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SEC APPROVES NASDAQ CORPORATE GOVERNANCE RULE CHANGES

By Dionne M. Rousseau and Celeste E. Rasmussen

On November 4, 2003, the Securities and Exchange Commission approved the Nasdaq Stock Market's proposed corporate governance rule changes. *(Click here to link to the SEC's release approving the Nasdaq rule changes.)*

Significant provisions of the final rules are as follows:

Board Independence

A majority of the board of directors of each listed company must be "independent." Nasdaq has stated that the board must make an affirmative determination that the independent directors have no relationship with the company that would impair their independence. As amended, Rule 4200 lists seven relationships or circumstances that would preclude a director from being independent:

- A director who is employed by the company (or any parent or subsidiary of the company) cannot be deemed independent until three years after the termination of the employment relationship.

- A director who is a family member of an individual who is employed by the company (or by any parent or subsidiary of the company) as an executive officer cannot be deemed independent until three years after the termination of the employment relationship.

- A director who accepted, or has a family member who accepted, any payments (including political contributions) from the company (or any parent or subsidiary of the company) in excess of $60,000 during the current fiscal year or any of the past three fiscal years, other than certain permitted payments (such as compensation for board or committee service, benefits under a tax-qualified retirement plan and compensation paid to a family member who is a non-executive employee), cannot be deemed independent.

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- A director who is, or has a family member who is, a partner in, or a controlling shareholder or an executive officer of, any organization (including not-for-profit entities) to which the company made, or from which the company received, during the current fiscal year or any of the past three fiscal years, payments (other than those arising solely from investments in the company's securities) that exceed 5% of the recipient's consolidated gross revenues for that year, or $200,000, whichever is more, cannot be deemed independent.

- A director of the listed company who is, or has a family member who is, employed as an executive officer of another entity, where any of the executive officers of the listed company serve on the compensation committee of such other entity, cannot be deemed independent until three years after the end of such employment or service.

- A director who is, or has a family member who is, a current partner of the company's outside auditor, or was a partner or employee of the company's outside auditor and worked on the company's audit, cannot be deemed independent until three years after the end of the employment or auditing relationship.

A person's "family member" means that person's spouse, parents, children and siblings (whether by blood, marriage or adoption), and anyone residing in that person's home.

Each listed company must disclose in its annual proxy statement those directors that the board has determined to be independent. The independent directors also must have regularly scheduled meetings at which only the independent directors are present. There is a grace period (the earlier of the company's next annual shareholders' meeting or one year) for issuers who fail to comply with the majority independence requirement due to a board vacancy or circumstances beyond a director's reasonable control. A company relying on the cure period must notify Nasdaq.

Compensation of Executive Officers & Nomination of Directors

The compensation of the CEO and all other executive officers of a listed company must be determined, or recommended to the board for determination, either by a majority of the independent directors or by a compensation committee comprised solely of independent directors. The CEO may not be present during any voting or deliberations regarding his or her compensation.

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Director nominees must be selected, or recommended for the board's selection, either by a majority of independent directors or by a nominating committee comprised solely of independent directors. However, listed companies need not comply with this requirement to the extent the right to nominate directors legally belongs to a third party. The nominating committees (or independent directors acting in lieu thereof) of listed companies must also have a written charter.

A listed company may appoint one non-independent director to its compensation committee and/or nominating committee if (i) the committee is comprised of at least three members, (ii) the non-independent member is not, and a family member of the member is not, an officer or employee of the company, (iii) the non-independent member serves on the committee for no more than two years, and (iv) the board determined under "exceptional and limited circumstances" that the membership is required by the best interests of the company and its shareholders. In addition, the board must disclose its reasons for relying on this exception in the company's next proxy statement.

Controlled Company Exemption

"Controlled companies" are exempt from the board independence and compensation and nominating committee requirements outlined above, except for the requirement that independent directors meet in executive session. Controlled companies are, however, subject to Nasdaq's other corporate governance requirements. A "controlled company" is a company in which more than 50% of the voting power is held by an individual, a group, or another company. A company relying on this exemption must disclose in its proxy statement that it is a controlled company.

Audit Committee Charter and Responsibilities

Nasdaq currently requires listed company audit committees to have a written charter, reassessed on an annual basis. The final rules require the audit committee to have certain responsibilities (including those required by the Sarbanes-Oxley Act of 2002) and that these be outlined in the charter, including:

- direct responsibility to appoint, determine the compensation of, and oversee the company's independent auditor;
- the responsibility to establish procedures for the receipt and handling of complaints regarding the company's accounting and

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auditing matters, including confidential anonymous tips from employees;

- the authority to retain and determine the compensation of independent legal counsel and other advisors for the audit committee; and

- the right to receive appropriate funding for payment of the independent auditor and other outside advisor compensation and the committee's administrative expenses.

Audit Committee Composition

Under current Nasdaq rules, each company must have an audit committee comprised of at least three independent members. Under the new rules, each member must be "independent," as defined in both the amended Nasdaq and new SEC definitions. In addition to being able to read and understand financial statements at the time of their appointment, the members must also have not participated in the preparation of the financial statements of the company at any time during the past three years.

One director who is not an officer or an employee, or a family member of an officer or an employee, and who is not "independent" under Nasdaq rules, but who meets the criteria for independence set forth under the SEC rules, may be appointed to the audit committee under "exceptional and limited circumstances." The board must disclose its reliance on this exception in the company's next proxy statement. In addition, this director may not serve for longer than two years and may not chair the committee.

The final rules retain Nasdaq's current requirement that at least one member of the committee be "financially sophisticated," but do not require that audit committees have a "financial expert," as that term is defined by SEC rulemaking.

The final rules also contain a grace period (the earlier of the company's next annual shareholders' meeting or one year) for listed companies that fail to comply with the Nasdaq and SEC audit committee composition requirements because of a vacancy or because an audit committee member ceases to be independent for reasons beyond such member's control.

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Notification of Noncompliance

Listed companies must provide Nasdaq with prompt notification after an executive officer of the company becomes aware of the company's material noncompliance with any of Nasdaq's corporate governance or other qualitative listing requirements.

Code of Business Conduct and Ethics

Each listed company must adopt a code of conduct applicable to all directors, officers and employees, and must make the code publicly available. The code must meet the requirements for a "code of ethics," as defined by the SEC in new Item 406 of Regulation S-K. The code must provide:

- an enforcement mechanism that ensures prompt and consistent enforcement of the code;
- protections for persons reporting questionable behavior;
- clear and objective standards for compliance; and
- a fair process by which to determine violations.

Waivers of the code for directors or executive officers must be approved by the board and disclosed in a Form 8-K within five days of the granting of such waiver.

Public Announcement of Audit Opinions with Going Concern Qualifications

Each listed company that receives an audit opinion that contains a going concern qualification must make a public announcement through the news media disclosing the receipt of the qualification. The announcement must be released to the media not later than seven calendar days after the filing of the audit opinion in a SEC filing.

Related Party Transactions

The final rules require that all related party transactions (of the type that would have to be disclosed in the listed company's proxy statement) must be reviewed and approved by the listed company's audit committee or another independent body of the board of directors.

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Compliance Dates

- Director Independence, Independent Board Committees, and Notification of Noncompliance – By the earlier of (i) the listed company's first annual shareholders' meeting after January 15, 2004, or (ii) October 31, 2004. Except for the audit committee requirements, an issuer with a staggered board has until its second annual meeting after January 15, 2004 (but no later than December 31, 2005) to implement the new requirements related to board independence if the company would be required to change a director who would not normally stand for election at an earlier meeting. Small business issuers have until July 31, 2005.

  Nasdaq has informally clarified to us that listed companies must be in compliance with the board and committee independence requirements *at the conclusion of* their annual meeting. Therefore, if a listed company requires, for example, additional independent directors in order to have a majority independent board, the company may nominate the additional independent directors for election at the annual meeting (and include such directors in the company's proxy materials for the annual meeting).

- Audit Committee Approval of Related Party Transactions – January 15, 2004.

- Code of Conduct – On or about May 4, 2004 (the final rules require compliance "six months after approval" by the SEC).

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SEC ISSUES FINAL RULES REGARDING PURCHASES OF EQUITY SECURITIES BY ISSUERS

By Dionne M. Rousseau and Izabela M. Chabinska

On November 10, 2003, the SEC issued the final rule adopting amendments to Rule 10b-18 under the Securities Exchange Act of 1934. *(Click here to link to the SEC's release regarding the adopted amendments to Rule 10b-18.)* Rule 10b-18 provides issuers repurchasing their own common stock with a safe harbor from federal securities law liability for manipulative trading activity if they satisfy certain manner of purchase, timing, price and volume conditions. The SEC also adopted new rules requiring new periodic disclosure of all open market and private repurchases of registered equity securities by issuers.

The amendments to Rule 10b-18 extend the period during which an issuer meeting an average daily trading volume ("ADTV") and public float test may remain in the market, extend the safe harbor to certain after-hours repurchases, modify the block trade exception and clarify and modify the scope of safe harbor eligibility regarding mergers, acquisitions and similar transactions.

The amendments to Rule 10b-18 will be effective on December 17, 2003. Companies must comply with the periodic disclosure requirements in their Forms 10-Q and 10-K filed for periods ending on or after March 15, 2004.

Amendments to Rule 10b-18

Scope of the Safe Harbor

Compliance with Rule 10b-18 is voluntary. In order to qualify for the safe harbor, issuer repurchases must, on a daily basis, satisfy the manner of purchase, timing, price and volume conditions. The safe harbor applies to repurchases by issuers and affiliated purchasers of common stock (or an equivalent interest).

Although we believe most issuers conduct repurchases of common stock in compliance with Rule 10b-18, in order to obtain the protection of the safe harbor it provides, the Rule states that repurchases not made in compliance with the conditions of the safe harbor are not presumed to violate the securities laws. In other words, Rule 10b-18 is not the

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exclusive means of making non-manipulative repurchases of equity securities. Also, repurchases made in compliance with Rule 10b-18 may still violate the antifraud provisions of the securities laws if the issuer repurchases equity securities while in possession of favorable, material nonpublic information. Accordingly, companies must stop purchases of equity securities under a repurchase program while in possession of favorable material nonpublic information.

The current safe harbor applies only to repurchases effected in the U.S. and the SEC has determined not to extend the safe harbor to purchases effected outside the U.S. at this time.

Manner of Purchase Limitation

The amendments to the Rule do not modify the manner of purchase condition that requires issuers to use a single broker or dealer, on a given day, to bid for or repurchase the company's common stock. However, the SEC's release regarding the final Rule clarifies that issuers can repurchase directly through an ECN (electronic communication networks) or other ATS (alternative trading system), but cannot use both an ECN (or other ATS) directly and a non-ECN (or other non-ATS) broker-dealer on any single day.

The "single broker or dealer" condition continues to apply only to purchases solicited by or on behalf of the issuer. Therefore, an issuer may purchase shares from more than one broker or dealer if the issuer does not solicit the transaction. The SEC does not consider the announcement of a repurchase program alone as causing a subsequent purchase to be deemed "solicited" by or on behalf of the issuer.

Timing Limitation

Currently, Rule 10b-18 prohibits a company from repurchasing its shares during the last half-hour of trading. The amendments to the timing limitation have been adopted as proposed and allow issuers of more actively traded securities to stay in the market until 10 minutes before it closes. To qualify for this time extension a company must have an ADTV of $1 million or more for the four calendar weeks preceding the week of the bid or purchase and a public float value of $150 million or more (*i.e.,* aggregate market value of common equity securities held by non-affiliates of the company). The current Rule prohibiting the issuer from making a

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purchase in the opening transaction of the day is unaffected by the amendments.

Price Limitation

Under current Rule 10b-18, price limitations vary according to the market where the securities are traded. The amendments apply a uniform price condition for all trading markets, whereby companies may repurchase their securities at a price that is no higher than the highest independent bid or the last independent transaction price, whichever is higher, reported in the consolidated system. (Securities not reported in the consolidated system have separate pricing requirements.)

Volume Limitation

Under current Rule 10b-18, a company's daily purchases may not exceed 25% of the ADTV of its shares over the four calendar weeks preceding the week of the bid or purchase. Shares purchased in block trades are not included in the calculation of the ADTV or subject to the 25% volume limitation. Accordingly, under the current Rule, companies can purchase an unlimited amount of securities in block size.

The amendments require companies to include block purchases in their calculation of the 25% volume limitation. At the same time, companies can include block purchases when calculating the security's four-week ADTV. However, an issuer may execute one block purchase per week that exceeds the 25% volume limitation for that day but no other purchases under the Rule can be made on that day and these shares may not be included when calculating a security's four week ADTV under the Rule.

After-Hours Trading Sessions

The amendments extend the safe harbor to issuer repurchases occurring after-hours at prices not exceeding the lower of the closing price of the primary trading session and any lower bids or sale prices subsequently reported in the consolidated system. Such purchases still need to comply with the other limitations of the safe harbor.

The amended Rule, however, permits the issuer to use a broker or dealer for the after-hours purchases that is different from the one used during normal trading hours. Issuers are precluded from purchasing under Rule 10b-18 as the opening transaction of the after-hours trading session, but can purchase until the end of the period in which last sale prices are reported in the consolidated system. The volume calculation carries over from the regular trading session.

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Market-Wide Trading Suspensions

Under the current Rule, after a market-wide trading suspension, the time of purchase condition is suspended from the reopening of trading until the scheduled close of trading or, if the suspension is in effect at the close, at the opening of trading on the next trading day. The amendments increase the 25% volume limit to 100% of a security's ADTV during the trading session following a market-wide trading suspension.

Mergers, Acquisitions, or Similar Transactions Involving Recapitalization

Currently, purchases made "pursuant to a merger, acquisition or similar transaction involving a recapitalization" are not eligible for the safe harbor. The final Rule clarifies and modifies this "merger exclusion" from the safe harbor. The final Rule provides that the safe harbor does not apply to purchases effected from the time of public announcement of a merger, acquisition or similar transaction involving a recapitalization until the earlier of the completion of the transaction or the completion of the vote by target shareholders (including any period where the market price of the security will be a factor in determining the consideration to be paid). In other words, the safe harbor is available after the target stockholder vote where the only pending issue is regulatory approval or other action that could not affect the consideration.

Notwithstanding the foregoing, however, the safe harbor is available where the consideration is solely cash and there is no valuation period. In addition, the SEC modified the merger exclusion to allow issuers, after the announcement of a merger, to continue repurchases made consistent with past practices during the three calendar months preceding the announcement, as set out in more detail in the amended Rule. (Repurchases after announcement of a merger or similar transaction must also continue to be made in compliance with Regulation M and any other applicable restrictions.)

Affiliated Purchaser

In order to determine eligibility for the safe-harbor, the issuer must combine its repurchases with any purchases made by "affiliated purchasers." The amendments do not change this requirement. "Affiliated purchaser" is defined as "a person acting, directly or indirectly, in concert with the issuer for the purpose of acquiring the issuer's securities; or an affiliate who, directly or indirectly, controls the issuer's purchases of such securities,

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whose purchases are controlled by the issuer, or whose purchases are under common control with, those of the issuer." The definition does not include a broker, dealer or other person solely because they conduct Rule 10b-18 purchases on behalf of the issuer, or an officer or director of the issuer solely because they participate in the decision to authorize the issuer to conduct Rule 10b-18 purchases.

New Stock Repurchase Disclosure Rules

The amendments to the repurchase disclosure rules were adopted substantially as proposed and require the issuer to report information regarding all repurchases of its equity securities registered under the Exchange Act by the issuer and affiliated purchasers in both open market and private transactions. The disclosure has to be made in a table format in Forms 10-Q and 10-K and must include the following items, reported for the most recently completed fiscal quarter and shown on a monthly basis:

- the total number of shares repurchased;
- the average price per share;
- the number of shares repurchased under publicly announced plans or programs; and
- the maximum number or approximate dollar value of shares that the company may repurchase under the programs in the future.

The SEC eliminated the proposed requirement that issuers disclose the identity of any broker-dealer(s) used to effect repurchases.

Issuers must also disclose, in footnotes to the table, the principal terms of publicly announced plans or programs, including:

- the date the plan or program was announced;
- the dollar amount or number of shares approved;
- the expiration date of the plan or program (if any);
- each plan or program that has expired during the period covered by the table; and

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- each plan or program the company has determined to terminate before expiration or under which the issuer does not intend to make further purchases.

Additionally, the table must include footnotes that briefly disclose the nature of purchases made other than under a publicly announced repurchase plan or program. These include:

- open market and privately negotiated purchases;
- issuer tender offers; and
- purchases made by the issuer upon another person's exercise of outstanding put rights.

Please remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues you may contact the head of our Corporate and Securities practice group:

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