

# Client Alert

A report  
for clients  
and friends  
of the firm    May 2003

## The SEC Has Published Proposed Corporate Governance Listing Standards of the New York Stock Exchange and NASDAQ

The Securities and Exchange Commission ("SEC") has published for comment listing standards proposed by The New York Stock Exchange ("NYSE") and the National Association of Securities Dealers ("NASD") through the Nasdaq Stock Market ("NASDAQ") with respect to their definitions of the term "independent director" and other corporate governance matters relating to independent directors and audit committees.

### Background

In 2002, the NYSE and NASDAQ submitted proposals to the SEC to amend their corporate governance related listing standards.<sup>1</sup> The proposed new listing standards related to, principally, the roles of independent directors of listed companies, the definition of the term "independent director," the functions of audit, compensation and nominating/governance committees of listed companies and the role stockholders of listed companies in approving equity compensation plans of those companies.<sup>2</sup>

Previously, in July, 2002, the Congress had enacted the Sarbanes-Oxley Act of 2002 ("SOX"). Sec. 301 of that act required that the SEC direct all of the national securities exchanges and the NASD (the "SROs") to adopt listing standards applicable to audit committees and their members. In April, 2003, the SEC issued its directives to the SROs to implement Sec. 301.<sup>3</sup> The SEC directed that the SROs submit proposals to comply with Sec. 301 by July 15, 2003, and that the required listing standards must be approved by the SEC and be in effect by December 1, 2003. Listed companies must comply with the required listing standards by the earliest of their first annual meeting of shareholders after January 15, 2004, or October 31, 2004.<sup>4</sup> Many of the SRO's proposals overlap or duplicate the SEC's rules under SOX.

In 2003, the SEC persuaded the NASDAQ and the NYSE to amend their 2002 proposals. NASDAQ and the NYSE, accordingly, filed amended proposals. The SEC has published their proposals for comment.<sup>5</sup>

### Effective Dates

The effective date of the NASDAQ and NYSE listing standards must be coordinated with the SEC's directive under Sec. 301 of SOX.

### Proposed NYSE effective dates

The NYSE has proposed the following effective dates for its new listing standards:

- Independence standards — no later than 18 months after the SEC approves the standards. (However, the standards relating to or required

1 File Nos. SR-NASD-2002-141; SR-NYSE-2002-33. The NASD also has pending a separate proposal that would require the audit committee to approve related party transactions

2 Subsequently, at the urging of the SEC, the NYSE and the NASD broke out their proposals for shareholder approval of equity compensation plans and those proposals were published for comment by the SEC. See Rel. Nos. 34-46649 (October 22, 2002) [NASD] and 34-46620 (October 8, 2002) [NYSE]. The SEC has not yet approved those proposals

3 Rel. 33-8220 (April 9, 2003). The subject matter of that Release was dealt with in a previous Alert to our clients.

4 While national securities exchanges, other than the NYSE, most notably, the American Stock Exchange, have corporate governance related listing standards, none of those exchanges have yet proposed to amend those standards to comply with the SEC directive.

5 See Rel. 34-47516 (March 17, 2003) [NASDAQ]; Rel. 34-47672 (April 11, 2003) [NYSE]. No other SROs have submitted proposed amendments to their listing standards as yet.

by Sec. 301 of SOX with respect to audit committees must be in effect at the earlier of the listed company's first annual meeting of shareholders after January 15, 2004 or October 31, 2004.);

- Companies with classified boards of directors - these companies will have an additional year for compliance with respect to directors in classes not up for election in 2004 (with the exception of audit committee members, as indicated above);
- Companies listing in conjunction with their initial public offerings — 24 months from listing (with the exception of audit committee members, as indicated above);
- Companies transferring from another securities market that does not have the same independence requirements as the NYSE — 24 months from listing (with the exception of audit committee members, as indicated above); and
- Companies transferring from another securities market which has independence requirements substantially similar to those of the NYSE — any unexpired transition period which the other market had (with the exception of audit committee members, as indicated above).

### Proposed NASDAQ effective dates

NASDAQ has proposed the following effective dates<sup>6</sup>:

- Composition of a company's board of directors and committees of the board of directors ("board composition requirements") — the company's first annual meeting after January 1, 2004;
- All other (executive sessions of the independent directors and audit committee charters) — six months after approval of Nasdaq's proposals by the SEC;
- Newly listed companies, board composition requirements — two years after listing (other requirements would apply six months after SEC approval); and
- Companies transferring from other U.S. securities markets with corporate governance standards substantially similar to those of Nasdaq — any balance of any grace period afforded by the other market.

### The NYSE's Proposals

The NYSE's proposed Rule 303A relates to Director independence standards, audit committees, compensation committees, nominating/corporate governance committees and other corporate governance related matters.

Under the NYSE's proposals, each CEO of a listed company would be required to certify annually to the NYSE that the CEO is unaware of any violation of the NYSE's corporate governance listing standards (Section 303A of the NYSE's Listed Company Manual) and the listed company would be required to disclose that certification in its annual report to its shareholders.<sup>7</sup>

In addition, each listed company CEO would be required to notify the NYSE promptly after my executive officer of the company becomes aware of any material non-compliance with Section 303A.

### Definition of the term independent director

The NYSE proposed the following with respect to the definition of the term "independent director" for purposes of its listing standards:

- No director is "independent" unless the board of directors affirmatively determines that the director has no material relationship with the listed company, either directly or as a partner, shareholder or officer of an organization that has a relationship with the listed company;
- A director who receives, or whose "Immediate Family Member"<sup>8</sup> receives more than \$100,000 a year in direct compensation from the listed company (such a director is presumed to be not independent until five years<sup>9</sup> after the director ceases to receive more than such \$100,000 in compensation.);

### Exceptions:

Director and committee fees;

Pension or other deferred compensation for prior service, if not contingent, in any way, on continued service;

- A director who, or whose Immediate Family Member, is affiliated with, or employed in a professional capacity by, a present or former auditor of the company (a five year look-back applies);
- A director who, or whose Immediate Family Member, is employed as an executive officer of another company where any of the listed company's present executive officers serve on the other company's compensation committee (a five year look-back applies); and
- A director who is an executive officer or employee, or whose Immediate Family Member is an executive officer, of another company that accounts for at least 2% or \$1

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<sup>6</sup> Effective dates relating to audit committees are subject to the required effective dates under the SEC's April 9, 2003, directive.

<sup>7</sup> A flagrant or continued failure to comply with a NYSE listing standard can result in suspension of trading or delisting. Under the NYSE's proposals a lesser failure to comply could result in a public reprimand letter to the listed company. A public reprimand letter is not available as a sanction for companies that fall below financial listing standards.

<sup>8</sup> The term "Immediate Family Member" "includes" a person's spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-laws any one (other than employees) who share the person's home. This definition is narrower than NASDAQ's proposed definition, discussed below.

<sup>9</sup> The corresponding NASDAQ proposed "look-back" period is only three years.

million (whichever is greater) of the listed company's consolidated gross revenues or for which the listed company accounts for at least 2% or \$1million (whichever is greater) of the other company's consolidated gross revenues (a five year look-back applies).

## Transition

During the five years immediately following the effective date of these listing standards, each five year look-back period instead is the period from that effective date.

## Exceptions to all or part of the provisions of proposed Rule 303A

The NYSE has proposed several exceptions to Rule 303A.

- A company more than 50% of whose voting power is held by an individual, a group or another company (the "controlled company exception") need not comply with proposed requirements that a listed company have a majority of independent directors, a nominating/corporate governance committee or a compensation committee (proposed Rules 303A(1), (4) and (5));
- Limited partnerships need not comply with proposed Rules 303A(1), (4) or (5);
- Companies in bankruptcy need not comply with proposed Rules 303A(1), (4) or (5);
- Closed-end investment companies are exempt, except for rules relating to audit committees and CEO certifications;
- Passive entities, in the form of trusts, are exempt from all of the provisions of proposed Rule 303A;
- "Derivatives" are exempt from all of the provisions of proposed Rule 303A;
- Certain special purpose entities are exempt from all of the provisions of proposed Rule 303A;
- Foreign private issuers, as discussed below, would be permitted to follow their home country practice, except with respect to the provisions of proposed Rule 303A relating to audit committees, (except for the audit committee charter requirements), the disclosure requirements discussed below and the CEO certification requirements;
- Companies listing only preferred or debt securities would not be subject to proposed Rule 303A, except those which are subject to the audit committee requirements of Rule 10A-3 under the Exchange Act would be subject to the audit committee requirements of proposed Rule 303A (except for the audit committee charter requirements) and to the CEO certification requirements.

## Proposed disclosure requirements.

The NYSE has proposed to require disclosure of the following in each listed company's proxy statement for its annual meeting of shareholders<sup>10</sup>:

- A "controlled company" must disclose that it is relying on the controlled company exception discussed above and the basis for its determination that it is a controlled company;
- The determination of the board of directors as to the independence of each independent director (In this regard, the board may adopt categorical standards to assist such determinations<sup>11</sup> and make general disclosure if a director satisfies those standards.);
- The categorical standards adopted by the board to assist its determinations of director independence;
- The explanation for determining that a director who does not satisfy such categorical standards is never the less independent;
- The determination by the board required under NYSE listing standards that audit committee members service on more than three audit committees of public companies would not impair the ability of those members to effectively serve on that listed company's audit committee;
- Each listed company's web site must include its corporate governance guidelines and the charters of its audit, compensation, nominating/governance and other important committees and its annual report to shareholders must state that these documents are available on the web site and will be furnished in hard copy to any shareholder who requests;
- A listed company must post its code of business conduct and ethics on its web site and disclose in its annual report to its shareholders that the code is so available and hard copies will be furnished to shareholders on request;
- Waivers of provisions of a code of business conduct and ethics for an executive officer or director must be promptly disclosed to shareholders (The NYSE does not specify the means for this disclosure.);
- Foreign private issuers must disclose in summary fashion any significant ways in which their corporate governance practices differ from those required by the NYSE's proposed standards, either on their web sites in English or in an English version of their annual reports to their shareholders and, if only disclosed on their web sites, the annual report must so state and provide the address of their web site; and
- The CEO's annual certification to the NYSE as to compliance with the NYSE corporate governance listing stan-

<sup>10</sup> Foreign private issuers are not subject to the SEC's proxy rules, but those that solicit proxies would have to rely on an exemption from the NYSE listing standards.

<sup>11</sup> In this case, immaterial relationships need not be disclosed.

dards and the CEO and CFO certifications required by SOX to be filed with the SEC<sup>12</sup> must be disclosed in the listed company's annual report to shareholders (or if it does not prepare an annual report to shareholders, in its Form 10-K).

## Other proposals.

The NYSE's other director independence related proposals are:

- Each listed company must have a majority of independent directors;  
**Exception:** A "controlled company" (a company more than 50% of whose voting power is held by an individual, another company or a group) need not have a majority of independent directors or have a compensation committee or nominating/corporate governance committee composed of independent directors. (A controlled company must have an audit committee composed of a minimum of three directors and all of its member must be independent and the controlled company must comply with the NYSE's other audit committee requirements.)
- The "non-management directors" must meet in regularly scheduled executive sessions ("non-employee directors" are all directors who are not company "officers," as defined in Rule 16a-1(f) under the Exchange Act, and, accordingly, may not all be "independent directors," as defined in proposed Rule 303A);
- Each listed company must have a nominating/corporate governance committee comprised entirely of independent directors, which a charter that addresses:<sup>13</sup>
  - The committee's purpose, which, at a minimum, must be to identify individuals qualified to become board members and to select, or recommend to the board, the director nominees for the next annual meeting and develop and recommend to the board corporate governance principles for the listed company;
  - The committees goals and responsibilities, which, at a minimum must reflect the board's criteria for selecting new directors and oversight of the evaluation of the board and management; and

- An annual performance evaluation of the committee.<sup>14</sup>

## Exception:

Legal commitments to third parties to nominate directors.

- A listed company must have a compensation committee comprised solely of independent directors, which has a charter that addresses:
  - The committees purpose, which, at a minimum, must be to discharge the board's responsibilities relating to compensation of executive officers and to produce the compensation committee report required in the company's proxy statement or annual report on Form 10-K;
  - The committees duties and responsibilities, which at minimum must be to review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of those goals and objectives<sup>15</sup> and have sole authority to determine the CEO's compensation level based on that evaluation, and to make recommendations to the board with respect to compensation other than the CEO's, and with respect to the company's incentive compensation plans and equity based plans; and
- An annual performance evaluation of the committee.

## Audit Committees

Audit committee members must be independent directors under the NYSE standards and SEC Rule 10A-3 under the Exchange Act.<sup>16</sup> Rule 10A-3(b)(1) requires that audit committee members not receive compensation directly or indirectly from the listed company and not be "affiliates" of the listed company. Rule 10A-3(e) provides certain exceptions and exemptions from these requirements, particularly with respect to foreign companies.

In addition, the NYSE's proposed listing standards would require that:

- Each listed company must have an audit committee of at least three members and each member must be an independent director;

12 Neither SOX nor the SEC require these CEO and CFO certifications to be included in an issuer's annual report to shareholders. Also, it is not clear whether the NYSE is proposing that both the certification required by Sec. 302 of SOX and SEC rules and that required Sec. 906 of SOX be included in the annual report to shareholders.

13 The board may allocate the functions of the nominating/corporate governance committee (and the compensation committee, as discussed below) to other committees comprised solely of independent directors, provided those committees have published committee charters covering the required functions. The functions of the audit committee may not be allocated to other committees.

14 The NYSE also suggests that the charter should but is not required to, address committee members qualifications, appointment and removal; committee structure and operations, including authority to delegate to subcommittees; reporting to the board; giving the committee sole authority to hire or terminate and determine the fees and other terms of the engagement of executive search firms.

15 The NYSE suggests that, in determining the long-term incentive component of the CEO's compensation, the committee should consider the company's performance and relative shareholder return, the value of similar incentive awards to CEOs of comparable companies and awards given to the CEO in the past. (The NYSE notes that the committee, with or without ratification by the board, is not precluded from approving awards required to comply with Section 162(m) of the Internal Revenue Code.) The NYSE further suggests that the charter also should address committee member qualifications, appointment and removal; committee structure and operations, including authority to delegate to subcommittee; reports to the board; and sole authority as to compensation consultants' retention, including terms, termination and fees, if the consultants are to assist in the evaluation of director, CEO or senior executive compensation.

16 This Rule was the subject of a previous client alert.



- The audit committee must have a charter which addresses:
  - The committee's purpose, which at a minimum must be to assist board oversight of the integrity of the company's financial statements, the company's compliance with legal and regulatory requirements, the independent auditor's qualification and independence and the performance of the company's internal audit function and independent auditors; and prepare the audit committee report required by SEC rules;
  - The duties and responsibilities of the audit committee required under the NYSE's listing standards;
- As required by SEC Rule 10A-3 and subject to the exceptions and exemptions in Rule 10A-3(c), the audit committee must directly appoint, retain, compensate, evaluate and terminate the listed company's independent auditors;
- The audit committee must establish procedures for the receipt, retention and treatment of complaints from the listed company's employees about accounting, internal accounting controls or auditing matters and confidential anonymous submissions by employees of concerns regarding questionable accounting or auditing matters;
- The audit committee must obtain advice and assistance from outside legal, accounting or other advisers as the committee deems advisable to carry out its duties;
- The audit committee must receive appropriate funding from the listed company, as determined by the committee, for payment of compensation to its outside advisers; and
- In addition to the duties mentioned above, the audit committee must, at a minimum:
  - At least annually, obtain and review a report from the independent auditor describing its internal quality control procedures, any material issues raised in its most recent internal quality control or peer review or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, with respect to one or more of its audit engagements and any steps taken to deal with any such issues and all relationships between the auditor and the listed company;<sup>17</sup>
  - Discuss the annual audited financial statements or quarterly financial statements, as applicable, and the related MD&A with management and the independent auditor;
  - Discuss earnings press releases and financial information and earnings guidance provided to security analysts and rating agencies (These discussions may be general and need not be in advance of the releases or providing of guidance.);
- Discuss guidelines policies with respect to risk assessment and risk management (The audit committee is not required to be solely responsible for risk assessment and risk management.);
- Periodically, meet separately with management, with the internal auditors or persons performing the internal audit function<sup>18</sup> and with the independent auditors;
- Review with the independent auditor any audit problems or difficulties, including any restrictions on the scope of its activities or access to information and significant disagreements with management and management's response;<sup>19</sup>
- Set clear hiring policies for employees or former employees of the independent auditor (SOX and the SEC's rules limit the hiring of former audit personnel); and
- Report regularly to the board.

The NYSE states that the audit committee must review:

- Major issues regarding accounting principles and financial statement presentation, including any significant changes in the selection or application of accounting principles; major issues as to the adequacy of the company's internal controls and any special audit steps adopted in light of material internal control deficiencies; analyses prepared by management or the independent auditors identifying significant financial reporting issues and judgments made in connection with preparation of financial statements, including analyses of alternative GAAP methods, the effects of regulatory and accounting initiative, the effects of off balance sheet structures, the type and presentation of information in earnings releases, particularly use of non-GAAP financial measures and the type of financial information and earnings guidance provided to security analysts.

### Corporate Governance Guidelines

The NYSE proposed to require listed companies to adopt and disclose corporate governance guidelines. The following must be covered by these guidelines:

- Director qualifications, including, at a minimum, those required under proposed Sections 303A(1) and (2);

<sup>17</sup> The NYSE commentary states that this report will assist in evaluating the independent auditor and that this evaluation should include an evaluation of the lead partner. The NYSE suggests that, in addition to the rotation of the lead partner, as required by SOX and SEC rules, the audit committee should consider the rotation of the audit firm and report its conclusions to the board.

<sup>18</sup> Under the NYSE's proposed listing standards, all listed companies must have an internal audit function.

<sup>19</sup> The NYSE suggests that the committee may want to review any accounting adjustments that were noted or proposed by the auditor, but were passed by them as immaterial or otherwise (Sec. 401(a) of SOX [section 13(i) of the Exchange Act] requires that all financial statements prepared in accordance with, or reconciled to, U.S. GAAP must reflect all material correcting adjustments that have been identified by the outside auditor.), any communications between the audit team and the audit firm's national office with respect to auditing or accounting issues concerning the engagement, any management or internal control letters issued or proposed to be issued by the auditors to the company and the responsibilities, budget and staffing of the company's internal audit function.

- Director responsibilities;
- Director compensation;
- Director orientation and education;
- Management succession; and
- Annual performance evaluation of the board.

## Code of Business Conduct and Ethics

The NYSE has proposed that each list company must adopt a code of business conduct and ethics for directors, officers and employees and promptly disclose any waivers of the code for directors and executive officers. Each code must:

- Require that any waiver of the code for executive officers or directors must be made only by the board and must be promptly disclosed to shareholders; and
- Must contain compliance standards and procedures.

The NYSE suggests that the code should include provisions dealing with:

- Conflicts of interests;
- Corporate opportunities;
- Confidentiality of company information;
- Fair dealing with customers, suppliers, competitors and employees;
- Protection and proper use of company assets;
- Compliance with laws, rules and regulations; and
- Encouraging the reporting of any illegal or unethical behavior without retaliation.

## Foreign Issuers

Under the NYSE's proposals, foreign private issuers only will be required to comply with the audit committee independence standards imposed under Sec. 301 of SOX and the related SEC directive, the disclosure requirements discussed above and the NYSE's CEO certification requirements.

## "Small business issuers."

The NYSE proposals make no exceptions for small business issuers. However, it would be unusual for a small business issuer, as defined by SEC rules, to achieve a listing on the NYSE.

## NASDAQ's Proposals

Nasdaq has proposed listing standards with respect to direction independence and other corporate governance matters.

## Definition of the term "Independent director."

Under the NASDAQ proposals, an "independent director" is a person other than an officer or employee of the listed company or its subsidiaries or any other individual who has a relationship which, in the judgment of the listed company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.

The following persons would not be considered independent under these proposals:

- A director who is, or during the past three years, was employed by the company or by any parent or subsidiary of the company;<sup>20</sup>
- A director who accepts, or who has a "Family Member"<sup>21</sup> who accepts, payments from the company or any of its parents or subsidiaries in excess of \$60,000 during the current fiscal year (there also is a three-year look-back);

## Exceptions:

(These exceptions should be available to members of the listed company's audit committee who are subject to the more stringent requirements under Sec. 301 of SOX, the SEC directive and Nasdaq's proposed listing standards):

Compensation for board service (presumably including service on committees of the board);

Payments arising solely from investments in the listed company's securities;

Payments to a Family Member who is an employee (but not an executive officer) of the listed company or its parents or subsidiaries;

Benefits under a tax-qualified retirement plan; and

Non-discretionary compensation.

- A director who is a Family Member of an individual who is, or during the past three years, was employed by the listed company or any of its parents or subsidiaries as executive officer;
- A director who is a partner, controlling shareholder or executive officer of any organization to which the listed company made, or from which it received, payments (other than solely for investment in the listed company's securities.) that exceeded 5% of the recipient's gross revenues for that year, whichever is more, in current fiscal year or any of the past three fiscal years;
- A director of the listed company who is employed as an executive officer of another entity where any of the executive officers of the listed company serve on the other entity's compensation committee, or if such relationship existed during the past three years; or

<sup>20</sup> Under NASDAQ's proposals, "parents" and "subsidiaries" are intended to be companies whose financial statements are consolidated with those of the listed company.

<sup>21</sup> "Family Member" means any person who is a relative by blood, marriage or adoption or who has the same residences the as the director.

- A director who is or was a partner or employee of the listed company's outside auditor and worked on the audit of the company's financial statements during the past three years.

## Other proposals

NASDAQ has also proposed a number of other corporate governance listing standards:

- A majority of the board of directors must be "independent directors";
- The independent directors must have regularly scheduled executive sessions;
- The compensation of a listed company's chief executive officer ("CEO") must be determined by a majority of the independent directors or by a compensation committee comprised solely of independent directors meeting in executive sessions;
- Compensation of all "officers,"<sup>22</sup> other than the CEO, must be determined by a majority of the independent directors or a compensation committee comprised solely of independent directors (The CEO may be present during these deliberations of the compensation committee, but may not vote.);

## Exceptions:

If the compensation committee is comprised of at least three members, one member who is not a current officer or employee of the listed company or a Family Member of such an individual, but who is not otherwise independent, may be appointed to the committee by the board of directors for a term of not longer than two years, but only under exceptional and limited circumstances, if the board determines that that individual's membership on the committee is required in the best interests of the company and its shareholders and the board makes specified disclosures discussed below (the "exceptional and limited circumstances exception"); and

- The nomination of directors must be determined either by a majority of the independent directors or by a nominations committee comprised solely of independent directors.

## Exceptions:

- There is an "exceptional and limited circumstances" exception;
- If the exceptional and limited circumstances exception is not used and the audit committee has at least three members, the board may determine that one director who owns 20% or more of the company's common stock or voting power and is also an officer can be appointed to the committee, if the board determines the appointment is required by the best interests of the listed company and its shareholders

and makes the specified disclosure discussed below; and

- In addition, a "controlled company" (a company of which 50% of the voting power is held by an individual, another company or a group<sup>23</sup>) is not subject to the independent director requirements (the "controlled company exception"), except with respect to the members of its audit committee. (Reliance on this exemption is required to be disclosed, as discussed below.)

## Audit committee requirements

In addition to current NASDAQ requirements for independence of audit committee members and audit committee charters, NASDAQ has proposed that the charter must specify:

The committee's purpose of overseeing the accounting and financial reporting processes of the listed company and the audits of its financial statements;

- The committee must pre-approve all audit and permissible non-audit services as required by section 10A(i) of the Exchange Act;
- The committee must have the sole authority to appoint, determine funding for and overseeing the listed company's outside auditor, as provided in section 10A(m)(2) of the Exchange Act;
- The committee must have the responsibility to establish procedures for employee complaints, as provide in section 10A(m)(4) of the Exchange Act; and
- The committee must have the authority to engage and determine funding for independent counsel and other advisers, as provided in section 10A(m)(5) of the Exchange Act.

In addition, NASDAQ has proposed, as to audit committee composition, that:

- Each listed company must have and certify to NASDAQ that it has, and will continue to have an audit committee of at least three members, each whom is independent, as defined in NASDAQ proposed Rule 4200 and section 10A(m)(3) of the Exchange Act, and not know to own or control, or be employed by an entity that owns or controls, 20% or more of the listed company's voting securities or such lower percentage as the SEC may establish;
- Each member of the audit committee must be able to read and understand financial statements; and
- Each listed company must certify to NASDAQ that it has, and will continue to have, at least one member of its audit committee who has past employment experience in finance or accounting, requisite professional or other certification in accounting or any other comparable experience or back-

<sup>22</sup> As defined SEC Rule 16a-1 under section 16 of the Securities Exchange Act of 1934.

<sup>23</sup> For the exception to apply to a group, the "group" must have publicly filed a notice with the SEC, a Schedule 13D, for example, that it is acting as a group.

ground which results in the member's financial sophistication, including being, or having been a CEO, CFO or other senior officer with financial oversight responsibility.

### Exception

Under the "exceptional and limited circumstances exception", one director who is not independent under NASDAQ Rule 4200, but who is independent under the criteria of Sec. 10A(m)(3) of the Exchange Act, does not own 20% or more of the listed company's voting securities and who is not a current officer or employee of the listed issuer, may serve on the audit committee for up to two years.

### Foreign issuers

NASDAQ's proposals make no exceptions for foreign issuers and Rel. 34-47516 makes no reference to foreign issuers. Thus, current NASDAQ Rule 4350(a) presumably would continue to apply. That rule provides that no provision of NASDAQ's Qualitative Listing Standard's will be construed to require any foreign issuer to do any act that is contrary to a law, rule or regulatory of any public authority exercising jurisdiction over the listed company or that is contrary to generally accepted business practices in the listed company's country of domicile. Nasdaq has the authority to provide exemptions from the provisions of its Qualitative Listing Standards to carry out this intent. However, it cannot exempt foreign issuers from the listing standards applicable to audit committees mandated by Sec. 301 of SOX and the SEC's directive thereunder.

### "Small business issuers."

The NASDAQ proposals eliminate its previously proposed exceptions for "small business issuers", as that term is defined under SEC rules. Thus, these NASDAQ's proposal would apply to small business issuers.

### Disclosure requirements.

NASDAQ has proposed certain disclosure requirements to complement is proposed corporate governance listing standards. These disclosure requirements, which would be in addition to any SEC disclosure requirements, would require disclosure, as follows:.

- If the board of directors exercises the exceptional and limited circumstances exception with respect to a member of the listed company's compensation committee, the board must disclose, in the company's proxy statement for its next annual meeting of shareholders after the board makes that determination, the nature of the director's relationship

<sup>24</sup> Sec. 301 of SOX provides that, under SEC's implementing rules with respect to the independence standards under Sec. 301, the SROs must provide an opportunity for their listed companies to correct defects before they prohibit a listing or delist a company's securities.

with the company and the board's reasons for its determination;

- The same type of disclosure discussed immediately above would be required, if the board uses the exceptional and limited circumstances exception with respect to a member of the nominations committee;
- This same type of disclosure would be required, if the board uses the 20% exception with respect to a member of the nominations committee; and
- If a company relies on the "controlled company exception," it would be required to disclose, in its proxy statement, that it is a controlled company and the basis for that determination.

### Conclusion

It remains to be seen whether the NYSE's and NASDAQ's proposed transition periods will be sufficient for all of their listed companies to become compliant with the independence standards.<sup>24</sup>

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#### Client Alert

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