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Nasdaq Reissues Corporate Governance Proposals with Modifications

On October 10, 2002, The Nasdaq Stock Market Inc. released a summary of its corporate governance proposals to date. 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 and October 1, 2002. 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; and
- expand the scope of audit committee authority and tighten the qualification requirements for audit committee members.

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 1, 2004. All other independence-related corporate governance requirements (e.g., executive sessions and audit committee charters) are proposed to be implemented 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 shareholder approval of all stock option plans and any material modification of such plans (effective upon SEC approval; existing plans would be grandfathered, so long as they are not materially amended);

- require corporate codes of conduct (effective as of the first annual meeting held on or after January 1, 2004); 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. Shareholder Approval of Stock Options Plans

Nasdaq rules generally require shareholder approval for all stock option or purchase plans in which officers or directors participate. However, the current rules contain an exception for broadly based plans (i.e., plans in which at least a majority of the participants are not officers or directors). The proposed rule changes would eliminate this exception for broadly based plans and, accordingly, would require shareholder approval for all plans in which officers, directors, employees or consultants participate and for any material modification of such plans.

The proposal would eliminate the so-called "treasury share" exception that permits a company to use certain repurchased shares to fund options to executive officers without prior shareholder approval as well as the de minimis exception, which allows for the grant of the lesser of 1% of the number of shares of common stock or 25,000 shares without shareholder approval.

The proposals include an exception for inducement grants to new employees or directors of the issuer (previously the exception was only for new employees), provided that such inducement grants be subject to approval by either (i) the issuer's compensation committee or (ii) a majority of the issuer's independent directors. The language has been changed to apply to "material" inducements instead of "essential" inducements. Inducement grants include grants of options or stock to new employees in connection with a merger or acquisition.

The exceptions for tax qualified, non-discriminatory plans, such as Employee Stock Ownership Plans, would be retained; however, it is proposed that such plans would have to be approved by (i) the issuer's compensation committee or (ii) a majority of the issuer's independent directors. The exemption for warrants or rights issued generally to security holders of the issuer would be retained.

Pre-existing option plans assumed in connection with an acquisition or merger transaction would not require shareholder approval in two situations. First, approval would not be required to convert, replace or adjust outstanding options or other equity compensation awards to reflect the transaction. Second, shares available under acquired plans may be used for post-transaction grants without shareholder approval, so long as (i) the time during which the shares are available for grants is not extended beyond the initial term and (ii) options or awards are not granted to persons employed by the granting company at the time the transaction was consummated. Plans adopted in contemplation of a transaction would not be deemed "pre-existing."

Nasdaq will continue to provide guidance as to what amendments are material and therefore subject to shareholder approval. Nasdaq currently is guided by SEC interpretations of former Rule 16b-3, and is considering whether to refine its standards.

II. 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.

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

- **A director employed by the company or by any parent or subsidiary within the past three years.** 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 (i.e., entities consolidated on the issuer's financial statements). The existing one-year period was expanded to three.

- **A director who accepts or has a non-employee family member who accepts any payments in excess of $60,000 during the current fiscal year or any of the past three fiscal years, other than compensation for board service, benefits under tax-qualified retirement plans or non-discretionary compensation.** 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 current version of this provision refers to payments from the company or any of its affiliates, but as this would preclude employees of venture capital firms who receive more than $60,000 from the firm, Nasdaq has indicated that the term affiliates will be replaced with parent and subsidiaries.

- **A director who is a family member of an individual who is, or has been within the past three years, employed as an executive officer of the company or any parent or subsidiary of the company.**

- **A director 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 (other than those arising solely from investments in the company's securities) that exceed 5% of the recipient's consolidated gross revenues for that year, or $200,000, which ever is more, in the current fiscal year or any of the past three fiscal years.** 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 was a partner or employee of the outside auditors, and who worked on the company's audit, within the past three years.**

- **Interlocking compensation committee members.**

For purposes of the proposals, "family member" means any person who is a relative by blood, marriage or adoption or who has the same residence.

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 meeting in executive session or by a majority of the independent directors meeting in executive session. The compensation of other executive officers would require independent director approval, either by a majority of the independent directors or by an independent compensation committee in a meeting at which the CEO may be present but may not vote.

A single non-independent director (other than an 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 term limited to two years, 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 or by a majority of the independent directors. 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.

If the nominating committee is comprised of at least three members and the board is not relying on the exceptional and limited circumstances provision, one director who owns 20% or more of the company's common stock or voting power outstanding, and is not independent because the director is also an officer, may be appointed to the nominating committee if the board determines that such individual's membership on the committee is in the best interests of the company and the nomination and reasons therefor are disclosed. We understand that the purpose of this provision is to allow a major shareholder that has a designee serving as an officer (e.g., as a CFO) to serve on the nominating committee.

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 for 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.

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)."

Director Continuing Education

The Nasdaq proposals would mandate continuing education for all directors pursuant to rules to be developed by the Nasdaq Listing and Hearing Review Council and approved by Nasdaq's board of directors.

III. 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). For purposes of determining whether a person is an affiliate solely by virtue of stock ownership, an audit committee member will be considered an affiliated person of the issuer if such member owns or controls, directly or indirectly, 20% or more of the company's voting stock, or such other lower threshold as the SEC may establish 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, (ii) must meet the independence requirements of Section 301 of the Sarbanes-Oxley Act and (iii) may not own or control 20% or more of the issuer's voting securities. 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 be considered by the board to be a "financial expert." In determining whether an audit committee member is a financial expert, the board must consider whether a person has sufficient financial expertise in the accounting and auditing areas, in accordance with the requirements of Section 407 the Sarbanes-Oxley Act. The SEC issued its proposal under Section 407 on October 16.

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 consult with and retain legal, accounting and other experts and the responsibility to establish procedures for the treatment of accounting and audit complaints.

IV. Other Proposals

Accelerated Disclosure of Insider Transactions

Nasdaq intends to accelerate its insider reporting requirements and is exploring a method to do so that complements the Sarbanes-Oxley Act.

Transparency With Respect to Non-U.S. Companies

Exemptions would continue to be available to non-U.S. companies 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) 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.

It is unclear at this point whether foreign private issuers that currently are listed on Nasdaq and have waivers from various existing corporate governance provisions will be required to request additional waivers from Nasdaq in respect of new requirements. As the waivers generally are tied to specific provisions of the listing rules, new requests may well be required.

Codes of Conduct

Nasdaq proposes to require all companies to have a code of conduct applicable to all directors, officers and employees, addressing conflicts of interest and compliance with laws, rules and

regulations, and providing for an enforcement mechanism. 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. The code of conduct must be publicly available. The corporate code of conduct proposed by Nasdaq will have a broader application than the code of ethics for senior financial officers mandated by the Sarbanes-Oxley Act, as it will apply to all officers, directors and employees of any issuer and not just the senior financial officers.

The enforcement mechanism must ensure 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.

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. Current Nasdaq rules do 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 seek to harmonize the Nasdaq rule on the disclosure of material information with SEC Regulation FD so that issuers may use Regulation FD compliant methods such as conference calls, press conferences and webcasts, so long as the public is provided adequate notice (generally by press release) and granted access.

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.

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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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