

SEC Approves New NASDAQ Corporate Governance Requirements

Introduction

In late 2003, the SEC issued an order approving significant amendments to NASDAQ's corporate governance requirements that apply to companies with securities listed on The NASDAQ Stock Market: <http://www.sec.gov/rules/sro/34-48745.htm>. The new requirements represent the culmination of a series of proposals regarding NASDAQ corporate governance standards that were submitted in the wake of a number of high profile corporate scandals that raised significant concerns about the effectiveness of existing standards.

Summary of Rule Changes

Among other things, the new NASDAQ rules:

- ▶ modify the definition of independence for board members;
- ▶ require that a majority of directors be independent;
- ▶ require regularly scheduled executive sessions of independent directors;
- ▶ require audit committee members to meet more stringent independence criteria;
- ▶ require the audit committee (or another independent committee) to approve all related-party transactions;
- ▶ require compensation of executive officers to be determined by a majority of independent directors or a compensation committee composed solely of independent directors;
- ▶ require nominations for director to be determined by a majority of independent

directors or a nominating committee composed solely of independent directors; and

- ▶ require adoption and disclosure of a code of conduct applicable to all directors, officers and employees, as well as disclosure of waivers of the code for executive officers and directors.

Independent Board of Directors

The new rules require that a majority of the members of a listed company's board of directors be "independent" within the meaning of revised NASD Rule 4200(a)(15). A company must disclose in its annual meeting proxy statement (or if the company does not file proxy statements, in its annual report on Form 10-K or Form 20-F, as applicable), those directors that the board has determined to be independent under the revised NASDAQ definition. If a company fails to comply with the majority independence requirement as a result of a single vacancy or because a director ceases to be independent due to circumstances beyond the director's reasonable control, the company will be required to regain compliance by the earlier of its next annual meeting of stockholders or one year after the event that caused the noncompliance.

In addition, the new NASDAQ rules require that independent members of the board of directors convene in regularly scheduled executive sessions. Interpretative material accompanying the new rules indicates that NASDAQ contemplates that executive sessions will be held at least twice annually, and perhaps more frequently, in conjunction with regularly scheduled board meetings.

Changes to Definition of Independence

Under NASD Rule 4200(a)(15), an "independent director" is a "person other than an officer or employee of the company or 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." The new rules provide a two-part test of independence, comprising both objective and subjective elements. The objective element consists of a list of specific relationships, discussed below, that automatically preclude a finding of independence. The subjective component

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requires the board to make an affirmative determination that there are no relationships, whether or not among those specifically enumerated, that would impair independence.

As noted above, the revised rules list a number of relationships that, if present, constitute *per se* disqualifications from independent status. In particular, the new rules provide that a director will not be considered independent if:

- ▶ the director is or was, at any time during the past three years, employed by the company or any parent or subsidiary of the company;
- ▶ the director or any family member of the director has accepted any payments (including amounts which are non-compensatory, such as political contributions) from the company or any parent or subsidiary of the company in excess of \$60,000 (other than compensation for board or board committee service, payments arising solely from investments in the company's securities, compensation paid to a family member of the director who is not an executive employee of the company or a parent or subsidiary of the company, benefits under a tax-qualified plan or non-discretionary compensation, or loans permitted under the Sarbanes-Oxley Act) during the company's current fiscal year or any of its past three fiscal years;
- ▶ the company has made payments (other than payments arising solely from investments in the company's securities or under nondiscretionary charitable contribution matching programs) for property or services to, or received such payments from, any organization (including a non-profit organization) of which the director or a family member of the director is a partner, controlling shareholder or executive officer and such payments exceed \$200,000 or five percent of the recipient's consolidated gross revenues, whichever is greater, in its current fiscal year or any of its past three fiscal years;
- ▶ the director has a family member that is or was, at any time during the past three years, an executive officer of the company or any parent or subsidiary thereof;
- ▶ the director is an executive officer or has an immediate family member that is an executive officer of another entity where any of the listed company's executives serves or has served, at any time during the past three years, on the compensation committee; or
- ▶ the director or a family member of the director is, or has been, a partner or employee of the company's outside auditor who worked on the company's audit at any time during the past three years.

NASDAQ advises that the second provision above is generally intended to capture payments made directly to or for the benefit of the director or his or her family member, while the third provision is generally intended to capture payments to entities related to the director or his or her family member.

The new rules define "family member" to mean a director's spouse, parents, children and siblings, whether by blood, marriage or adoption, and anyone residing in the director's home. The reference to marriage is intended to capture relationships specified in the rule (parents, children and siblings) that arise as a result of marriage, such as "in-law" relationships.

References in the new rules to "parent or subsidiary" are intended to cover entities that the listed company controls and whose financial statements the company consolidates with its own (unless the listed company reflects the entity solely as an investment in its financial statements). NASDAQ has informally indicated that the reference is intended to include any entity that controls and consolidates the listed company's financial statements in its own financial statements. Finally, NASDAQ has also informally indicated that the terms "parent and subsidiary" are intended to extend to both direct and indirect parents and subsidiaries of the listed company.

The references in the new rules to "executive officer" are intended to cover Section 16 officers, that is, the listed company's president, principal financial officer, principal accounting officer (or, if none, the controller), any vice president in charge of a principal business unit, division or function, or any other person who performs similar policy-making functions for the company. Officers of the listed company's parent or subsidiaries will also be considered "executive officers" if they perform policy-making functions for the listed company.

Audit Committee Standards

Under previous NASDAQ rules, listed companies were required to maintain written audit committee charters. The new rules require that the audit committee charter address a number of specific matters:

- ▶ the scope of the committee's responsibilities and how they will be carried out, including structure, process and membership requirements;
- ▶ the committee's responsibilities with respect to auditor independence;
- ▶ the committee's purpose of overseeing the accounting and financial reporting processes of the company and the audits of the company's financial statements;
- ▶ the audit committee's authority to:
 - ▶ be directly responsible for the appointment, compensation, retention and oversight of the company's independent auditor (including resolution of disagreements with management);
 - ▶ establish procedures for the receipt, retention and treatment by the company, and the confidential and anonymous submission by employees, of complaints or concerns regarding accounting, internal accounting controls or auditing matters; and
 - ▶ engage outside legal or other advisors, as it determines necessary; and
- ▶ the availability of adequate funding for the audit committee to carry out its duties, including the compensation of

any outside legal, accounting and other advisors retained by the committee.

The audit committee charter must be reassessed annually.

Audit Committee Membership

The new rules do not alter the requirement that listed companies maintain an audit committee consisting of at least three members, each of whom is independent and financially literate. However, the new rules require that all audit committee members satisfy this financial literacy requirement at the time of their appointment to the audit committee, rather than within a “reasonable period of time” after appointment, as was previously permitted. NASDAQ rules also continue to require that one member of the audit committee 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.

Furthermore, the new rules require that each audit committee member also satisfy the heightened independence criteria applicable to audit committee members set forth in the Sarbanes-Oxley Act. Under the Sarbanes-Oxley Act, a director may not serve on an audit committee of a listed company if:

- ▶ he or she accepts, directly or indirectly, any consulting, advisory or other compensatory fee, in any amount, from the company or any subsidiary of the company other than fees received for serving as a member of the board of directors or committee of the board; or
- ▶ he or she is an affiliate of the company or a subsidiary of the company.

The term “affiliate” means any person that directly or indirectly controls, is controlled by, or is under common control with, the company. The term “control” means the power to “direct or cause the direction of

the management and policies of a person, whether through the ownership of voting securities, by contract or otherwise.” Whether a person is an affiliate of a company is dependent on the relevant facts, and there are no bright line tests. However, the SEC has adopted a safe harbor which provides that a person will not be deemed to “control” a listed company under this rule if the person is not an executive officer of the company and does not own 10% or more of any class of the company’s voting securities. Persons who are executive officers, employee directors, general partners or managing members of affiliates will be deemed to be affiliates.

If a listed company fails to comply with NASDAQ’s new audit committee composition requirements as a result of a single vacancy or if an audit committee member ceases to be independent due to circumstances beyond his or her reasonable control, the company will be required to regain compliance by the earlier of its next annual meeting of stockholders or one year after the event that caused the noncompliance.

Compensation Committee

NASDAQ rules did not previously require listed companies to maintain compensation committees. The new rules require compensation of the chief executive officers of listed companies to be determined, or recommended to the full board of directors, by a majority of the company’s independent directors or by a compensation committee composed solely of independent directors. The same procedure is required for approval of the compensation of all other executive officers, except that the chief executive officer may be present during those deliberations, but may not vote on the matter.

Nominations Committee

As with compensation committees, prior NASDAQ rules did not require listed companies to maintain nominating committees. The new rules require all director nominations to be determined, or recommended to the full board of directors, by a majority of the company’s independent directors or by

a nominating committee composed solely of independent directors. Additionally, the nominating committee will be required to adopt a written charter or resolution governing the nominations process.

Exceptions to Composition Requirements

Exceptional and limited circumstances. If either the compensation or nominating committee is composed of at least three members, one non-independent director who is not a current executive officer or employee, or a family member of such person, would be permitted to serve on that committee if the board of directors determines “under exceptional and limited circumstances” that the director’s membership on the committee is required by the best interests of the company and its stockholders. The same exception applies to the audit committee, except that the director must still meet the audit committee enhanced independence criteria set forth in the Sarbanes-Oxley Act and may not serve as chair of the audit committee. If a company uses this exception for any committee, it will be required to disclose in its next annual meeting proxy statement (or if the company does not file proxy statements, in its annual report on Form 10-K or Form 20-F, as applicable) the nature of the director’s relationship to the company and the reasons for the board’s determination. A director appointed to a committee under this exception may not serve longer than two years.

Controlled Companies. Recognizing that majority stockholders have the right to control certain decisions, NASDAQ has also provided an exception to several of its requirements for “controlled companies.” A company would be considered a “controlled company” under the rules if greater than 50% of its voting power is held by an individual, a group or another company. Controlled companies are exempt from the requirements regarding majority board independence, compensation committees and nominating committees. In order for a group to exist for purposes of this rule, the stockholders forming the group must have

publicly filed a notice that they are acting as a group (e.g., Schedule 13D). A controlled company relying on this exception must disclose in its annual meeting proxy statement (or if the company does not file proxy statements, in its annual report on Form 10-K or Form 20-F, as applicable) its status as a controlled company and the basis for determining that it is a controlled company. Controlled companies remain subject to the audit committee requirements and the requirement that their independent directors regularly meet in executive session.

Related-Party Transactions

The new rules will require that each related-party transaction be approved by either the company's audit committee or another independent body of the board. As a result, companies will need to review on an ongoing basis all related-party transactions for potential conflicts of interest. For these purposes, "related-party transaction" means any transaction that would be required to be disclosed in a company's SEC filings under Item 404 of Regulation S-K.

Disclosure of Audit Opinions with Going-Concern Qualifications

The new rules require a listed company that receives an audit opinion containing a going-concern qualification to announce the receipt of the qualification to the public through the news media not later than seven calendar days following the public filing of the qualified audit opinion with the SEC. Any company making this public disclosure must provide the text of the press release in advance to NASDAQ.

Codes of Conduct

The new rules require listed companies to adopt and make publicly available codes of conduct applicable to all directors, officers and employees. The code of conduct must comply with the definition of "code of ethics" outlined in the Sarbanes-Oxley Act and related SEC rules. The code must include standards that are reasonably calculated to deter wrongdoing and promote:

- ▶ honest and ethical conduct, including the ethical handling of conflicts of interest;
- ▶ full, fair, accurate, timely and understandable disclosure in SEC reports and other public disclosures;
- ▶ compliance with applicable laws, rules and regulations;
- ▶ prompt internal reporting of violations of the code of conduct to appropriate persons; and
- ▶ accountability for adherence to the code.

The code of conduct must also provide for a mechanism for its enforcement that ensures prompt and consistent enforcement, protection for persons reporting questionable behavior, clear and objective standards for compliance and a fair process by which to determine violations. Listed companies may satisfy the code of conduct requirements by establishing one or more codes of conduct, so long as all directors, officers and employees are subject to a code that satisfies the definition of "code of ethics." The code must also require that any waiver of the code of conduct for a director or executive officer be approved by the board of directors and be disclosed, along with the reasons for the waiver, in a current report on Form 8-K within five business days of the waiver.

Disclosure of Noncompliance

Listed companies will be required to notify NASDAQ promptly when any executive officer of the company becomes aware of any material noncompliance with any of NASDAQ's qualitative listing standards, including the new corporate governance rules described in this Alert.

Foreign Private Issuers

A foreign private issuer (as defined under SEC rules) may apply to NASDAQ for an exemption from the corporate governance listing standards, other than the audit committee requirements contained in the Sarbanes-Oxley Act or other federal securities laws, if compliance with the rules would require the company to be in violation of

the laws, rules, regulations or generally accepted business practices of the company's home country. Foreign private issuers that receive this exemption are required to disclose in their annual reports each exempted requirement and to describe the home country practices that they follow as an alternative.

Effective Dates

Listed companies will have until the earlier of (1) their first annual stockholders' meeting after January 15, 2004, or (2) October 31, 2004, to comply with the new rules. However, with the exception of the new rules regarding audit committee requirements, if a listed company that has a classified board of directors would be required to change a director who would not normally stand for election at that annual meeting in order to comply with the new rules, the company will not be required to implement the new requirements related to board composition until the second annual stockholders' meeting after January 15, 2004, but in no event later than December 31, 2005. NASDAQ representatives have informally advised that, in that event, a company should still disclose the board's determination of independence, but could apply either the old or new definitions of independence until the company becomes subject to the new rules. Small business issuers (as defined under SEC rules) and foreign private issuers will generally have until July 31, 2005 to comply with the new rules.

Companies transferring to NASDAQ from markets with substantially similar requirements have the same grace period as they would have had if they had remained listed on the other market.

For newly public companies that list on NASDAQ in connection with their initial public offerings, their audit, compensation and nominating committees must each be composed of:

- ▶ at least one independent director at the time of the company's initial public offering;

- ▶ a majority of independent directors within 90 days of the company's initial public offering; and
- ▶ exclusively independent directors within one year of the company's initial public offering.

In addition, these companies will be required to satisfy the requirement to have a board consisting of a majority of independent directors within one year of the company's initial public offering.

Finally, the following effective dates are applicable to other provisions of NASDAQ's new corporate governance rules:

- ▶ the requirements relating to codes of conduct will become effective May 4, 2004;
- ▶ the requirements that the audit committee (or another independent committee) approve related-party transactions became effective on January 15, 2004; and
- ▶ the requirement that companies receiving an audit opinion containing a going-concern qualification make a public announcement of the qualification became effective on November 4, 2003. ■