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SEC approves

New Nasdaq
Corporate Governance
Standards for
Listed Companies

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The Sarbanes-Oxley Act of 2002 made major changes in the laws governing public companies. One of the most frequently discussed provisions of Sarbanes-Oxley is an amendment to Section 10A of the Securities Exchange Act of 1934, which instructed the Securities and Exchange Commission to adopt rules directing the New York Stock Exchange and Nasdaq Stock Market, Inc. to strengthen the corporate governance rules for their listed companies.

Soon after the law was enacted, the NYSE and Nasdaq filed proposals with the SEC to change their governance standards. Those proposals went significantly beyond the matters mandated by Section 10A. Over the last year, the SEC adopted a large number of new rules under Sarbanes-Oxley, including Rule 10A-3, which mandated that the NYSE and Nasdaq adopt listing rules related to audit committees. In parallel with those actions, the SEC continued to negotiate with the NYSE and Nasdaq on the details of their corporate governance proposals. At several points, the SEC pushed the two markets to make their respective proposals more similar. Finally, on November 4, 2003, the SEC approved the rule changes proposed by the NYSE and Nasdaq.

This Client Alert discusses the new Nasdaq requirements for corporate governance standards, including the requirements that a majority of boards of directors' members be independent, requirements for listed companies audit committees and the compensation and nomination committees or processes. While the NYSE and the Nasdaq rules as finally approved are substantially similar, some differences remain.

Scope of Nasdaq Rule The new Nasdaq listing standards will apply to all companies that are listed on the Nasdaq National Market or the Nasdaq Small Cap Market.

Companies whose shares are traded on OTC Bulletin Board or the "Pink Sheets" are technically not listed companies. Accordingly, these new Nasdaq corporate governance rules do not apply to them. When the corporate governance proposals were first made, Nasdaq had already made a separate proposal to create a new Bulletin Board Exchange (the "BBX") to supercede the OTC. Companies on the BBX would have been required to meet reduced listing standards. With Nasdaq's 2003 abandonment of the BBX proposal, it is not clear whether OTC Bulletin Board and Pink Sheet companies will continue to remain outside the scope of the corporate governance standards indefinitely, or whether the SEC and/or Nasdaq will ultimately impose corporate governance regulation on these companies in some manner.

Implementation/ Timing Recognizing that companies may need to make necessary adjustments to comply with SEC Rule 10A-3 and the new Nasdaq listing requirements, the new rules provide time for implementation. The rules on director independence and independent committees must be implemented by the following dates:

- For all listed companies except foreign private issuers and small business issuers, by the earlier of (1) the listed company's first annual shareholder meeting after January 15, 2004, or (2) October 31, 2004.
- For foreign private issuers and small business issuers, by July 31, 2005.
- Companies that first complete an initial public offering after November 4, 2003 must have one independent director at the completion of the IPO, a majority of independent directors within 90 days after the completion, and fully qualified committees of independent directors (as described below) within one year after the IPO.

The rules requiring a code of conduct require adoption by May 2004, and the rules on approval of related party transactions apply to transactions after January 15, 2004.

Requirements for Majority of Independent Directors and Separate Meetings of Independent Directors

Under Nasdaq Rule 4350, a majority of the board of directors of each Nasdaq-listed company will have to be composed of directors who are “independent,” as defined by the Nasdaq rules (specifically, Rule 4200). Under the Nasdaq rules, the board has an affirmative duty to determine director independence. In addition, the Nasdaq-listed company must disclose in its annual meeting proxy statement those directors that it has determined to be independent.

Further, in order to encourage communication among independent directors, the new Nasdaq rule also requires that the independent directors have regularly scheduled meetings at which only independent directors are present (so-called “executive sessions”).

Nasdaq Rule 4350 provides an exception from the requirements that a majority of the directors be independent for a “controlled company.” A controlled company is one where more than 50% of the voting power is held by an individual, a group or another company. A company choosing to take advantage of this exemption must disclose in its annual meeting proxy statement that it is a controlled company and the basis for that determination.

The Definition of Independence

Nasdaq requires that individuals serving as independent directors not have a relationship with the listing company that “would interfere with the exercise of independent judgment.” The ownership of stock, per se, is not a bar to a finding of independence under the general definition.

The new Nasdaq rule provides that the following are **not** independent:

- Any director who is, or who has been at any time during the past three fiscal years, employed by the listed company (or its parent or subsidiary).

General Definition of Independence

- Any director who accepted, or a member of whose family accepted, any payments from the listed company (or its parent or subsidiary) in excess of \$60,000 during the current fiscal year or any of the past three fiscal years, other than (i) compensation for board or committee service; (ii) payments arising solely from investments in the company’s securities; (iii) compensation paid to a family member who is a non-executive employee of the company (or its parent or subsidiary); (iv) certain benefits plans or other non-discretionary compensation, or (v) loans still permitted by Sarbanes-Oxley (principally loans by companies in lending or credit businesses made to a director in the ordinary course of business on terms comparable to those extended to unaffiliated persons).
- Any director who is a family member of an individual who is, or who has been at any time during the past three fiscal years, employed by the company (or its parent or subsidiary) 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 listed company made or from which the listed company received payments in the current or any of the past three fiscal years (other than those arising solely from investments in the company's securities) that exceed the greater of 5% of the recipient's consolidated growth revenues for that year, or \$200,000 (whichever is greater). (For purposes of this test, payments arising from investments in the company's stock (i.e., dividends) and payments under non-discretionary charitable contribution matching programs are ignored.)
- Any director who is, or who has a family member who is, employed as an executive officer of another company, where at any time during the last three fiscal years any of the executive officers of the listed company serve or have served on the compensation committee of the other company.

- A director who is, or who has a family member who is, a current partner of the listed company's outside auditor or was a partner or employee of the auditor who worked on the company's audit at any time during the past three years.

For purposes of the above limits, a "family member" means a person's spouse, parents, children and siblings, whether by blood, marriage or adoption, or anyone who has the same residence.

Higher Definition of Independence for Audit Committee Members

In addition to the general definition of independence for directors, all directors who are members of the listed company's audit committee (with a limited exception discussed below) must meet a stricter definition of independence under both the Nasdaq rule and SEC Rule 10A-3.

SEC Rule 10A-3 requires that every member of an audit committee of a listed company may not, other than in his or her capacity as a member of the audit committee, the board of directors or any other board committee, (1) receive any consulting, advisory or other compensatory fee from the listed

company, or (2) be an "affiliated person" of the company or its subsidiaries.

The first component not only prohibits direct payments to the director, but also means that in the case of a law firm, investment banking firm, etc. that receives fees from the public company, no partner of that firm can serve on the audit committee if any fees are received. (Further, he/she cannot be considered an independent director under the general definition if the 5%/ \$200,000 tests are exceeded.) An "affiliated person" means a person who directly or indirectly through one or more intermediaries, "controls," or is controlled by, or is under common control with the person specified. Executive officers, directors who are also employees of an affiliate, and general partners and managing members of an affiliate are deemed to be affiliates. With respect to stock ownership, Rule 10A-3 provides a "safe harbor" that beneficial ownership of 10% or less of any class of voting security does not create an affiliate relationship.

Requirements for Audit Committees **Composition**

Committees Nasdaq Rule 4350(d) requires that each listed company have an audit committee of at least three members, each of whom must: (1) be independent as defined under Rule 4200 as discussed above; (2) also meet the criteria for independence under Rule 10A-3 discussed above; (3) not have participated in the preparation of the company's financial statements at any time during the last three years; and (4) be able to read and understand fundamental financial statements. Further, under the Nasdaq rule each listed company must certify that it has at least one member of the audit committee with past employment experience in finance or accounting, certification in accounting or any other comparable background resulting in financial sophistication, including having been a CEO, CFO or

other senior officer with financial oversight. The new SEC rules under Sarbanes-Oxley also require the listed company to disclose whether or not it has at least one director whom the board of directors has affirmatively determined meets the SEC definition of an "audit committee financial expert," the definition of which is slightly stricter than the Nasdaq requirements for past financial experience.

There is a limited exception to the requirement that every member of the audit committee be independent. This permits one non-independent director who is not a current officer, employee or family member of either, and meets all other requirements to be appointed to the audit committee if the board determines that, under "exceptional and limited circumstances," it is in the best interest of the company to have the non-independent director and if the company discloses in the next annual meeting proxy statement the nature of the relationship and the reasons for the determination. Such director may only serve for two years.

There also is an exception to the Nasdaq rule for companies that are small business filers. These companies may have a committee of at least two directors, a majority but not all of whom must fully satisfy the independent test above. As a practical matter, this means that two out of three audit committee members must be fully independent. The third member must satisfy the Rule 10A-3 requirements that they not receive any payments and not be an affiliated person and must not have a family member who is an officer or employee.

There are also provisions in the Nasdaq rules for curing problems if the composition of the audit committee ceases to satisfy the requirements of the rule because a committee member ceases to be independent for reasons outside his/her control or if a vacancy in the committee creates a problem.

Responsibilities of Audit Committee

SEC Rule 10A-3 and Nasdaq Rule 4350(d) require that the audit committee of the board of directors be directly responsible for the appointment, compensation, retention and oversight of the work of any registered public accounting firm engaged for the purpose of preparing or issuing an audit report (or similar service), including resolving disagreements between management and the auditor related to financial reporting, and that the accounting firm report directly to the audit committee.

The new rules also now require the audit committee (or another independent body of directors) to conduct an appropriate review and specifically approve all transactions with related parties (the same types of transactions already required to be disclosed in proxy materials) that occur after January 15, 2004.

Each audit committee must have the authority to engage independent counsel and other advisors as it determines necessary. The listed companies must provide for appropriate funding, as determined by the audit committee, for compensation to any registered public accounting firm preparing an audit report, compensation to advisors employed by the audit committee and ordinary administrative expenses of the audit committee.

Written Charter

Each listed company must certify to the Nasdaq that it has adopted a formal written audit committee charter and has annually reviewed its adequacy. The charter must specify: (1) the committee's purpose of overseeing accounting and financial reporting processes and auditing financial statements of the listed company; (2) the committee's responsibilities including (i) pre-approval of all audit services and certain non-audit services; (ii) sole authority to appoint and determine funding for outside auditors; (iii) responsibility to establish procedures for complaints; and (iv) authority to engage and determine funding for independent counsel and other advisors.

Written Code of Conduct and Ethics

Earlier this year, the SEC adopted a rule under the Sarbanes-Oxley Act requiring all public companies to adopt a code of ethics for senior financial officers. The new Nasdaq rules go beyond that to require listed companies to adopt a code of conduct applicable to all directors, officers and employees (which includes the SEC required code of ethics for senior financial officers as a subset), and to make the code of conduct publicly available.

Whistle Blower Procedures

Under Rule 10A-3 and Nasdaq Rule 4350(d), each audit committee also must establish procedures for (1) the receipt, retention and treatment of complaints received by the listed company regarding accounting, internal accounting controls or auditing matters; and (2) the confidential anonymous submission by listed company employees of concerns regarding questionable accounting or auditing matters.

Compensation Of Officers Under the new Nasdaq rules, the compensation of the chief executive officer of a company must be determined or recommended to the full board by either a compensation committee comprised solely of independent directors or a majority of the independent directors meeting in executive session. The CEO may not be present during such deliberations or voting. Compensation of all other executive officers must be determined in the same manner, but for those deliberations the CEO may be present and participate in deliberations, but may not vote.

Nasdaq offers an "exceptional and limited circumstances" exception to this rule for up to two years where the committee has at least three members. In this situation, one non-independent director who is not a current officer, employee or family member of either may be appointed to the compensation committee if the board determines this is in the best interest of the company. The listed company must disclose the relationship and reasons for the determination in its proxy statement for the election of directors.

Nomination Committees Under the new Nasdaq rules, the nomination of directors also must be determined by either a nominations committee comprised solely of independent directors or by a majority of independent directors. There is an exception allowing a single non-independent director to serve on the committee under "exceptional and limited circumstances" upon the same conditions as described above for the compensation committee.

If a company is legally required by contract or otherwise to provide third parties with the ability to nominate directors (e.g., preferred stock rights to elect directors upon a dividend default, shareholder agreements, etc.), the nomination of such directors need not be subject to the nominating committee process.

The listed company must certify that if there is a nominating committee it has a written charter, or, if there is no committee, the listed company has adopted board resolutions, in each case addressing the nominating process and such related matters as are required by securities laws. This ties into the SEC's recent proposals to expand disclosure of the nomination process in SEC filings.

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