

Supplement: Summary of NYSE and NASDAQ Corporate Governance Rules

The NYSE and NASDAQ have adopted, and the SEC has approved, changes to their corporate governance rules, which are summarized below. The most recent changes approved by the SEC are italicized.

The New York Stock Exchange

The principal NYSE rule changes are contained in Section 303A of the NYSE Listed Company Manual.

Independent Directors

Independent directors must comprise a majority of the board of every listed company. NYSE rules previously required that only 3 members of a company's board qualify as independent directors, regardless of the size of the board.

- Controlled Company Exemption – An exemption is available for controlled companies (companies of which over 50% of the voting power is held by a single person, entity or group). A controlled company must disclose its reliance on this exemption and the basis for considering itself a controlled company in its proxy statement or Form 10-K.
- Standards for Director Independence
 - The board must affirmatively determine that an independent director has no material relationship with the company and disclose the basis for this determination in its proxy statement or Form 10-K.
 - Categorical Standards – A company may create (and disclose) categorical standards for determining independence. Only deviations from the standards require specific explanation in the proxy statement or Form 10-K.
 - Stock Ownership – Ownership of a significant amount of the listed company's stock, in and of itself, does not preclude a finding of independence. The concern is independence from management.
 - Prohibited Relationships – Several relationships do preclude a finding of independence, including:
 - Employee Test – A director who is employed by, *or whose immediate family member is employed as an executive officer of*, the listed company would not be independent until three years after the end of the employment relationship. *Employment as an interim chairman or CEO will not disqualify a director following that employment.*
 - The Direct Compensation Test – A director who receives, or whose immediate family member receives, more than \$100,000 per year in direct compensation from the listed company *is not independent* until *three years* after he or she, or such family member, ceases to receive more than \$100,000 in such compensation.

- ❖ *Under revised rules proposed by the NYSE in March 2003, a director who received such compensation was presumed not to be independent. The final rules eliminate the presumption and impose a bright-line test.*
- ❖ *Compensation paid to an immediate family member who is not an executive officer does not count for this test.*
- **Auditor Affiliation Test** – A director who is affiliated with or employed by, or whose immediate family member is affiliated with or employed in a professional capacity by, a present or former auditor of the listed company is not independent until *three years* after the end of either the affiliation or the auditing relationship.
- **Interlocking Directorate Test** – A director who is employed, or whose immediately family member is employed, as an executive officer of another company where any of the listed company’s current executive officers serve on that company’s compensation committee is not independent until *three years* after the end of such service or the employment relationship.
- **Business Relationship Test** – A director who is an executive officer or an employee, or whose immediate family member is an executive officer, of another company, *that makes payments to, or receives payments from, the listed company for property or services in an amount which, in any single year accounts for at least 2% or \$1 million, whichever is greater, of such other company’s consolidated gross revenues* is not independent until three years after falling below such threshold.
 - ❖ *The final rules clarify that charitable organizations are not considered “companies” for purposes of the business relationship test, provided that a listed company shall disclose any charitable contributions made by the listed company to any charitable organization in which a director serves as an executive officer if, within the preceding three years, contributions in any single year exceeded the greater of \$1 million, or 2% of the charitable organization’s consolidated gross revenues. The final rules caution boards to consider the materiality of any relationships between directors and charitable contributions when assessing independence under Section 303A(2).*
 - ❖ *The payments and the consolidated gross revenues to be measured under this test are those reported in the last completed fiscal year.*
 - ❖ *The provision applies only to the financial relationship between the listed company and the director or immediate family member’s current employer. A listed company would not need to consider former employment of the director or immediate family member.*
- **Definition of Immediate Family Member** – For purposes of these tests, an “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-law, and anyone (other than employees) who shares such person’s home. *When applying the look-back provisions, listed companies do not need to consider individuals who are no longer family members because of legal separation or divorce, or those who have died or become incapacitated.*
- **Definition of Company** – For purposes of these tests, a “company” includes any parent or subsidiary in a consolidated group with the company.
- **Cooling-Off Periods** – *Each of the independence tests contains a three-year “cooling-off” period before the director would become eligible to be independent directors. Under revised rules proposed by the NYSE in March 2003, the cooling-off period was only to be applied prospectively. Relationships that ended prior to the effective date of the new rules would not disqualify a director. Under the final rules, the independence tests*

have a one-year look-back period during the first year after the effective date of the rules and a three-year look back thereafter. For example, if a director received in excess of \$100,000 per year in direct compensation from a listed company during the year prior to the effective date of the rules, the director would be disqualified; if he received the \$100,000 only during the year before that, he would not be disqualified. However, once the three-year look back became applicable, the director would again be disqualified.

- By contrast, under current listing standards, the three independent directors requirement has been unwritten and independence determinations have been left entirely within the board's discretion.

Meetings of Non-Management Directors

Non-management directors must hold regularly scheduled meetings, outside the presence of management.

- Independent Directors – This group may include non-management directors not otherwise considered independent. *If this group includes directors who are not independent, the company should schedule an executive session including only independent directors at least once a year.*
- Presiding Directors – The company must designate a lead director to preside at these meetings. The company need not appoint a single lead director for all meetings, but if one is chosen, the lead director must be publicly identified. If different presiding directors are chosen for different meetings, the company must disclose the procedures for choosing the presiding directors. In either case, a company must disclose a method for third parties to contact the non-management group or presiding member directly.

Nominating and Compensation Committees

Listed companies must have a nominating/corporate governance committee and a compensation committee, each comprised entirely of independent directors.

- Controlled Company Exemption – Controlled companies are exempt from the requirement that these committees include solely independent directors. A controlled company must disclose its reliance on this exemption in its proxy statement or Form 10-K.
- Duties of the Nominating Committee – The duties of the nominating committee include the identification, selection or recommendation, of qualified candidates for board membership. Nominations governed by third party contractual rights (for example, stockholders' agreements) need not be subject to the nominating committee process.
- Duties of the Compensation Committee – The duties of the compensation committee include reviewing and approving corporate goals and objectives relevant to CEO compensation, evaluating the CEO's performance in light of those goals and setting the CEO's compensation level based on this evaluation.
 - *The compensation committee is required to produce a report on executive compensation to be included in the company's proxy statement or Form 10-K filed with the SEC.*
 - *The compensation of the CEO may be determined either by the compensation committee alone or together with the other independent directors (as directed by the full board).*
 - *The NYSE has clarified that the board in general is not prohibited from discussing the CEO's compensation.*

Independence and Authority of Audit Committee

- *NYSE listed companies must comply with the audit committee requirements imposed by the Sarbanes-Oxley Act and adopted as Rule 10A-3 of the Securities Exchange Act of 1934.*
- The audit committee must have sole responsibility for hiring and firing the independent auditors and for approving significant non-audit work by the auditors. Listed companies may still have stockholders ratify the choice of independent directors.
 - The current rules, by contrast, provide that the audit committee *and the board* retain *ultimate responsibility* for selection, evaluation and replacement of the auditors.
- Other responsibilities with which the audit committee is expressly charged include:
 - Reviewing internal controls, evaluating the performance of the auditors and reviewing at least annually all relationships between the auditor and the company.
 - Periodic meetings with management and the independent auditors and discussing with them all annual and quarterly reports, including MD&A.
 - Discussing earnings press releases, as well as financial data and guidance provided to analysts and rating agencies, which may be satisfied by a general discussion of appropriate types of information rather than case-by-case reviews of releases and guidance.
 - Setting hiring policies for former employees of the auditors.

Corporate Governance Guidelines and Officer Certifications

- Listed companies must adopt and disclose their corporate governance guidelines, written charters for the audit, nominating and compensation committees, and a code of business ethics for directors, officers and employees. Companies must state in their *Form 10-K filed with the SEC* that these charters and codes have been adopted and are available on the company's website. Any waivers of the code for directors and executive officers must be promptly disclosed.
- Each listed company CEO must certify to the NYSE that he or she is not aware of any violation by the company of the listing standards.

Foreign Private Issuers

Listed foreign private issuers are allowed to follow the practices of their home countries in lieu of the new requirements, except that these issuers must have an audit committee that meets the requirements of Rule 10A-3 of the Exchange Act and must notify the NYSE in writing when any executive officer becomes aware of any non-compliance with any applicable provision.

Listed foreign private issuers must disclose any significant ways in which their corporate governance practices differ from those followed by domestic listed companies. The NYSE notes in commentary that a detailed line-by-line analysis of the differences is not required. The issuer may provide a brief, general discussion of the differences on its website (provided the website is in English and is accessible from the United States) and/or in its annual report distributed to shareholders in the United States.

Equity-Based Compensation Plans

For a discussion of the final rules approved by the SEC relating to equity-based compensation plans, please see our SEC Alert dated July 22, 2003 available on our website or by clicking on the following link: [July 22, 2003 Alert](#)

Deadlines for Compliance

- Currently Listed Companies – Listed companies must comply with the new corporate governance rules by the earlier of their first annual meeting after January 15, 2004, or October 31, 2004. Companies with classified boards are not required to replace a director if that director would not normally stand for election in the first annual meeting after January 15, 2004. Such a director may continue in office until the second annual meeting after January 15, 2004, but no later than December 31, 2005.
- Foreign Private Issuers – Listed foreign private issuers must comply with the new audit committee standards by July 31, 2005 and all other requirements by the earlier of their first annual meeting after January 15, 2004, or October 31, 2004.
- Initial Public Offerings; Bankruptcy; Others – Companies listing in connection with their initial public offering may phase in their independent nomination and compensation committees on the same schedule as that required for audit committees under Rule 10A-3 of the Securities Exchange Act of 1934. These companies must have one independent member on each committee at the time of listing, a majority of independent members within 90 days of listing, and fully independent committees within one year of listing. These companies would be required to meet the majority independent board requirement within 12 months of listing.

Transition Rules

- Companies that are emerging from bankruptcy or that have ceased to be controlled companies may phase in their independent nomination and compensation committees on the same schedule as companies listing in connection with their initial public offering. Companies that are transferring from another market to the NYSE have 12 months from the date of transfer to comply with any requirement to which it was not previously subject in the other market.

The Nasdaq Stock Market

The principal Nasdaq rule changes are contained in NASD Rules 4200 (Definitions) and 4350 (Qualitative Listing Requirements for Nasdaq National Market and Nasdaq SmallCap Market Issuers Except for Limited Partnerships).

Independent Directors

- Independent Directors to Comprise a Majority of the Board. Every listed company must have a board of directors comprised of a majority of independent directors.
 - Cure Period – If a company does not have a majority of independent directors because of one vacancy or one director ceases to be independent due to circumstances beyond his or her reasonable control, the issuer must remedy the situation before the earlier of its next annual shareholders meeting or one year from the date of the occurrence of the event that caused the failure to comply.
 - Disclosure – A company must disclose the directors that the board determines to be independent in its proxy statement or Form 10-K.
 - Executive Sessions – The new rules require that the independent directors hold regularly scheduled executive sessions at which only independent directors are present.
 - The comparable NYSE provision requires regularly scheduled meetings of non-management directors, whether independent or not.
- Definition of “Independent” Director. The new rules clarify and tighten the definition of independence and preclude the following individuals from being considered independent:

- Payments Test – A director who accepts payments, or has a family member who accepts payments, in excess of \$60,000 during the current or any of the past three fiscal years except for the following:
 - 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 a parent or subsidiary of the company;
 - Benefits under tax-qualified retirement plans; or
 - *Loans permitted under Section 13(k) of the Exchange Act.*¹
 - Employee Test – Under current Nasdaq rules, which are not being amended by the new rules, a director is not independent if the director is an officer or employee of the company or any of its subsidiaries or the director has a relationship which, in the opinion of the board, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.
 - Business Relationship Test – A director who is, or *who has a family member who is*, an executive officer, partner or controlling shareholder of any organization (including charities) to which the company paid or from which the company received payments exceeding the greater of \$200,000 or 5% of the recipient’s consolidated gross revenue in the current year or any of the past three years.
 - Family of Executive Officer Test – A director who has a family member who is, or was at any time during the previous three years, an executive officer of the company or its affiliates.
 - Auditor Relationship Test – A director who is, *or has a family member who is*, a current partner of the outside auditors, or former partner or employee of the outside auditors who worked on the company’s audit engagement during the previous three years.
 - Interlocking Directorate Test – A director who is, *or who has a family member who is*, employed as an executive officer of another entity in which any of the executive officers of the listed company have served on the other entity’s compensation committee during the past three years.
 - Definition of Family Member – A family member is defined as *a person’s spouse, parents, children and siblings, whether by blood, marriage or adoption, or anyone residing in such person’s home.*
- Investment Company Directors. *Directors of investment companies will not be considered independent if the director is an “interested person” under Section 2(a)(19) of the Investment Company Act of 1940. This standard will apply to directors of investment companies in lieu of the other standards for determining independence.*

Compensation of Officers

The new rules mandate the involvement of the independent directors in setting compensation for executives of the company. They do not, however, mandate that there be a compensation committee, although most companies will probably choose to establish one.

- CEO Compensation – Independent directors are required to determine, or recommend to the Board for determination, CEO compensation, either by an independent compensation committee or a majority of independent directors. *The CEO may not be present during these deliberations or voting.*

¹ A limited exception permitted by the Sarbanes-Oxley Act for companies in the business of lending.

- Officer Compensation – Independent directors are required to determine, or recommend to the Board for determination, executive officer compensation, either by an independent compensation committee or a majority of independent directors.
- Exception – A single non-independent director would be permitted to serve on the compensation committee for no longer than two years if:
 - The individual is not a current officer or employee (or a family member of an officer or employee).
 - The board, under “exceptional and limited circumstances,” determines that the person’s membership on the committee is required by the best interests of the company.

A company is required to disclose its reliance on this exception in its proxy statement or Form 10-K.

Nomination of Directors

The new rules also require involvement of the independent directors in nominating individuals to serve on the board of directors.

- Selection of Nominees – Director nominees must be selected, or recommended for the Board’s selection, by a majority of the independent directors or a nominations committee comprised solely of independent directors *unless the right to nominate a director legally belongs to a third party or the company is subject to a binding obligation that requires a different and conflicting director nomination structure that pre-dates the effectiveness of the new rules.*
- Certification – *Each listed company must certify that it has adopted a formal written charter or board resolutions addressing the nominations process.*
- Exception – A single non-independent director would be permitted to serve on the nominating committee for no longer than two years if:
 - The individual is not a current officer or employee (or family member of an officer or employee).
 - The board, under “exceptional and limited circumstances” determines that the person’s membership on the committee is required by the best interests of the company.

A company is required to disclose its reliance on this exception in the company’s proxy statement or Form 10-K.

Exemption for Controlled Companies

A controlled company is exempt from the requirement to have a majority of independent directors and from the compensation and nomination committee requirements. However, independent directors of controlled companies are required to hold regularly-scheduled executive sessions.

- Definition of Controlled Company – A controlled company is one in which more than 50% of the voting power is held by an individual, a group or another company.
- Disclosure – A controlled company must disclose that it is a controlled company and the basis for that determination in its annual proxy statement or Form 10-K.

Audit Committee

The rules contain a number of new requirements regarding composition and responsibilities of the audit committee.

- **Membership** – Each member of the audit committee must be independent, *must meet the definition of independence under Rule 10A-3(b)(1) of the Exchange Act, and must not have participated in the preparation of the financial statements of the company or any current subsidiary of the company at any time during the past three years.* A single non-independent director would be permitted to serve on the audit committee for no longer than two years, during which time the director may not chair the audit committee, if:
 - The individual meets the criteria set forth in Section 10A(m)(3) of the Exchange Act and the rules thereunder.
 - The board, under “exceptional and limited circumstances,” determines that the person’s membership on the committee is required by the best interests of the company.
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A company is required to disclose its reliance on this exception in the company’s proxy statement or Form 10-K.

- **Responsibilities** – The audit committee is to have the responsibilities and authority *necessary to comply with Rules 10A-3(b)(2), (3), (4) and (5) of the Exchange Act relating to (a) registered public accounting firms, (b) complaints relating to accounting, internal accounting controls or auditing matters, (c) authority to engage advisors and (d) funding as determined by the audit committee.*
 - **Investment Companies** – Audit committees of investment companies must establish procedures for the confidential and anonymous submission of complaints regarding accounting or auditing matters by employees of the investment company, investment adviser, administrator, principal underwriter, or any other provider of accounting related services.
- **Committee Charter** – The rules require that an audit committee charter now include the committee’s purpose in overseeing the accounting and financial reporting processes of the issuer and audits of the issuer’s financial statements, as well as specific audit committee responsibilities.
- **Cure Period** – *If a company fails to have an audit committee with at least three independent members because a member ceases to be independent due to circumstances beyond his or her reasonable control, the issuer must remedy the situation prior to the earlier of its next annual shareholders meeting or one year from the date of the occurrence of the event that caused the failure to comply.*

Disclosure of Going-Concern Opinions

Going concern qualifications in the opinion of a company’s independent auditors must be disclosed in a press release.

Related Party Transactions

All related party transactions must be reviewed (as required by current Nasdaq rules) and affirmatively approved by the audit committee or comparable body.

Notice of Non-Compliance

An issuer must notify Nasdaq promptly of any material noncompliance by the issuer with the requirements of NASD Rule 4350 (Qualitative Listing Requirements for Nasdaq National Market and Nasdaq SmallCap Market Issuers Except for Limited Partnerships).

Foreign Issuers

Nasdaq rules currently provide that a foreign issuer is not required to do any act that would violate the laws of any public authority having jurisdiction over it or that is contrary to generally accepted business practices in its home jurisdiction. Nasdaq may provide exemptions from Rule 4350 necessary to carry out this intent. The new rules clarify that the authority to grant exemptions is limited to foreign private issuers instead of all foreign issuers.

The new rules require that a foreign issuer that receives an exemption from Rule 4350 disclose in its annual report filed with the SEC each requirement from which it is exempted and describe the practice followed in its home jurisdiction, if any. A foreign issuer making its initial public offering or first U.S. listing on Nasdaq is required to disclose any exemptions in its registration statement.

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- *Foreign Private Issuers – Foreign private issuers must comply with the new corporate governance rules by July 31, 2005.*
- *Initial Public Offerings; Bankruptcy; Others – Companies listing in connection with their initial public offering may phase in their independent nomination and compensation committees on the same schedule as that required for audit committees under Rule 10A-3 of the Securities Exchange Act of 1934. These companies must have one independent member on each committee at the time of listing, a majority of independent members within 90 days of listing, and fully independent committees within one year of listing. These companies would be required to meet the majority independent board requirement within 12 months of listing.*

Companies Transferring to Nasdaq

- *Companies that are transferring from another market to Nasdaq have one year from the date of listing on Nasdaq to comply with any requirement to which it was not previously subject in the other market.*

Stockholder Approval of Option and Stock Purchase Plans

For a discussion of the final rules approved by the SEC relating to equity-based compensation plans, please see our SEC Alert dated July 22, 2003 available on our website or by clicking on the following link: [July 22, 2003 Alert](#).

Contact Information

If you have any questions or would like to learn more about these rules, please contact your usual legal advisor at Ropes & Gray.