

SEC APPROVES NEW NYSE AND NASDAQ CORPORATE GOVERNANCE RULES-FOCUS ON DIRECTOR INDEPENDENCE

Overview

On Tuesday, November 4th, 2003, the Securities Exchange Commission approved long-anticipated rules adopted by the New York Stock Exchange and the Nasdaq Stock Market, which are intended to increase director independence on corporate boards and strengthen corporate governance at listed companies.¹ Although the new rules adopted by the exchanges address a variety of topics related to corporate governance, the scope of this Client Alert is limited to a discussion of the most significant provisions:

- Independence of Majority of Board Members,
- Revised Definition of Independent Director,
- Separate Meetings for Independent Directors,
- Requirement of Independent Directors on the Audit Committee, Nominating/Corporate Governance Committee and Compensation Committee,
- Exemptions, and
- Implementation Dates.

The new rules promulgated by the NYSE and Nasdaq are the result of over a year of discussions between the exchanges and the SEC. The NYSE filed its original proposed rules with the SEC on August 16, 2002, and amended its proposals three times through October 20, 2003. Nasdaq filed its original proposed rules on October 9, 2002, and filed multiple amendments through October 30, 2003. One reason for the lengthy development of the rules was the desire on the part of

the SEC to harmonize each set of rules as much as possible.

Summary of Significant Changes from Prior Proposals

Most of the amendments by the exchanges worked to clarify the proposed rules as originally crafted. In this context, definitions were expanded, extended commentary was developed and ambiguous language was deleted.² However, a number of the key amendments were intended to harmonize the proposals of the two exchanges. Here, the exchanges worked to synchronize definitions and requirements as much as possible.

In harmonizing the rules, the exchanges made many significant changes to their original proposals.³ One of the most important developments in the proposals was the election of a three-year look-back period by both exchanges in determining director independence. Originally, the NYSE proposal contained a five-year look-back. Also, the NYSE elected to relax its requirement that a compensation committee have *sole* discretion over chief executive officer salary, and allowed a majority of the independent directors to make this decision, thereby bringing the NYSE requirements closer to those required by Nasdaq. A third significant development was the addition by both exchanges of several important exemptions to certain rules for open and closed-end management companies.

Because the new listing rules are largely identical, the description of the rules in this Client Alert applies to the rules as adopted by both exchanges, except where otherwise noted.

Independence of Majority of Board Members

Perhaps the most notable provision of the new rules is the requirement that independent directors compose a majority of the board of directors of each listed company. Under the new listing rules, the board of directors of each listed company is required to affirmatively determine whether a director is independent and to disclose in its annual proxy statement which directors the board has determined to be independent.⁴ The NYSE rules also require a listed company to disclose the basis for its determination that a director is independent by adopting standards to assist it in making the determination of independence, disclosing those standards, and then making the statement that the independent directors meet those standards.

Definition of Independent Director

Independence rests on the relationship of a director or his or her immediate family to the listed company, and the rules of both exchanges provide considerable guidance in determining independence. In order for a director to be considered independent under the new listing rules, he or she must pass several tests, which include the following:⁵

- A director may not have been an employee of the listed company or a parent or subsidiary of the listed company during any of the past three years.⁶
- A member of the director's immediate family⁷ may not have been an executive officer of the listed company or a parent or subsidiary of the listed company during any of the past three years.
- Neither the director nor a member of the director's immediate family may have received more than \$100,000 (NYSE) or \$60,000 (Nasdaq) in direct annual compensation, except permitted payments, from the listed company in any of the past three years.⁸
- A director may not have been an executive officer or an employee, and a member of a director's immediate family may not have been an executive officer, of a company that made payments to, or received payments from, the listed company in exchange for property or services above the greater of \$1 million or 2%

of such other company's consolidated gross revenues for the year (NYSE) or the greater of \$200,000 or 5% of the recipient's consolidated gross revenues (Nasdaq) in any of the past three years.

- Neither the director nor any member of a director's immediate family may be a current partner of the listed company's outside auditor or have been a partner or employee of the listed company's outside auditor, or have worked on the listed company's audit, at any time, during the past three years.⁹
- A director or a member of a director's immediate family may not have been employed as an executive officer of another company during any of the last three years where any of the listed company's executives at the time served on that company's compensation committee.

Separate Meetings for Independent Directors

Both exchanges require that independent directors have regularly scheduled meetings without management present. Additionally, the NYSE rules note that listed companies must provide a method for parties to communicate directly with the independent directors in such meetings or with the presiding director of such meetings.

Requirement of Independent Directors on Committees

Audit Committee Independence

Another major component of the new listing rules addresses the requirement of independent audits—a requirement that is driven largely by the requirements of Section 301 of the Sarbanes-Oxley Act of 2002. Section 301 of Sarbanes-Oxley mandates that securities exchanges adopt rules which require listed companies to increase the power and independence of audit committees in a number of areas. First, exchange rules must provide that a listed company's audit committee be composed solely of independent directors. Section 301 also requires that the audit committee “be directly responsible for the appointment, compensation, and oversight” of the independent auditor and that the company's audit firm report directly to the audit committee. Further, this section requires that the exchanges grant the audit

committee power to employ independent counsel and other advisors, whose fees will be paid by the company. Finally, section 301 requires that the audit committee take more than a passive role in corporate governance, by mandating that the exchange rules require the audit committee to establish procedures for the receipt and evaluation of anonymous and other concerns regarding “questionable accounting or auditing matters.”

Accordingly, under the new listing standards, listed companies must maintain audit committees comprised entirely of independent directors.¹⁰ Audit committees must be composed of at least three directors who meet the independence requirements of then new NYSE and Nasdaq listing rules, respectively, as well as the requirements imposed by Section 301 of Sarbanes-Oxley Act. In order for a director to be considered to be independent under the new SEC rule promulgated pursuant to Section 301 of Sarbanes-Oxley Act, a member of an audit committee of a listed company may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee:

- Accept directly or indirectly any consulting, advisory, or other compensatory fee from the issuer or any subsidiary thereof, provided that, unless the rules of the national securities exchange or national securities association provide otherwise, compensatory fees do not include the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the listed issuer (provided that such compensation is not contingent in any way on continued service); or
- Be an affiliated person of the listed company or any subsidiary thereof.¹¹

The audit committee must also include at least one director who has an expertise in finance, and the entire committee must be financially literate. On January 24, 2003, the SEC adopted rules to implement Section 407 of Sarbanes-Oxley, which requires disclosure of the audit committee financial expert.¹² Under these rules, which became effective March 3, 2003, a company subject to the reporting requirements of the Securities Exchange Act of 1934 is required to annually disclose in its Exchange Act filings whether it has at least one "audit committee financial expert" on its audit

committee, and if so, the name of the audit committee financial expert and whether the expert is independent of management. A company that does not have an audit committee financial expert is required to disclose this fact and explain why it has no such expert. An "audit committee financial expert" is defined by the SEC rules to include a person who has the following attributes:

- An understanding of financial statements and generally accepted accounting principles;
- An ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;
- Experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities;
- An understanding of internal controls and procedures for financial reporting; and
- An understanding of audit committee functions.

An individual is not required to possess all of the attributes listed in the above definition to qualify as an audit committee financial expert. Also, the designation of a person as an expert does not impose any duties, obligations, or liabilities on that person which are greater than those of other audit committee members.

Under the NYSE rules, a listed company's audit committee must have a written charter that addresses the committee's purpose, responsibilities, and duties, and which provides for an annual performance evaluation of the audit committee. The NYSE rules enumerate the following responsibilities, among others for audit committees of listed companies:

- those responsibilities required under Section 301 of Sarbanes-Oxley¹³ (collectively, the "Section 301 Rules"),
- annually obtain and review a report by the internal auditor,

- discuss the company's financial information provided to analysts, rating agencies, and the public,
- discuss the company's annual audited financial statement and quarterly financial statements with management and the independent auditor,
- discuss policies with respect to risk assessment and risk management,¹⁴
- meet separately, periodically, with management, with internal auditors, and with independent auditors,
- review with independent auditors any audit problems and management's response, and report regularly to the board.

The Nasdaq rules requires the audit committee to adopt a formal charter which specifies the audit committee's purpose of overseeing the accounting and financial reporting methods, as well as overseeing the audits of the financial statements of the listed company. The Nasdaq rules require that the audit committee perform those requirements set out in the Section 301 Rules.¹⁵

Nominating/Corporate Governance Committee

Under the NYSE rules, a listed company must have an independent nominating/corporate governance committee composed entirely of independent directors. The purpose of this committee is to use standards approved by the board to identify individuals qualified to become board members.¹⁶ NYSE rules require the nominating/corporate governance committee to have a written charger that addresses the committees responsibilities and purpose.

However, Nasdaq rules are slightly less restrictive, providing that director nominees may be selected or recommended for the board's selection by either a nominating committee composed solely¹⁷ of independent directors or by a majority of the independent directors. Also, Nasdaq rules require that a listed company certify that it has a formal written charter or board resolution addressing the nominations process.

Compensation Committee

Under the NYSE rules, a listed company must have an independent compensation committee composed entirely of independent directors. This committee,

either as a committee or together with the other independent directors, would determine and approve the compensation of the chief executive officer and would make recommendations to the board with respect to non-CEO compensation.¹⁸ Additionally, the NYSE rules require the compensation committee to have a written charter that addresses the committee's responsibilities and purpose.

Again, Nasdaq rules are less restrictive than their NYSE counterparts, in that CEO compensation may be determined or recommended to the board for determination by either a compensation committee composed solely¹⁹ of independent directors or by a majority of the independent directors. The Nasdaq rules also provide that the compensation of all other directors must also be determined by one of the above methods.

Exemptions

The rules of both exchanges provide exemptions for Controlled Companies and other specified entities. A Controlled Company is a listed company of which more than 50% of the voting power is held by an individual, a group or another company. The NYSE rules exempt any listed Controlled Company, limited partnership, or company in bankruptcy from the requirements that its board be composed of a majority of independent directors, and that the company's nominating/corporate governance and compensation committees be composed entirely of independent directors. The Nasdaq rules exempt any Controlled Company from the requirement that a majority of its board be composed of independent directors, as well as from the Nasdaq rules relating to the independence of compensation and nomination committees. Under the rules of both exchanges, a company that elects to take advantage of any exemption must report such election in its annual proxy statement or Annual Report on Form-10K.

Implementation Dates

Both the NYSE and the Nasdaq rules require most listed companies to conform to the new corporate governance rules by the earlier of their first annual meeting after January 15, 2004, or by October 31, 2004.

Under both sets of rules, if a listed company is required to change a director on a classified or staggered board,

and that director would not normally stand for election in such annual meeting, the company will be permitted to keep the director in office until the second annual meeting after January 15, 2004, but no later than December 31, 2005.²⁰ In addition, the rules provide that foreign private issuers have until July 31, 2005 to comply with audit committee requirements under Rule 10A-3, and the Nasdaq rules also extend the deadline for other provisions of the new corporate governance

rules in the case of a foreign private issuer.²¹ Finally, special rules apply for companies listing in conjunction with an initial public offering or upon transfer from another market.

* * * *

Should you have further questions about this Client Alert, please contact the Kirkland partner with whom you normally communicate, or you may contact any of the following:

Chicago

Jack S. Levin, P.C.
(312/861-2004)
Carter W. Emerson, P.C.
(312/861-2052)
Keith S. Crow, P.C.
(312/861-2181)
R. Scott Falk
(312/861-2340)
Willard G. Fraumann, P.C.
(312/861-2038)
Michael H. Kerr, P.C.
(312/861-2094)
Dennis M. Myers
(312/861-2232)
Gerald T. Nowak
(312/861-2075)
James S. Rowe
(312/861-2191)

New York

Vincent J. Pisano
(212/446-4980)
Jonathan F. Pedersen
(212/446-4750)
Stephen Fraidin
(212/446-4840)
Thomas W. Christopher
(212/446-4790)
Lance C. Balk
(212/446-4950)
Joshua N. Korff
(212/446-4943)
Andrew E. Nagel
(212/446-4973)

Washington D.C.

George P. Stamas
(202/879-5090)
Mark D. Director
(202/879-5151)

San Francisco

Jeffrey C. Hammes
(415/439-1450)
David A. Breach
(415/439-1410)
Stephen D. Oetgen
(415/439-1414)

Los Angeles

Eva H. Davis
(213/680-8508)

London (Kirkland & Ellis

International LLP)
Stuart L. Mills
(4420-7816-8750)

This publication is distributed with the understanding that the author, publisher and distributor are not rendering legal, accounting, or other professional advice or opinions on specific facts or matters and, accordingly, assume no liability whatsoever in connection with its use. Pursuant to Rules 7.2 to 7.4 of the Illinois Rules of Professional Conduct, this publication may constitute advertising material.

Copyright © 2003 KIRKLAND & ELLIS LLP . All rights reserved.

¹ SEC Release No. 34-48745, which describes and approves the NYSE and Nasdaq proposed rules, may be found on the Internet at: <http://www.sec.gov/rules/sro/34-48745.htm>.

² For example, the NYSE clarified that listed companies did not need to consider as “immediate family members” individuals who had died, become incapacitated, or were no longer immediate family members as a result of legal separation or divorce.

³ Many of these changes to the proposals resulted in relaxing the standards originally proposed by an exchange. This result has been criticized by some commentators who assert that the harmonization of the two proposals served to dilute the more stringent standards.

⁴ If a listed company does not file a proxy statement, the new rules require that it identify its independent directors in its Annual Report on Form 10-K.

⁵ Each of these tests is subject to certain applicable exceptions, the discussion of which is outside the scope of this Client Alert.

⁶ The Nasdaq rules also provide that a director would not be independent if the director is an officer or employee of the listed company or its subsidiaries, *or any other individual having a relationship which, in the opinion of the company’s board, would interfere with the exercise of independent judgment* in carrying out the responsibilities of a director.

⁷ A director’s immediate family includes his or her spouse, parents, children and siblings, whether by blood, marriage or adoption, or anyone residing in such director’s home.

⁸ Examples of permitted payments include director and committee fees, pensions or other forms of deferred compensation, and compensation received by an immediate family member for service as a non-executive employee of the company.

⁹ The NYSE rules also extend this to the listed company’s internal auditing staff.

¹⁰ A limited exception is available under the Nasdaq rules. Under limited circumstances, Nasdaq listed companies may include one audit committee director who meets the SEC’s independence standards and is not a current officer or employee of the company or a member of such person’s immediate family, but who fails to meet the additional requirements outlined in the Nasdaq rules. Use of this exception must be disclosed on the listed company’s annual proxy statement or Annual Report on Form 10-K, and any member appointed under this exception may serve no longer than two years and may not chair the audit committee.

¹¹ The term affiliate of, or a person affiliated with, a specified person, means a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified. The SEC rules provide that a person will be deemed not to be in control of a specified person for purposes of this section if the person:

- (1) Is not the beneficial owner, directly or indirectly, of more than 10% of any class of voting equity securities of the specified person; and
- (2) Is not an executive officer of the specified person.

¹² See SEC Releases 33-8177 and 34-47235.

¹³ These rules, set out in Rule 10A-3(b)(2), (3), (4), and (5) of the Exchange Act, establish audit committee provisions governing auditor independence and reporting, audit committee independence, provision of methods for receiving complaints, the authority to engage advisors, and appropriate funding as determined by the audit committee.

¹⁴ Under the NYSE rules, each listed company is also required to provide for an internal audit function.

¹⁵ Under the Nasdaq rules, each listed company must also review all related party transactions for conflicts of interest, and each such transaction must be approved by the company’s audit committee or other body of independent directors.

¹⁶ In order to determine whether the nominating/corporate governance committee is achieving its directives, the NYSE rules direct that it should be evaluated annually.

¹⁷ If the nominating committee is comprised of at least three members, the Nasdaq rules provide an exception similar to the audit committee exception described, *supra* note 11.

¹⁸ Like the nominating/corporate governance committee, the compensation committee under NYSE rules should be evaluated annually.

¹⁹ If the compensation committee is comprised of at least three members, the Nasdaq rules provide an exception similar to the audit committee exception described, *supra* note 11

²⁰ The Nasdaq rule exempts audit committee requirements from eligibility for this extended deadline.

²¹ Although the Nasdaq rules do not explicitly define the term foreign private issuer, the NYSE rules adopt the term as defined in Rule 3b-4 of the Exchange Act, which provides that a foreign private issuer is any issuer that is a national of any foreign country or a corporation or other organization incorporated or organized under the laws of any foreign country *except an issuer* meeting the following conditions:

- (1) More than 50 percent of the issuer's outstanding voting securities are directly or indirectly held of record by residents of the United States; and
- (2) Any of the following:
 - a. The majority of the executive officers or directors are United States citizens or residents;
 - b. More than 50 percent of the assets of the issuer are located in the United States; or

The business of the issuer is administered principally in the United States.” (emphasis added)