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NASDAQ Reissues Corporate Governance Proposals With Modifications

In October 2003, The Nasdaq Stock Market, Inc. released a draft of its proposed board and committee independence rule changes. The proposed rule changes are designed to increase accountability and transparency for the benefit of investors and facilitate uniform application of the rules. These proposals contain modifications of the proposals released on July 25, 2002, September 13, 2002, October 1, 2002, October 10, 2002, November 20, 2002 and February 26, 2003. The proposals include cross-references to the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act"), and in many cases the most recent changes are designed to harmonize Nasdaq rules with Sarbanes-Oxley Act requirements.

The proposed changes are subject to a public comment period before approval by the SEC and implementation by Nasdaq. It is unclear when the Nasdaq proposals and the NYSE proposals will be issued for public comment, and whether the SEC will address all of the proposals at once or issue them one at a time or in groups.

As described in greater detail below, these proposals would, among other things:

- narrow the definition of an independent director;
- require a majority of independent directors on corporate boards;
- require independent director approval of director nominations and executive officer compensation;
- expand the scope of audit committee authority and tighten the qualification requirements for audit committee members; and
- narrow the definition of family members to immediate family members and apply all of the *per se* bars to a finding of independence if an immediate family member would be covered thereby.

Nasdaq has proposed that any rule changes requiring a company to modify the composition of its board of directors or its board committees be effective as of the company's first annual meeting occurring after January 15, 2004, but not later than October 31, 2004 (issuers with staggered boards have an additional year to comply with the non-audit committee requirements). All other

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independence-related corporate governance requirements (e.g., codes of conduct, executive sessions and audit committee charters) are proposed to be effective six months after SEC approval. Newly listed companies would have two years to comply with the board composition requirements and would have the balance, if any, of the six-month grace period following SEC approval for compliance with all other requirements.

Other proposals would:

- require corporate codes of conduct (effective six months after SEC approval); and
- require non-U.S. companies to disclose any exemptions to Nasdaq's corporate governance standards (effective for new listings and filings of annual reports made on or after January 1, 2004).

I. Board Independence

Definition of "Independence"

The Nasdaq rules currently 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 rule then sets forth various *per se* bars. Nasdaq, in contrast to the NYSE, which requires an affirmative finding of independence, would retain the presumption of independence, subject to the *per se* bars. Additional requirements apply to directors serving on audit committees.

The following *per se* rules would 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.** This bar had been expanded to cover all affiliates, but in a recognition that "affiliates" would pick up a number of venture capital and private equity firms, Nasdaq narrowed the coverage to parents and subsidiaries. The intention is to only pick up entities the issuer controls and consolidates on the issuer's financial statements. The existing one-year period was expanded to three.
- **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.

Nasdaq proposes to extend the current prohibition on the receipt of \$60,000 in “*compensation*” to include “*any payments*” (which would include political contributions) in excess of \$60,000 and to extend this prohibition to the receipt of such payments by a non-employee family member of a director. In addition, Nasdaq proposes to clarify that these rules apply to payments made in the current fiscal year or any of the past three fiscal years. The initial version of this provision referred to payments from the company or any of its affiliates, but as this would have precluded employees of venture capital firms who receive more than \$60,000 from the firm, Nasdaq has replaced the term affiliates with parent and subsidiaries.

- **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 of 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.

Nasdaq proposes to expand the rule to cover not-for-profit companies by deleting the phrase “for-profit business” from the existing rule.

- **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.**

The proposals would require a majority of the board of directors to be independent and would require independent directors (in contrast to the NYSE proposal, which calls for meetings of “non-management” directors) to meet in regularly scheduled executive sessions. Nasdaq contemplates that executive sessions would occur at least twice a year, and perhaps more frequently in conjunction with regularly scheduled board meetings.

Role of Independent Directors in Compensation Decisions

The Nasdaq proposals seek to strengthen the role played by independent directors in decisions relating to the compensation of executive officers. Nasdaq proposes to require independent director approval of CEO compensation, either by an independent compensation committee voting in executive session or by a majority of the independent directors voting in executive session. The compensation of other executive officers would require independent director approval, either by a majority of the independent directors voting in executive session or by an independent compensation committee voting in executive session. The CEO may be present during such deliberations but not during voting.

A single non-independent director (other than a current officer, employee or family member) would be 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 would require independent director approval, either by an independent nominating committee voting in executive session or by a majority of the independent directors voting in executive session. A single non-independent director (other than an officer, employee or family member) would be 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 would not be required to comply with the new independence requirements until such agreement expires.

Nasdaq recognizes independent director approval should not be required for nominations that are subject to contractual obligations (under shareholders agreements, for example).

Controlled Company Exemption

“Controlled” companies are exempt from the requirements to have a board with a majority of independent members, executive sessions of the independent directors, and 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. 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. Such companies remain subject to the audit committee requirements discussed below and to the requirement that independent directors meet in executive session.

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).”

II. Audit Committees

Independence Standards

The proposals require audit committees to have a minimum of three members and be comprised only of independent directors. In addition to satisfying the Nasdaq requirements for independence, audit committee members must satisfy the heightened independence standards of the Sarbanes-Oxley Act (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) and 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 Section 301 of the Sarbanes-Oxley Act.

The Nasdaq proposals would restrict membership on an audit committee to those individuals able to read and understand financial statements at the time of their appointment, rather than those capable of doing so "within a reasonable time thereafter" as is currently the rule.

A director who fails the general independence test would be permitted to serve on the audit committee pursuant to "exceptional and limited circumstances" for a maximum of two years, but would be 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 Section 301 of the Sarbanes-Oxley Act. 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. This is a departure from the previous Nasdaq proposal that would have required that each audit committee have a "financial expert," as such term was defined by proposed rules under the Sarbanes-Oxley Act.

The Nasdaq proposals 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

Nasdaq proposes to harmonize its rules relating to the audit committees with the requirements of the Sarbanes-Oxley Act. Under the new proposals, the power to hire and fire a company's outside auditors would rest solely with the audit committee. In addition, the approval of the audit committee would be required in advance of the provision by the auditor of any audit services and any permitted non-audit services. Audit committees would also 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 Proposals

Transparency With Respect to Foreign Private Issuers

Exemptions would continue to be available to a foreign private issuer if Nasdaq's rules would require the issuer to do anything contrary to the laws, rules, regulations or generally accepted business practices of the home country. The proposed rules would add a proviso that such waivers may not provide exemptions that would be "contrary to the federal securities laws." Nasdaq stated that this proviso is intended to clarify that no exemption will affect an issuer's obligations to comply with applicable law and regulations (i.e., of the SEC).

The proposals would require non-U.S. issuers 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 would be required each year. In addition, newly listed companies would have to include such disclosure in their initial registration statements (e.g., on Form F-1 or 20-F). Nasdaq believes that this disclosure requirement will encourage companies to consider which exemptions they really need, as opposed to applying for them as a matter of course.

Note that this exemption has been narrowed such that it would be unavailable to foreign issuers that are not, or cease to be, foreign private issuers.

Codes of Conduct

Nasdaq proposes to require all companies to 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 proposed by NASDAQ will have a broader application than the SEC code of ethics as it will apply 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

Nasdaq's conflict of interest rule currently provides that an issuer must conduct an appropriate review of all related party transactions on an ongoing basis and utilize its audit committee or comparable body of the board of directors for the review of potential conflicts of interest. Nasdaq is

proposing to expand this rule by requiring the audit committee or comparable body of the board of directors to *approve*, rather than merely *review*, related party transactions.

Explicit Prohibition on Misrepresenting Information to Nasdaq

Nasdaq proposed, and the SEC has approved, a clarification that an issuer can be delisted for misrepresenting material information to Nasdaq. In the past, Nasdaq rules did not explicitly state that an issuer that makes a material misrepresentation to Nasdaq, omits necessary material information in a communication with Nasdaq, or otherwise fails to provide requested material information, may be delisted.

Requirement to Disclose Audit Opinions with Going Concern Qualifications

Current Nasdaq proposals would require issuers to 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, the proposed rule change would require 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 Form 10-K.

Clarifications

The proposals clarify that Nasdaq will presume that a change of control of an issuer will occur, for purposes of the shareholder approval rules, once an investor acquires 20% of an issuer's outstanding voting power, unless a larger ownership and/or voting position is held on a post-transaction basis by: (1) a shareholder, or an identified group of shareholders, unaffiliated with the investor, or (2) the issuer's directors and officers that are unaffiliated with the investor.

The authority of Nasdaq to deny re-listing to an issuer based upon a corporate governance violation that occurred while that issuer's appeal of the delisting was pending is also clarified.

IV. Proposals Under Consideration

Nasdaq previously announced that it would propose certain other rules. At the present time those rules remain under consideration, but rule filings relating to those proposals have not been filed. These proposals would:

- prohibit loans to officers and directors through the adoption of a Nasdaq rule that mirrors Section 402 of the Sarbanes-Oxley Act;
- require continuing education for all directors; and
- require accelerated disclosure of insider transactions that would harmonize with, and reinforce, the provisions of the Sarbanes-Oxley Act and the SEC rules thereunder.

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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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