Paul|Weiss

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SEC Approves NASDAQ Corporate Governance Rules

The SEC has approved the proposed board and committee independence rule changes of The Nasdaq Stock Market, Inc. submitted to the SEC through October 9, 2003. The full-text revisions of the Nasdaq rules are not yet available, but we have summarized the final proposals below.

General Application

The new corporate governance rules apply to all companies listing equity or debt securities on Nasdaq.

"Controlled" companies are exempt from the requirements to have a board with a majority of independent members and the requirements regarding compensation and nominating committees.

- A controlled company is a company of which more than 50% of the voting power is held by an individual, group or another company. For purposes of this provision, Nasdaq interprets a "group" as "shareholders that have publicly filed a notice that they are acting as a group (e.g., a Schedule 13D)."

- A controlled company relying upon the exemption must disclose in its annual meeting proxy that it is a controlled company and the basis for that determination.

- Controlled companies remain subject to the audit committee requirements and to the requirement that independent directors meet in executive session.

Foreign private issuers continue to be exempt from corporate governance standards that would require them to do anything contrary to the laws, rules, regulations or generally accepted business practices of their home country. However, Nasdaq does not have the authority to grant exemptions to the extent such exemptions would be "contrary to the federal securities laws" and no exemption affects an issuer's obligations to comply with applicable law and regulations (including those of the SEC). This means that foreign private issuers must comply with the audit committee independence provisions of Rule 10A-3 under the Securities Exchange Act of 1934 ("Rule 10A-3"). We note that the exemption has been narrowed and is unavailable to foreign issuers that are not, or cease to be, foreign private issuers.

Non-U.S. issuers are required to disclose in their annual reports (i.e., a Form 20-F or 40-F) filed after January 1, 2004 each requirement from which they are exempted as well as any alternative practices in lieu of the waived requirements. The disclosure is required each year. In

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addition, newly listed companies are required to include such disclosure in their initial registration statements (e.g., on Form F-1, 20-F or 40-F).

Effective Dates

- Companies are to comply with the new requirements by the earlier of (i) the company's first annual meeting occurring after January 15, 2004 and (ii) October 31, 2004.
- Companies with staggered boards have an additional year (but not later than December 31, 2005) to comply with the non-audit committee requirements.
- All other independence-related corporate governance requirements (e.g., codes of conduct, executive sessions and audit committee charters) will be effective May 4, 2004 (the six-month anniversary of SEC approval).
- Newly listed companies have two years to comply with the board composition requirements and have the balance, if any, of the six-month grace period through May 4, 2004 to comply with all other requirements.
- Foreign private issuers have until July 31, 2005 to comply with applicable audit committee requirements.

I. Board Matters

Board Composition

A majority of the board of directors must be independent. In addition, independent directors must meet in regularly scheduled executive sessions (this differs from the NYSE rules, which call for meetings of "non-management" directors). Nasdaq contemplates that executive sessions would occur at least twice a year, and perhaps more frequently in conjunction with regularly scheduled board meetings.

Definition of "Independence"

The Nasdaq rules define an independent director as a person other than an officer or employee of a company or its subsidiaries or a person who, in the opinion of the board of directors, has a relationship that would interfere with the exercise of independent judgment in carrying out the responsibilities of a director. The rules then set forth various *per se* bars to independence. Nasdaq, in contrast to the NYSE, which requires an affirmative finding of independence, retains the presumption of independence, subject to the *per se* bars. Additional requirements apply to directors serving on audit committees.

The following *per se* rules preclude a finding of independence:

- **A director 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.** The intention is to only pick up entities the issuer controls and consolidates on the issuer's financial statements.

- **A director who accepted or has an immediate family member who accepted, any payments from the company or any parent or subsidiary of the company in excess of $60,000 during the current fiscal year or any of the past three fiscal years, other than:**

  - compensation for board or board committee service;

  - payments arising solely from investments in the company's securities;

  - compensation paid to an immediate family member who is a non-executive employee of the company or a parent or subsidiary of the company;

  - benefits under tax-qualified retirement plans or non-discretionary compensation; or

  - loans permitted under Section 13(k) of the Securities Exchange Act of 1934.

- **A director whose immediate family member is, or at any time during the past three years was, employed as an executive officer of the company or any parent or subsidiary of the company.**

- **A director who is, or has an immediate family member who is, a partner in, 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 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, which ever 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 who is, or has an immediate family member who is, a current partner of the outside auditors, or was a partner or employee of the outside auditors who worked on the company's audit within the past three years.**

- **A director of the listed company who is, or has an immediate 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 served on the compensation committee of the other entity.**

Role of Independent Directors in Compensation Decisions

The Nasdaq rules require independent director approval of CEO compensation, either by an independent compensation committee or by a majority of the independent directors. The CEO may be present during such deliberations but not during voting. The compensation of other executive officers requires independent director approval, either by a majority of the independent directors or by an independent compensation committee.

A single non-independent director (other than a current officer, employee or family member) is permitted to serve on the independent compensation committee under the "exceptional and limited circumstances" provision, but only for a two-year term, provided the committee has at least three members.

Under the exceptional and limited circumstances provision, the board must determine that the individual's membership on the committee is in the best interest of the company and its shareholders and must disclose in the next annual proxy statement after such determination the nature of the relationship and the reasons for the determination.

Role of Independent Directors in Nominating Decisions

Nominations of directors require independent director approval, either by an independent nominating committee or by a majority of the independent directors. A single non-independent director (other than an officer, employee or family member) is permitted on the independent committee pursuant to the "exceptional and limited circumstances" provision for a term limited to two years, provided the committee has at least three members. Issuers whose nominating committees are constituted pursuant to a pre-existing agreement that is inconsistent with the new rule are not required to comply with the new independence requirements until such agreement expires.

Independent director approval is not required for nominations that are subject to contractual obligations (under shareholders agreements, for example).

II. Audit Committees

Independence Standards

Audit committees are required to have a minimum of three members. Each member must satisfy Nasdaq's independence standards as well as the independence standards of Rule 10A-3 (i.e. no consulting, advisory, or other compensatory fee from the company other than for board service and they must not be an affiliate of the company). In addition, audit committee members must 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.

For purposes of determining whether a person is an affiliate solely by virtue of stock ownership, an audit committee member will not be considered an affiliated person of the issuer if such member owns or controls, directly or indirectly, not more than 10% of the company's voting stock in keeping with the threshold set forth under Rule 10A-3.

Each audit committee member must be able to read and understand financial statements at the time of their appointment. This differs from the NYSE rule, which allows audit committee members a "reasonable time" to comply with the financial literacy requirements.

A director who fails the general independence test is permitted to serve on the audit committee pursuant to "exceptional and limited circumstances" for a maximum of two years, but is prohibited from serving as the committee's chair. However, this exception is limited as the non-independent director (i) may not be a current officer, employee or family member and (ii) must meet the independence requirements of Rule 10A-3.

As above, under the exceptional and limited circumstances provision, the board must determine that the individual's membership on the audit committee is in the best interest of the company and its shareholders and must disclose in the next annual proxy statement after such determination the nature of the relationship and the reasons for the determination.

At least one audit committee member must have 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 chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.

The Nasdaq rules provide for a cure period of the earlier of the next annual meeting or one year in the event that an issuer is non-compliant with the composition requirements because an audit committee member has ceased to be independent for reasons outside such members reasonable control. Nasdaq must be promptly notified of the event or circumstance causing non-compliance. The Nasdaq rules also provide for a cure period of the earlier of the next annual meeting or one year in the event that an issuer is non-compliant with the composition requirements because of a vacancy, so long as no other member is non-compliant at the time because they have ceased to be independent.

Authority and Responsibility

The power to hire and fire a company's outside auditors must rest solely with the audit committee. In addition, the approval of the audit committee is required in advance of the provision by the auditor of any audit services and any permitted non-audit services. Audit committees also must have the authority to arrange for funding and consult with and retain legal, accounting and other experts and the responsibility to establish procedures for the treatment of accounting and audit complaints.

III. Other Corporate Governance Requirements

Codes of Conduct

All companies must have a code of conduct applicable to all directors, officers and employees which must be publicly available. The code of conduct must include those elements necessary to meet the "code of ethics" requirements, as defined by the SEC pursuant to the Sarbanes-Oxley Act. The code of conduct required by Nasdaq has a broader application than the SEC code of ethics as it applies to all officers, directors and employees of any issuer and not just the senior financial officers. Waivers of the code of conduct for directors and executive officers may only be granted by the board or a board committee and must be promptly disclosed.

Related Party Transactions

The audit committee or comparable body of the board of directors must review and approve related party transactions.

Requirement to Disclose Audit Opinions with Going Concern Qualifications

Issuers must disclose in a press release the receipt of an audit opinion with a going concern qualification. Ordinarily, if an auditor concludes that substantial doubt exists about the entity's ability to continue as a going concern for a reasonable period of time, the auditor provides this conclusion through an explanatory paragraph in the auditor's opinion. While the audit opinion is available in the Form 10-K (or Form 20-F or 40-F, if applicable), the new rule requires that the going concern qualification be brought to the attention of investors and potential investors through a press release issued within seven calendar days after the filing of the audit opinion in a public filing with the SEC.

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Any questions concerning the foregoing should be addressed to any of the following. This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. In addition, memoranda on related topics may be accessed under Securities Group publications on our web site (www.paulweiss.com).

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