

Nasdaq Refines Director and Committee Rule Proposals

April 30, 2003

[Marked to show changes from relevant portions of Perkins Coie's October 18, 2002 Update]

Nasdaq contemplates that rule changes affecting Board of Directors or Board committee composition will become effective with a listed company's first annual meeting after January 1, 2004.

Increased Board Independence and Role of Independent Directors

Majority of Independent Directors

A majority of the directors of a listed company would be required to qualify as "independent" directors.

Qualification as an Independent Director

The new rules would tighten the definition of "independent" director. A director could *not* be deemed "independent" by a company's Board of Directors if he or she

- or a "family member" (i.e., a relative by blood, marriage or adoption, or any person who has the same residence) accepted from the company or ~~its affiliates~~ any "parent or subsidiary" (i.e., entities that are consolidated with the company's financial statements) any payments in excess of \$60,000 during the current or any of the past three fiscal years, ~~including any political contributions, but excluding Board fees, benefits under tax-qualified retirement plans, and non-discretionary compensation, other than~~
 - compensation for board service,
 - payments arising solely from investments in the company's securities,
 - compensation paid to a family member who is an employee of the company or its parent or subsidiary (but not if such family member is an executive officer of the company or its parent or subsidiary),
 - ~~including any political contributions, but excluding Board fees, benefits under tax-qualified retirement plans, and non-discretionary compensation, or~~
 - nondiscretionary compensation (provided, however, that audit committee members would be subject to heightened requirements under NASD Rule 4350(d), discussed under "Further Independence Requirements for Audit Committee Membership" below).
- is or within the past three years has been employed by (or has a family member who is or within the past three years has been employed as an executive officer of) the company or its parent or subsidiary,
- is a partner, executive officer or controlling shareholder of any organization (including a not-for-profit organization) that in the current or any of the past three fiscal years received from or made payments to the company exceeding the greater of \$200,000 or

5% of the recipient's consolidated gross revenues for the year current fiscal year or any of the past three fiscal years, other than payments arising solely from investments in the listed company's securities,

- is a former partner or employee of the company's outside auditor and worked on the company's audit within the past three years, or
- is part of an "interlocking directorate" -- where a listed company's executive officer serves on another company's compensation committee that employs the director as an executive -- or if such relationship existed within the past three years.

Executive Sessions for Independent Directors

Independent directors would be required to meet "regularly" in executive sessions, without management or other directors present. Nasdaq contemplates at least two executive sessions each year, and proposes that this rule become effective six months after SEC approval.

Increased Role in Compensation and Nomination Decisions

An independent compensation committee or a majority of the independent directors meeting in executive session would determine compensation for the CEO and other executive officers. The CEO could be present for compensation discussions for other executive officers, but could not vote. One non-independent director could serve for two years on the independent compensation committee if the committee has at least three members and "exceptional and limited circumstances" exist.

The "exceptional and limited circumstances" exception for committee service would be available for a director who is not an officer or employee of the company or a family member of such a person, but only if the Board determines that the director's service on the committee is in the best interests of the company and its shareholders and the company discloses in the next annual proxy statement the director's relationship to the company and the basis for the Board's determination. A director relying on the special exceptional and limited circumstances exception could not serve on the committee for more than two years.

An independent nominating committee or a majority of the independent directors would be required to approve all director nominations, except where a third party by contract or otherwise legally has the legal right to nominate a director. The "exceptional and limited circumstances" exception would also be available for service on the nominating committee under the same conditions as for service on the compensation committee. Alternatively, one non-independent director who

- is not independent because he or she is an officer ~~or employee~~ of the company ~~or a family member of such a person, and~~
- ~~does not own or control~~ owns or controls more than 20% of the company's voting securities,
- ~~receives no compensation from the company other than as a Board or committee member, and~~

- ~~is not an "affiliated person" of the company or any subsidiary,~~

could serve on the nominating committee if the Board determines his or her service on the committee is in the best interests of the company and its shareholders, and the company discloses in the next annual proxy statement the director's relationship to the company and the basis reasons for the Board's determination.

Controlled Company ~~Exception~~ Exemption

There is no "controlled company" exemption from the Sarbanes-Oxley Act. Nasdaq proposes an exemption, however, from many of its requirements for independent directors. If a listed company is a "controlled company" (i.e., one where more than 50% of the voting power of the company's securities is held by an individual, group or another company), the company need not:

- have a majority of independent directors on its Board,
- hold regular executive sessions of independent directors, or
- maintain independent compensation and nominating committees.

The company must disclose in its annual proxy statement that it is a controlled company and the basis for that determination. A controlled company must continue to comply with Nasdaq's requirement for an independent audit committee and other audit committee rules.

Increased Role and Independence ~~and Role~~ of Audit Committee

Further Independence Requirements for Audit Committee Membership

Existing Nasdaq rules generally require that listed companies have an audit committee comprised solely of at least three independent directors. The proposed rules would impose additional requirements for audit committee members beyond the tightened definition of "independent" director discussed above. Consistent with Section 301 of the Sarbanes-Oxley Act, audit committee members could may not:

- receive any compensation consulting, advisory or other compensatory fee from the company other than payment for Board or committee service, or
- be an "affiliated person" of the company or any parent or subsidiary.

Nasdaq would impose the additional requirement that no audit committee member own or control 20% or more of the company's voting securities, or such lower percentage as the SEC may designate. Nasdaq would also consider the employee of an entity that owns or controls such securities as an affiliated person.

Nasdaq's "exceptional and limited circumstances" exception would apply in a modified form for the audit committee. A director who does not satisfy the general "independence" standard for directors, but who does satisfy the additional audit committee independence requirements of the Sarbanes-Oxley Act listed above and who is not a current officer or employee or a family member of a company employee, could serve on the audit committee for up to two years, but not as the committee chair. In addition, the company must disclose

[the nature of the director's relationship and the reasons for the Board's determination in the company's next annual proxy statement.](#)

Financial Statement Literacy of Audit Committee Members; Financial Expert

All audit committee members would need to be able to read and understand fundamental financial statements at the time of their appointment. Also, the audit committee must have at least one "financial expert," consistent with Section 407 of the Sarbanes-Oxley Act. The SEC recently indicated that its proposed definition of "financial expert" will include all the attributes listed in Section 407 (essentially that the individual has expertise or be experienced in preparing or auditing financial statements of public companies as a result of education or service as a CPA, CFO, ~~comptroller~~ or other ~~role~~[senior officer](#) with similar ~~functions~~[responsibilities](#)) and that the SEC will provide a list of factors companies should consider in determining whether a member of the audit committee is a financial expert.

Approval of Related Party Transactions

A listed company's audit committee or a comparable body of independent directors would be required to review *and approve* all related-party transactions. Only review of these transactions is required under existing Nasdaq rules. Related-party transactions are described in Item 404(a) of SEC Regulation S-K and include transactions to which the company or a subsidiary will be a party that involve over \$60,000 and in which any director or nominee, executive officer, 5% or more shareholder or any family member of the foregoing has or will have a direct or indirect "material" interest.

Authority and Power of Audit Committee Over the Audit Process

Consistent with Sections 202 and 301 of the Sarbanes-Oxley Act, the proposed rules would require that the audit committee:

- ~~pre-approve~~[pre-approve all audit and permissible non-audit services provided by the company's accountants.](#)
- have exclusive authority to appoint, determine funding for, and oversee the outside auditors,
 - ~~pre-approve all audit and permissible non-audit services provided by the company's accountants,~~
 - ~~be authorized to engage and determine funding for independent legal counsel and other advisors, and~~
- establish procedures for the receipt, retention and treatment of complaints to the company regarding accounting, internal accounting controls or auditing matters, and for the confidential, anonymous submission by employees of accounting or auditing concerns; ~~and~~
- ~~be authorized to engage and determine funding for independent legal counsel and other advisors, and~~

[An audit committee would be required to adopt a formal written charter stating:](#)

- [the scope of its responsibilities and the means by which it carries them out.](#)
- [the auditor's accountability to the audit committee, and](#)
- [the audit committee's responsibility to ensure the independence of the outside auditor.](#)

These responsibilities and other matters would be required to be included in audit committee charters within six months after SEC approval of the proposed rule.

Elimination of Exception for Small Business Issuers

Small Business issuers would no longer be exempt from audit committee requirements generally applicable to U.S. listed companies.

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