

**NASDAQ PROPOSES NEW RULES
TO STRENGTHEN CORPORATE
GOVERNANCE STANDARDS**

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INTRODUCTION

In response to the request of Harvey L. Pitt, Chairman of the Securities and Exchange Commission, asking the Nasdaq Stock Market, Inc. and the New York Stock Exchange to review their corporate governance listing standards, Nasdaq's board of directors approved changes to its rules relating to director independence, approval of stock option plans, and related-party transactions, among others. The adoption of the proposed rules is subject to SEC approval.

EXECUTIVE SUMMARY

The proposed rules approved by Nasdaq's board of directors include the following:

- **Require shareholder approval of stock option plans that include directors and officers**
 - Grants to newly hired executives must be approved by an independent compensation committee or a majority of a company's independent directors.
- **Tighten the definition of independence**

In addition to the current restrictions on independence, the Nasdaq proposal would:

 - Prohibit any payments by the company to a director in excess of \$60,000, exclusive of payments for board service.
 - This prohibition extends to payments to the director's immediate family members.
 - Restrict payments by the company to a charity of which a director is an executive officer.
 - If such payments exceed the greater of \$200,000 or 5% of either the company's or the charity's gross revenues, then the director will not be considered independent.
- **Require audit committee review and approval of all related-party transactions**

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- **Provide that an issuer that intentionally misrepresents information to Nasdaq may be delisted**
- **Increase disclosure obligations**
 - A company that receives a going concern qualification in connection with an audit will be required to promptly issue a press release.
- **Modify existing disclosure rules to provide for the use of disclosure methods permitted under Regulation FD**

Nasdaq began submitting its proposed rules to the SEC on June 6, 2002. The proposed rules will be subject to a comment period prior to receiving any approval from the SEC. In a June 5, 2002 press release, Nasdaq chairman and chief executive officer Hardick Simmons reiterated that these are just the first in a series of proposals to revise corporate governance standards. In the coming months, Nasdaq is expected to consider making further corporate governance reforms, which may include mandating a majority of independent directors on corporate boards, expanding the scope of audit committee authority, and mandating that compensation committees, like audit committees, be composed entirely of independent directors. Nasdaq's board of directors expects to rule on the additional proposals later this summer.

A detailed description of these proposed rules, as well as further discussion concerning their status and recommended actions companies can take in response to these proposals, is set forth below.

THE PROPOSED RULES

Stock Option Plans

The current Nasdaq rule relating to stock option plans generally requires shareholder approval for all plans in which officers or directors participate. This current rule, however, contains a significant exception for broadly based plans, which are plans in which at least a majority of the participants are not officers or directors. A proposed rule by Nasdaq would delete this exception, so that all plans in which officers or directors participate will require shareholder approval. This proposed rule would also delete a *de minimis* exception to the current rule for plans covering the lesser of 1% of the number of shares of a Company's common stock outstanding or 25,000 shares. The exceptions currently in place regarding warrants or other rights issued generally to security holders of the company and for tax-qualified, nondiscriminatory employee benefit plans would be retained by the proposed rule.

In addition, the exception for inducement grants to newly hired officers would also remain in place under this proposed rule, but would be modified so that these grants would need to be approved by a compensation committee comprised solely of independent directors, or by a majority of the company's independent directors. Inducement grants for these purposes would include grants to persons who become new

employees in connection with a merger or acquisition. This proposed rule also clarifies that the assumption of preexisting grants under plans in connection with an acquisition or merger would not be subject to the shareholder approval requirement.

Independent Directors

In 1999, Nasdaq adopted comprehensive changes to its definition of the term “independent director.” Among other things, specifically excluded from “independent director” status was a director who accepted any compensation from the company or any of its affiliates in excess of \$60,000 during the previous fiscal year (other than compensation for board service), benefits under a tax-qualified retirement plan or nondiscretionary compensation. A proposed Nasdaq rule would expand the prohibition on the receipt of \$60,000 to include any payments (including political contributions), not just compensation, made in either the current or previous fiscal year, subject to the same exceptions as are currently in effect, and would extend this prohibition to the receipt of any such payments by an immediate family member of a director. In addition, the 1999 changes also specifically excluded from “independent director” status a director who was a partner in, or a controlling shareholder of or an executive officer of, any for-profit business organization to which the company made or from which the company received payments (other than through investments) in any of the past three years that exceeded the greater of 5% of the company’s or business organization’s consolidated gross revenues for that year and \$200,000. A proposed Nasdaq rule would expand this exclusion to pertain to any organization (including nonprofit organizations) and would clarify that this rule applies to payments made in the current year. Therefore, payments to charitable organizations of which a director is an executive officer could cause the director to be not independent.

Related Party Transactions

Nasdaq’s current “conflict of interest” rule provides that an issuer must conduct an appropriate review of all related party transactions on an ongoing basis and use its audit committee or a comparable body of the board of directors for the review of potential conflicts of interest. A proposed rule by Nasdaq would expand this “conflict of interest” rule by requiring the audit committee or comparable body of the board of directors to approve, rather than merely review, related party transactions. A “related party transaction” for this purpose is to be read consistently with SEC Regulation S-K, Item 404(a), which generally pertains to any company transaction or series of similar transactions that occurred since the beginning of the company’s last fiscal year or is currently proposed, in which the amount involved exceeds \$60,000 and in which any director, executive officer, nominee for election as a director, or 5% security holder, or any of their immediate family members, has a direct or indirect material interest.

Explicit Prohibition on Misrepresenting Information to Nasdaq

Nasdaq’s current rules state that Nasdaq may request certain information and documentation from a company, public or nonpublic, deemed necessary to make a determination regarding a security’s initial or continued inclusion on the Nasdaq,

including any material provided to or received from the SEC or other appropriate regulatory authority. A proposed rule by Nasdaq would specifically state that a company may be delisted if it fails to provide such information. In addition, this proposed rule would also expressly provide that a company may also be delisted if any communication to Nasdaq contains a material misrepresentation or omits material information necessary to make the communication to Nasdaq not misleading. Nasdaq believes that existing rules already allow for delisting in these situations, but proposed this rule to clarify its right to delist in these situations.

Requirement to Disclose Audit Opinions with Going Concern Qualifications

Nasdaq believes that, while an auditor's opinion is available in a company's Form 10-K filed with the SEC, the receipt of a going concern opinion qualification is so material that it should be brought to the attention of investors and potential investors through a press release issued promptly after the filing of the Form 10-K with the SEC. Accordingly, a proposed rule by Nasdaq would require a company that receives an audit opinion that contains a going-concern qualification to make a public announcement through the news media disclosing the receipt of such qualification. Prior to the release of the public announcement, the company would be required to provide the text of the public announcement to the StockWatch section of Nasdaq's MarketWatch Department. The public announcement would be required to be provided to Nasdaq StockWatch and released to the media within seven calendar days from the date the audit opinion is publicly filed with the SEC.

Disclosure of Material Information

Current Nasdaq rules require that, except in certain unusual circumstances, companies promptly disclose to the public through the news media any material information that would reasonably be expected to affect the value of their securities or influence investors' decisions. "News media" refers to news services such as Bloomberg, Dow Jones, Reuters, Business Wire and PR Newswire. In order to align Nasdaq's methods of disclosure with those outlined in the SEC's Regulation FD adopted on August 10, 2000, a proposed rule by Nasdaq would permit disclosure of any material information required to be disclosed pursuant to Nasdaq's rules through any method permitted under Regulation FD. In addition to a broadly disseminated press release, other Regulation FD-compliant methods include current reports on Form 8-K and conference calls, press conferences and webcasts, so long as the public is provided adequate notice (generally by press release) and granted access. Companies would still be required to provide prior notification of certain planned material news announcements to Nasdaq StockWatch.

Status of Proposed Rules

These proposed rules were approved by Nasdaq's board of directors on May 22, 2002. They were also approved by the National Association of Securities Dealers Inc.'s board of governors. These proposed rules have been submitted to the SEC for final approval, after a public comment period. Following the comment period, these rule proposals, if approved by the SEC, could be implemented for Nasdaq companies later this summer.

Additional Rule Proposals

Nasdaq also began to examine additional corporate governance reforms at its meeting of the Nasdaq Listing and Hearing Review Council held on June 26, 2002. These potential reforms include:

- requiring a majority of independent directors on corporate boards;
- requiring compensation committees to be composed solely of independent directors;
- requiring a cooling-off period during which former auditors would be precluded from serving on corporate audit committees;
- expanding the scope of audit committee authority;
- strengthening continuing education for directors;
- increasing the use of corporate codes of conduct and compliance methods to support them; and
- mandating non-U.S. companies to disclose if they have received waivers of corporate governance standards through a new SEC disclosure requirement.

Chairman Simmons indicated that Nasdaq anticipates that additional rule proposals with respect to the above potential reforms will be presented to its board of directors in July 2002 and also noted that the rule proposals are “part of a process that is far from over.”

Recommended Actions

These proposed rules, as well as the additional rules that Nasdaq is considering for proposal in the future, would impose significant additional corporate governance requirements for Nasdaq-listed companies. There is a strong probability that these proposed rules will become adopted in the near future. Therefore, we recommend that companies prepare to address changes and enhancements in corporate governance and disclosure practices that will likely soon be required. At a minimum, companies should consider revising their related-party transactions approval procedures and reviewing board composition and whether future changes in board composition may be appropriate.

For more information concerning these proposed rules, please contact any member of Morgan Lewis' Securities Practice, or any of the following attorneys who contributed to this White Paper:

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