the past three fiscal years that exceed 5% of the recipient's consolidated gross revenues for that year, or \$200,000, whichever is more, other than the following:

- > payments arising solely from investments in the company's securities; or
- > payments under non-discretionary charitable contribution matching programs;
- A director of the listed company who is, or has a family member who is, employed as an executive officer of another entity where at any time during the past three years any of the executive officers of the listed company serve on the compensation committee of such other entity; and
- A director who is, or has a family member who is, a current partner of the company's outside auditor, or was a partner or employee of the company's outside auditor who worked on the company's audit at any time during any of the past three years.

As described below, members of the audit committee will be required to satisfy additional independence criteria.

The rules require a listed company to disclose in its annual proxy statement<sup>7</sup> those directors that the board of directors has determined to be independent. If a company fails to comply with the requirement to have a majority of independent directors due to one vacancy, or if one director ceases to be independent as a result of circumstances beyond their reasonable control, the company must regain compliance by the earlier of its next annual shareholders' meeting or one year from the occurrence of the event that caused the non-compliance. A company relying on such cure period is required to provide notice to Nasdaq immediately upon learning of the circumstance that caused the non-compliance.

#### **MEETINGS OF INDEPENDENT DIRECTORS**

Under the rules, the independent directors of a listed company must meet at regularly scheduled meetings at which only independent directors are present. In an effort to encourage and enhance communications among independent directors, the commentary contemplates that these "executive sessions" will occur at least twice a year in conjunction with regularly scheduled board meetings.

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6 Notwithstanding the reference to making or receiving payments for "property or services," the commentary states that this paragraph applies to a director who is, or who has a family member who is, an executive officer of a charitable organization. In addition to the express standard set forth above, Nasdaq states that it encourages companies to consider other situations where a director or his or her family member and the company each have a relationship with the same charity when assessing director independence.

7 If a listed company does not file proxy statements, any disclosure required by the Nasdaq rules to be made in a proxy statement must be made in the company's annual report on Form 10-K or 20-F, as applicable.

## COMPENSATION OF OFFICERS

The rules require that CEO compensation and the compensation of all other executive officers of listed companies be determined, or recommended to the board of directors for determination, either by: (i) a majority of the independent directors or (ii) a compensation committee comprised solely of independent directors. Under the rules, the CEO may not be present during voting or deliberations relating to his or her compensation.

If a listed company's compensation committee is comprised of at least three members, the rules specifically allow one director who is not independent and is not a current officer or employee or a family member of an officer or employee, to be appointed to the compensation committee if the board, under "exceptional and limited circumstances," determines that such membership is required by the best interests of the company and its shareholders. The board must disclose such determination, the nature of the relationship and the reasons for such determination in the company's next annual proxy statement. A member appointed pursuant to this exception may not serve longer than two years.

## NOMINATION OF DIRECTORS

The rules provide that director nominees of listed companies must either be selected, or recommended to the board of directors for selection, either by: (i) a majority of the independent directors or (ii) a nominations committee comprised solely of independent directors.<sup>8</sup> The rules also require each company to 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 federal securities laws. In preparing such a charter or board resolution, companies may wish to give appropriate consideration to the rules recently proposed by the SEC relating to enhanced disclosure regarding the nominating process.

If a listed company's nominations committee is comprised of at least three members, the rules specifically allow one director who is not independent and is not a current officer or employee or a family member of an officer or employee, to be appointed to the nominations committee if the board, under "exceptional and limited circumstances," determines that such membership is required by the best interests of the company and its shareholders. The board must disclose such determination, the nature of the relationship and the reasons for such determination in the company's next annual proxy statement. A member appointed pursuant to this exception may not serve longer than two years.

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<sup>8</sup> The director nomination rules are not applicable to a company if the company is subject to a binding obligation that requires a director nomination structure inconsistent with the rules and that pre-dates approval of the final rules. The rules also provide that independent director oversight of director nominations shall not apply where the right to nominate a director legally belongs to a third party; however, this does not relieve a company's obligation to comply with the committee composition requirements.

**AUDIT COMMITTEE COMPOSITION**

The rules require each company to have, and to certify that it has and will continue to have, an audit committee comprised of at least three members. Each such member must:

- Meet the requirements of an independent director outlined above;
- Meet the independence criteria set forth in Exchange Act Rule 10A-3(b)(1) (subject to the applicable exemptions), which provide that an audit committee member cannot: (i) accept directly or indirectly any consulting, advisory or other compensatory fee from the company other than fees for board and committee service or (ii) be an “affiliated person” of the company;
- 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
- Be able to read and understand fundamental financial statements, including a company’s balance sheet, income statement and cash flow statement.

Notwithstanding the requirement that each member must meet the independent director criteria applicable to directors generally, the rules provide that one director who is not independent under those criteria, but is independent under Rule 10A-3(b)(1), and is not a current officer or employee or a family member of a current officer or employee, may be appointed to the audit committee if the board, under “exceptional and limited circumstances,” determines that such membership is required by the best interests of the company and its shareholders. The board must disclose such determination, the nature of the relationship and the reasons for such determination in the proxy statement for the next annual meeting. A member appointed pursuant to this exception may not serve longer than two years and may not chair the audit committee.

In the event that a listed company fails to comply with the foregoing requirements because an audit committee member ceases to be independent for reasons outside the member’s reasonable control or due to a vacancy on the audit committee, the rules provide for a cure period until the earlier of the company’s next annual shareholders’ meeting or one year from the occurrence of the event that caused the non-compliance. A company relying on such cure period shall provide notice to Nasdaq immediately upon learning of the circumstance that caused the non-compliance.

As is the case under the current rules, each company is required to certify that it has, and will continue to have, at least one member of the audit committee who has past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual’s financial sophistication, including being or having been a CEO, CFO or other senior officer with financial oversight responsibilities.<sup>9</sup>

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<sup>9</sup> Although Nasdaq does not require an audit committee to have a member who qualifies as an “audit committee financial expert,” a person qualifying as such (as defined in Section 401(h) of Regulation S-K), is presumed to have the requisite financial sophistication.

**AUDIT COMMITTEE RESPONSIBILITIES**

The rules continue the existing requirements that each listed company certify that it has adopted a formal written audit committee charter and that the audit committee has reviewed and reassessed the adequacy of the charter on an annual basis. The rules also continue to require that the audit committee charter specify:

- The scope of the audit committee’s responsibilities and how it carries out those responsibilities, including structure, process and membership requirements; and
- The audit committee’s responsibility for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the company, and the audit committee’s responsibility for actively engaging in a dialogue with the auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the auditor and for taking appropriate action to oversee the independence of the outside auditor.

In addition, the proposed rules require the audit committee charter to specify the committee’s purpose of overseeing the accounting and financial reporting processes of the company and the audits of the financial statements of the company, and to include the specific audit committee responsibilities and authority mandated by Rule 10A-3 (“Rule 10A-3”) under the Exchange Act, which implements the audit committee minimum standards set forth in Section 301 of the Sarbanes-Oxley Act. Rule 10A-3 prohibits Nasdaq from listing any security of a company that does not have an audit committee comprised of independent directors and that is not in compliance with the following standards:<sup>10</sup>

- The audit committee must be directly responsible for the appointment, compensation, retention and oversight of the work of any independent auditor (including resolution of disagreements between management and the auditor regarding financial reporting) engaged for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the company, and the independent auditor must report directly to the audit committee;
- The audit committee must establish procedures for the receipt, retention and treatment of complaints received by the company regarding accounting, internal accounting controls or auditing matters, including procedures for the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters;
- The audit committee must have the authority to engage outside advisors, including independent counsel, as it determines necessary to carry out its duties; and

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<sup>10</sup> A more detailed description of Rule 10A-3 can be found in our mailing on the subject, available at [www.skadden.com](http://www.skadden.com).



- The company must provide appropriate funding, as determined by the audit committee, for payment of: (i) compensation to any independent auditor engaged for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the company, (ii) compensation to any independent advisors employed by the audit committee, and (iii) ordinary administrative expenses of the audit committee.

#### **RELATED PARTY TRANSACTIONS**

The rules require that a listed company's audit committee or other independent body of the board of directors review and approve all related party transactions for potential conflict of interest situations. For purposes of this rule, "related party transactions" mean transactions required to be disclosed pursuant to Item 404 of Regulation S-K.

#### **CODE OF CONDUCT**

The rules require each listed company to adopt a code of conduct applicable to all directors, officers and employees, which must be publicly available. The code of conduct must comply with the "code of ethics" definition set forth in Item 406 of Regulation S-K (describing codes of ethics applicable to CEOs and senior financial officers), which include such standards as are reasonably necessary to promote the ethical handling of conflicts of interest, full and fair disclosure, and compliance with laws, rules and regulations. The rules also require the code of conduct to include an enforcement mechanism that ensures prompt and consistent enforcement of the code, protection for persons reporting questionable behavior, clear and objective standards for compliance, and a fair process by which to determine violations. Any waivers of the code of conduct for directors or executive officers must be approved by the board of directors and disclosed, together with the reasons for such waiver, in a Current Report on Form 8-K within five days.

#### **NOTIFICATION OF NON-COMPLIANCE**

The rules require listed companies to promptly notify Nasdaq after an executive officer of the listed company becomes aware of any material non-compliance with any applicable provisions of these corporate governance rules.

#### **FOREIGN PRIVATE ISSUERS**

The rules provide that foreign private issuers listed on Nasdaq may obtain exemptions from Nasdaq's corporate governance standards upon a showing that the rules are contrary to a law, rule or regulation of any public authority exercising jurisdiction over the foreign private issuer or contrary to generally accepted business practices in the issuer's home country, except to the extent such exemptions would violate federal securities laws. The rules require foreign private issuers to disclose the receipt of any corporate governance exemption in their registration at the time of the company's original listing in the U.S., if that listing is on Nasdaq, and in their annual reports filed with the SEC. This disclosure must also include any alternative measures the company has taken in lieu of the waived corporate governance requirements.