



FENWICK & WEST LLP

## Corporate and Securities Law Update

### NASDAQ Corporate Governance Standards for Listed Companies

December 11, 2003

On November 4, 2003, the SEC approved the final version of The NASDAQ Stock Market's corporate governance rule changes. These new rules, which are designed to strengthen NASDAQ's listing standards, will have wide-ranging effects on the organization and operations of companies listed on NASDAQ. Many of the rules go into effect as of your company's 2004 annual meeting (in any event, by October 31). The text of the SEC's approval order is available at [www.sec.gov/rules/sro/34-48745.htm](http://www.sec.gov/rules/sro/34-48745.htm). The text of the NASDAQ rules as revised is available at <http://www.nasdaq.com/about/CorporateGovernance.pdf>.

#### What do the new rules cover?

The NASDAQ corporate governance rule changes are wide-ranging. For convenience, we have summarized them by category:

- Director Independence
  - A majority of the board of directors must be independent directors
  - New definition of independent director status
- Board Activities
  - Independent directors must meet in executive session
  - Independent committee must approve related party transactions
- Audit Committee
  - Audit Committee responsibilities expanded
  - Enhanced independence standards for Audit Committee members
- Compensation Committee and Nominations Committee
  - Independent directors must approve executive officer compensation
  - Independent directors must approve director nominees

- Corporate Practices and Related Disclosures
  - Adopt and publish a code of conduct that applies to all company employees and directors
- Effectiveness and Implementation Timing

#### Director Independence

##### How many members of our board of directors must be independent?

At each NASDAQ-listed company, a majority of the members of the board of directors must be independent. Most companies must comply with this new requirement by the time of the company's annual stockholder meeting after January 15, 2004, but in any event no later than October 31, 2004. Foreign private issuers and small business issuers have until July 31, 2005 to comply with these requirements.

If your company has a classified board of directors *and* compliance in 2004 would require the company to replace a director who normally would not stand for election at the 2004 annual meeting, then your company has until the second annual meeting after January 15, 2004 (but not later than December 31, 2005) to implement an independent majority.

##### Who determines whether a director is independent? Is the information disclosed?

The board of directors must make a determination of which of its members or nominees are independent. NASDAQ requires that those independent directors be identified in the company's annual proxy statement, or in its Form 10-K (or Form 20-F) if no proxy statement is filed. NASDAQ representatives have confirmed that the NASDAQ-mandated disclosure requirement does not apply to proxy statements distributed prior to the 2004 annual meeting, but senior SEC officials have suggested that this disclosure should be considered.

## How does the board of directors determine whether a person would be an “independent director”?

The board’s essential task is to apply NASDAQ’s general definition of independence:

“Independent director” means a person other than an officer or employee of the company or its subsidiaries or any other individual having a relationship, that, in the opinion of the company’s board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of the director.

The board’s discretion in determining director independence is not completely unfettered – the NASDAQ rules specify several relationships that disqualify a person from being eligible to be an independent director:

- Any person who was employed by the company at any time in the past three years is ineligible to be an independent director. A former employee is not independent until three years after termination of employment.
- Any person who accepted payments from the company in excess of \$60,000 during the current or any of the past three fiscal years is ineligible to be an independent director. Payments directly to, or for the benefit of, the director or a family member of the director are prohibited. Examples might include consulting or personal service contracts with, or political contributions to the campaign of, a director or family member of a director. Note that the look-back period on this test is generally a little longer than the look-back period on the employment test.
- A director will not be independent if a family member of the director is, or during the past three years was, employed as an executive officer of the company.
- Company payments to or from an organization affiliated with a person can disqualify the person as an independent director. Specifically, a person is not an independent director if the person (or a family member) is a general partner, controlling shareholder or executive officer of any entity (including charities) to which the company made, or from which it received, payments above a threshold amount in the current or any of the past three fiscal years. The threshold for disqualification is payments that exceed 5% of the recipient’s

consolidated gross revenues for that year or \$200,000 (whichever is greater). Payments made solely on account of investments in the company’s securities, or under non-discretionary charitable contribution matching programs, are excluded from this test.

- Interlocking directorates can disqualify a director from being considered independent. Specifically, a person is disqualified as an independent director of Company A if he or she (or a family member) is employed as an executive officer of Company B *and* at any time during the past three years an executive officer of Company A served on the Company B Compensation Committee.
- Any person who is (or who has a family member who is) a current partner of the company’s independent auditor, or who was a partner or employee of the company’s independent auditor and worked on the company’s audit at any time during the past three years, is disqualified from being considered an independent director.

The “super-independence” standards that apply to Audit Committee members by operation of SEC rules (also included in NASDAQ requirements) may preclude someone from serving as a member of the Audit Committee even though that person meets the general requirements for an independent director.

Please note that the board of directors must make an affirmative determination of director independence. In addition to verifying that none of the disqualifications listed above applies to a particular director, the board of directors must find that no relationship exists that would impair the director’s independence.

## Who is considered a “family member” for purposes of independent director analysis?

The term “family member” is a new term – it means a person’s spouse, parents, children and siblings, whether by blood, marriage or adoption, and anyone residing in the person’s home. This term replaces the prior concept of “immediate family member.”

## Are there any payments an individual can receive from the company without being disqualified from consideration as an independent director?

Yes. For example, the following payments do not count towards the \$60,000 limit:

- Compensation for board or board committee service;

- Payments arising solely from investments in the company's securities;
- Compensation paid to a family member who is a non-executive employee of the company or its parent or subsidiary (although payments of this nature may require disclosure in the company's proxy statement);
- Benefits under tax-qualified retirement plans, or non-discretionary compensation; or
- Loans permitted by Section 13(k) of the Exchange Act (i.e., loans other than those to executive officers and directors).

#### **Does our company have to disclose the identities of our independent directors?**

Yes. All NASDAQ-listed companies must disclose the identities of the directors that the board has determined to be independent. The disclosure would be provided in the annual proxy statement (or, if the issuer does not file a proxy statement, in its Form 10-K or Form 20-F).

#### **What if our company has an unexpected vacancy or disqualification among the independent directors?**

The principal issue in this case would be that the company might no longer meet the requirement that a majority of the board members be independent directors. The NASDAQ rules contemplate a cure period if a company fails to comply with the independent board majority requirement due to one vacancy, or if one director ceases to be independent due to circumstances beyond his or her reasonable control. In that event, the company must notify NASDAQ immediately upon learning of the event or circumstance that caused the non-compliance, and it must resume compliance by the earlier of the next annual stockholder meeting or one year after the occurrence of the event that caused the non-compliance.

### **Board Activities**

#### **I've heard that independent directors are required to meet separately in executive sessions. Is that right? How many sessions are required?**

The new rules require that independent directors hold regularly scheduled meetings at which only independent directors are present. No specific number of such sessions is required, but NASDAQ suggests that such executive sessions occur at least twice a year, and perhaps more frequently, in connection with regularly scheduled board meetings.

#### **How are conflicts of interest addressed by the new NASDAQ rules?**

Companies are required to conduct an appropriate review of all related party transactions, and any related party transactions must be approved by the company's Audit Committee (or another independent committee).

#### **What are "related party transactions" for purposes of these rules?**

The transactions requiring Audit Committee approval under the NASDAQ rules are the same transactions for which disclosure would be required in an annual proxy statement under SEC rules. In general, relevant transactions include any transaction or series of similar transactions, involving \$60,000 or more, in which any of the following persons had a direct or indirect material interest: directors, director nominees, executive officers, greater-than-five percent security holders, and family members of those persons.

#### **Are we required to have new committees?**

The only committee that NASDAQ requires is the Audit Committee. However, many companies will find it convenient to have a Compensation Committee and a Nominations Committee, each with an appropriate charter.

### **Audit Committee**

#### **What is our Audit Committee charter required to cover?**

Each NASDAQ-listed company must certify that it has adopted a formal written charter of the Audit Committee, and that the Audit Committee has reviewed and reassessed the adequacy of that charter on an annual basis. The charter must specify:

- The committee's purpose – overseeing the accounting and financial reporting process of the company and audits of the company's financial statements;
- The scope of the committee's responsibilities and the means by which the committee carries out those responsibilities, including structure, processes and membership requirements; and
- The committee's responsibility for ensuring receipt of independence statements from the company's independent auditor, and its responsibility for maintaining an active dialogue with the independent auditor about relationships or services that might affect auditor independence.

Consistent with these requirements, the Audit Committee charter must also provide the committee with responsibilities and authority sufficient to comply with provisions of Exchange Act Rule 10A-3, which was added pursuant to the Sarbanes-Oxley Act.

**How many members must the Audit Committee have? What are the qualifications for members?**

As before, NASDAQ requires each listed company to have an Audit Committee of at least three members. In order to be eligible to serve on an Audit Committee, a director must:

- Qualify as an independent director;
- Meet the “super-independence” criteria for Audit Committee membership described below;
- Not have participated in preparing the financial statements of the company or any current subsidiary of the company at any time in the past three years; and
- Be able to read and understand fundamental financial statements, including a company’s balance sheet, income statement and cash flow statement.

NASDAQ has not changed the financial acumen standards that apply to all Audit Committee members. In addition, NASDAQ’s requirement that one member of the Audit Committee be financially sophisticated continues to apply – note that this is a less stringent qualification than the new standard established by the SEC for its “audit committee financial expert” disclosure rules. NASDAQ commentary confirms that a director who qualifies as an audit committee financial expert is presumed to qualify as a financially sophisticated Audit Committee member for NASDAQ purposes.

Under exceptional and limited circumstances, one member who is not an independent director, but who is also not a current officer, employee or family member of an officer or employee, may serve on the Audit Committee for no longer than two years.

**What are the “super-independence” requirements that apply to Audit Committee members?**

Separately from the NASDAQ listing requirements, Exchange Act Rule 10A-3 mandates special independence standards for Audit Committee members. In essence, those additional “super-independence” rules require that no member of the Audit Committee receive any compensation from the

company other than for board or committee service, and that none is an affiliated person of the company. As such, no member of a listed company’s Audit Committee may accept any consulting, advisory or other compensatory fee from the company. Compensatory fees, however, do not include the receipt of fixed amounts under a retirement plan (including deferred compensation) for prior service with the company, provided that the compensation is not contingent on continued service.

No member of a listed company’s Audit Committee may be an affiliated person of the company or any company subsidiary. An affiliate is a person that directly or indirectly controls, is controlled by, or is under common control with the company. Executive officers, directors and large shareholders are generally deemed affiliates. A safe harbor rule provision protects from this affiliate determination persons who own 10% or less of any a company’s voting equity securities and are not company executive officers. Where a director owns or controls more than 10% of the company’s securities, directly or indirectly, special care must be taken to determine whether that director is eligible to serve on the Audit Committee.

**Are there any situations in which a company would not be required to comply with these Audit Committee composition requirements?**

Yes. For example, if a company fails to comply with the Audit Committee composition requirements because one director ceases to be independent due to circumstances beyond his or her reasonable control, the director may remain on the Audit Committee until the earlier of the next annual stockholder meeting or one year after the event that caused the company to fail to comply with these requirements. In addition, if a company fails to comply due to one vacancy on the Audit Committee, the company may allow the vacancy to continue until the earlier of its next annual stockholder meeting or one year after the event that caused the company to fail to comply with these requirements. A company that relies on either exemption must notify NASDAQ immediately upon learning of the event or circumstance that caused the non-compliance.

**Compensation Committee and Nominations Committee**

Are we required to have a Compensation Committee now? Not quite. The new NASDAQ rules require that the compensation of the chief executive officer and all other

executive officers be determined, or recommended to the board of directors for determination, either by a majority of the independent directors or by a Compensation Committee of only independent directors. The chief executive officer may not be present during voting or deliberations with respect to his or her compensation. A Compensation Committee of at least three members may include, for up to two years, one non-independent director, so long as he or she is not a current employee or officer (or a family member of an employee or officer), under “exceptional and limited circumstances.” Disclosure of the nature of the non-independence relationship and the reasons for the board’s determination must be made in the annual proxy statement.

**Are we required to have a Nominations Committee now?**

Not quite. Taking the same approach as it did for executive officer compensation, NASDAQ requires that director nominees must be selected, or recommended for the board’s selection, either by a majority of the independent directors or by a Nominations Committee of only independent directors. Temporary non-compliance with respect to one member of a three-member Nominations Committee is permitted in exceptional and limited circumstances, as is the case for the Compensation Committee.

Note that under new proxy statement disclosure requirements, the SEC now requires the company to disclose whether the Nominations Committee members are independent.

**What happens if we have conflicting obligations about director nominations?**

Independent director oversight of director nominations does not apply in cases where a third party has the legal right to nominate a director, such as pursuant to a stockholders’ agreement. Similarly, it does not apply where the company is subject to a binding obligation that requires a director nomination structure that is inconsistent with this rule and that obligation was entered into before November 4, 2003.

**Corporate Practices and Related Disclosures**

**Is my company required to adopt a code of conduct?**

Yes. Every NASDAQ-listed company must adopt a code of conduct that applies to all of its directors, officers and employees. The code of conduct must be publicly available.

**I know that the SEC mandates a code of ethics; how does the NASDAQ “code of conduct” relate to the SEC “code of ethics”?**

SEC rules require companies to report whether or not they have adopted a code of ethics that covers their chief executive officer and senior financial and accounting officers. The NASDAQ rules require that the company code of conduct must satisfy the SEC’s definition of a code of ethics under Regulation S-K Item 406.

The code of conduct must provide for an enforcement mechanism that ensures prompt and consistent enforcement, protections for persons reporting questionable behavior, clear and objective standards for compliance, and a fair process by which to determine violations.

**May the company waive provisions of the code of conduct?**

Yes. Provisions of the code of conduct may be waived in accordance with code processes. Any such waivers for the company’s directors or executive officers may be made only by the board of directors and must be disclosed in a Form 8-K, along with the reasons for the waiver, within five business days after the waiver.

**What do the new rules require if my company receives an audit opinion that contains a “going concern” qualification?**

The new rules require that, if a NASDAQ-listed company receives an audit opinion containing a “going concern” qualification, the company must make a public announcement through the news media disclosing the receipt of such qualification. The public announcement must be provided to NASDAQ StockWatch and released to the media not later than seven calendar days following the filing of the audit opinion in a public filing with the SEC.

**How much information about nominations must be disclosed?**

Each company must certify to NASDAQ that it has adopted a formal written charter or board resolution addressing the nominations process and related matters that may be required by federal securities laws. For example, the SEC recently adopted expanded disclosure requirements about the operations of nominations committees or independent directors performing the nominating function. These new disclosures are relatively extensive, and are designed to enhance transparency about the director nominating process.

## Effectiveness and Implementation Timing

### When does my company have to comply with the new rules?

NASDAQ-listed companies must comply with the rules regarding director independence, independent committees and notification of non-compliance by the earlier of the company's first annual stockholder meeting held after January 15, 2004 or October 31, 2004. Foreign private issuers and small business issuers have until July 31, 2005 to comply.

If your company has a classified, or staggered, board of directors, it has until the second annual meeting after January 15, 2004 (but not later than December 31, 2005) to meet the new requirements for board composition if earlier compliance would require the company to change a director who would not normally stand for election at an earlier annual meeting. However, no extended compliance date applies to Audit Committee requirements.

Companies must be in compliance with the code of conduct rules by May 4, 2004.

Companies must be in compliance with the rules related to Audit Committee approval of related party transactions by January 15, 2004.

Foreign private issuers must disclose the receipt of a NASDAQ corporate governance exemption in new listings and filings made after January 1, 2004.

### Is there some sort of phase-in or delayed effectiveness for companies that will become listed on NASDAQ in connection with an initial public offering?

Yes, but it is limited. A company to be listed on NASDAQ in connection with its initial public offering will be exempt from the independent majority board requirement for one year. For each board committee, the company would be required to have one independent director at the time of listing, a majority of independent directors within 90 days of listing, and entirely independent members within one year. Alternatively, the company could elect not to constitute a Compensation Committee or a Nominations Committee, but instead rely upon a majority of the independent directors to discharge the company's responsibilities.

### Are "controlled companies" subject to these rules?

"Controlled companies" are those companies in which an individual, group or another company holds a majority of the voting securities. Controlled companies are exempt

from the requirements of board independence, executive compensation and director nominations. Any controlled company relying on this exemption must disclose in its next annual meeting proxy statement that it is a controlled company and the basis for that determination. Controlled companies remain subject to the Audit Committee and executive session requirements.

### How do NASDAQ's qualitative listing requirements apply to non-U.S. companies?

Currently all non-U.S. companies may receive exemptions from NASDAQ's qualitative listing requirements upon a showing by the company that such requirements are contrary to a law, rule or regulation of any public authority exercising jurisdiction over such company, or contrary to the generally accepted business practices in the company's home country. However, the newly adopted NASDAQ rules limit the availability of those exemptions to foreign private issuers, rather than all non-U.S. companies. Foreign private issuers will still be required to comply with the Audit Committee requirements of Exchange Act Section 10(m) and Exchange Act Rule 10A-3.

### What if I have more questions?

Should you have any questions about these new requirements, please contact any member of your Fenwick & West team. You may also contact Scott Leichtner ([sleichtner@fenwick.com](mailto:sleichtner@fenwick.com)), Dan Winnike ([dwinnike@fenwick.com](mailto:dwinnike@fenwick.com)) or Horace Nash ([hnash@fenwick.com](mailto:hnash@fenwick.com)), who contributed to this update.

*December 11, 2003*

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