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Advisory

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SECURITIES LAW

NASDAQ Corporate Governance Rules

On November 4, 2003, the Securities and Exchange Commission (SEC) approved new corporate governance standards for companies listed on the Nasdaq National Market and the Nasdaq Small Cap Market ("Nasdaq"). Nasdaq initially proposed rule changes to enhance corporate governance in the spring of 2002 prior to the adoption of the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act"). The rules as finally adopted reflect requirements of the Sarbanes-Oxley Act including requirements regarding Audit Committees as mandated by the SEC in a rule adopted in April 2003. The new Nasdaq rules are designed to increase the role and the authority of the independent members of a company's board of directors. The rules include, among other provisions, a requirement that a majority of the directors be independent; a more stringent definition of independence; requirements regarding the composition of and the role of certain committees of the board; a requirement that companies adopt codes of conduct for all directors, officers and employees; and a requirement for the approval of all related party transactions. The new listing requirements are contained in NASD Rule 4350 and the definition of independence is set forth in Rule 4200. The key features of the new Nasdaq rules are discussed below.

Listed companies are required to comply with the new corporate governance listing standards described in this Advisory by the earlier of the listed issuer's first annual shareholders meeting after January 15, 2004 or October 31, 2004 unless another date is specified in this Advisory. Foreign private issuers and small business issuers have until July 31, 2005 to comply. Until then, listed companies that have not brought themselves into compliance with the new rules are required to comply with the previously existing rules, as applicable.

Majority of Independent Directors

Under the new Nasdaq rules, a majority of the directors on the board of a Nasdaq-listed company will have to be independent, as defined in NASD Rule 4200. Each company's board of directors will be required to make an affirmative determination that each individual who serves as an independent director has no relationship that would interfere with the exercise of independent judgment in carrying out his responsibilities as a director. In addition, the following relationships will automatically preclude a director from being designated as an independent director.

- A director who is, or at any time during the past three years¹ was, employed by the company or by any parent or subsidiary of the company.²
- A director who accepted or has a Family Member³ who accepted any payments 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 the following:
 - compensation for board or board committee service;
 - payments arising solely from investments in the company’s securities;
 - compensation to a Family Member who is not an executive employee of the company or any parent or subsidiary;
 - benefits under a tax qualified retirement plan or non discretionary compensation; or
 - loans not in violation of Section 402 of the Sarbanes-Oxley Act.
- A director who is a Family Member of an individual who is, or at any time during the past three years was, employed by the company or by any parent or subsidiary of the company as an executive officer.⁴
- 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 to which the company made, or from

which the company received, payments for property or services in the current or any of the past three fiscal years that exceed 5% of the recipient’s consolidated gross revenues for that year, or \$200,000, whichever is more, other than payments arising solely from investments in the company’s securities or payments arising under non-discretionary charitable contribution matching programs.

- A director of the listed company who is, or has a Family Member who is, employed as an executive officer of another entity where at any time during the past three years any of the executive officers of the listed company served on the compensation committee of such other entity.
- 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, at any time, during the past three years.

Although Nasdaq’s initially proposed definition of independence included a fixed percentage of company ownership that precluded a finding of independence, Nasdaq determined in its final rules that it does not believe that ownership of company stock would by itself preclude a board finding of independence and chose instead not to include that factor in the objective criteria regarding independence set forth above.

Each listed company will be required to disclose in its annual proxy statement (or, if the issuer does not file a proxy statement, in its Form 10-K or 20-F) those directors that the board has determined to be independent under NASD Rule 4200. If an issuer does not have a majority of independent directors on its board because of one vacancy, or if one director ceases to be independent due to circumstances beyond his or her reasonable control, Nasdaq will allow the issuer to regain compliance with the independence requirement by the earlier of its next annual shareholders meeting or one year from the occurrence of the event that caused the failure to comply with this requirement. Nasdaq will require any issuer relying on this exception to provide notice to Nasdaq immediately upon learning of the event or circumstance that caused the non-compliance.

Executive Sessions of the Independent Directors

Independent directors will be required to have regularly scheduled meetings at which only independent directors are present. Nasdaq has stated that the purpose of the meetings is to enhance the communication among the outside directors and to serve as a more efficient check on management. Nasdaq expects that these meetings will occur at least twice a year in conjunction with regularly scheduled board meetings.

¹ The look-back period commences on the date the relationship ceases, and “any time” during any of the past three years is considered. For example, a director employed by the company would not be independent until three years after such employment terminates.

² The reference to a “parent or subsidiary” in the definition of independence is intended to cover entities the issuer controls and consolidates with the issuer’s financial statements as filed with the SEC (but not if the issuer reflects such entity solely as an investment in its financial statements).

³ “Family Member” means a person’s spouse, parents, children and siblings, whether by blood, marriage or adoption, or anyone residing in such person’s home.

⁴ Executive officer” has the same definition as in Rule 16a-1(f) under the Securities Exchange Act of 1934.

Compensation of the Executive Officers

Compensation of the CEO and all other executive officers 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 the voting or deliberations of his or her compensation.

If the compensation committee is comprised of at least three members, one director—who is not independent and is not a current officer or employee or a Family Member of such person—would be permitted to be appointed to the committee if the board, under exceptional and limited circumstances, determines that such individual's membership on the committee is required by the best interests of the company and its shareholders, and the board discloses, in the next annual meeting proxy statement subsequent to such determination (or, if the issuer does not file a proxy statement, in its Form 10-K or 20-F), the nature of the relationship and the reasons for the determination. A member appointed under this exception would not be permitted to serve longer than two years.

Director Nominations

Nominees for director must be selected or recommended for the board's selection either by a majority

of independent directors, or by a nominations committee comprised solely of independent directors. Further, the issuer will have to certify that it has adopted a formal written charter or board resolution addressing the nominations process and such related matters as may be required under the federal securities laws.⁵

If the nominations committee is comprised of at least three members, one director, who is not independent and is not a current officer or employee or a Family Member of such person, would be permitted to be appointed to the committee if the board, under exceptional and limited circumstances, determines that such individual's membership on the committee is required by the best interests of the company and its shareholders, and the board discloses, in the next annual meeting proxy statement subsequent to such determination (or, if the issuer does not file a proxy statement, in its Form 10-K or 20-F), the nature of the relationship and the reasons for the determination. A member appointed under this exception may not serve longer than two years.

Independent director oversight of the nominations process will not apply in cases where either the right to nominate a director legally belongs to a third party, or the company is subject to a binding obligation that requires a director nomination structure inconsistent with this provision and such obligation pre-dates November 4, 2003.

Audit Committee Charter and Responsibilities of the Audit Committee

Issuers continue to need a formal written audit committee charter. However, the new listing requirements expand the responsibilities of the Audit Committee and thus the charter requirements. The audit committee charter must specify the committee's broadened purpose of overseeing the accounting and financial reporting processes and the audits of the financial statements of the issuer. The charter must also set forth the specific audit committee responsibilities and authority listed in NASD Rule 4350(d)(3) which are the same requirements as set forth in Rule 10A-3 of the Securities Exchange Act of 1934 (the "Exchange Act")⁶ a rule recently promulgated pursuant to the Sarbanes-Oxley Act. These requirements include:

- appointing, retaining, compensating, evaluating and terminating the company's independent auditors;
- establishing procedures for the receipt and treatment of complaints by employees on accounting and internal control matters;
- granting authority to engage independent counsel and other advisors to aid the Audit Committee in carrying out its duties; and
- authorizing appropriate funds to pay outside auditors.

⁵ The SEC approved rules effective January 1, 2004 requiring disclosure in a Company's proxy statement of the nominating committee process. Please refer to Mintz Levin Advisory, *Proxy Statement Disclosure Regarding Nominating Committee Functions and Communications between Security Holders and Directors*, for a description.

⁶ Please refer to Mintz Levin Advisory, *SEC Adopts Rules Regarding Independent Audit Committee Members and Responsibilities of Audit Committees*, for a description of Section 10A(m) of the Exchange Act and Rule 10A-3 thereunder.

Audit Committee Composition

The revised Nasdaq listing rules retain the requirement that each listed issuer have an audit committee composed of at least three independent members. However, the definition of independence has been expanded. Each audit committee member must be independent using the same independence criteria as set forth in NASD Rule 4200 for other Nasdaq listing requirements. In addition, each audit committee member must meet the criteria for independence set forth in Section 10A(m)(3) and Rule 10A-3 of the Exchange Act;⁷ and 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. The existing requirement that each audit committee member must be able to read and understand fundamental financial statements, including a company's balance sheet, income statement and cash flow statement has been revised to require that such ability must exist at the commencement of the audit committee member's term instead of within a reasonable time thereafter as is the rule currently. In addition, any partner in a law firm that receives payments from the issuer is ineligible to serve on that issuer's audit committee. One director who is not independent under NASD Rule 4200 but who meets the criteria set forth in Section 10A(m)(3) of the Exchange Act⁸ and the rules thereunder, and is not a

current officer or employee of the company or a Family Member of such person, may be appointed to the audit committee if the board, under exceptional and limited circumstances, determines that membership on the committee by the individual is required by the best interests of the company and its shareholders, and the board discloses, in the next annual proxy statement subsequent to such determination (or, if the issuer does not file a proxy statement, in its Form 10-K or 20-F), the nature of the relationship and the reasons for that determination. A member appointed under this exception may not serve longer than two years and would not be permitted to chair the audit committee. Nasdaq also recommends that an issuer disclose in its annual proxy (or, if the issuer does not file a proxy, in its Form 10-K or 20-F) if any director is deemed independent but falls outside the safe harbor provisions of Rule 10A-3(e)(1)(ii).⁹ Nasdaq has also retained its existing requirement that at least one member of the audit committee have past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities. A director who qualifies as an audit committee financial expert under Item 401(h) of Regulation S-K is presumed to be qualified as a financially

sophisticated audit committee member under this Nasdaq requirement.

If a listed issuer fails to comply with the audit committee composition requirements set forth above because an audit committee member ceases to be independent for reasons outside the individual's reasonable control, the audit committee member may remain on the committee until the earlier of the issuer's next annual shareholders meeting or one year from the occurrence of the event that caused the failure to comply with the audit committee composition requirements. If an issuer fails to comply with the audit committee composition requirements due to one vacancy on the audit committee, and there is not already an audit committee member who is no longer independent under the aforementioned exemption, the issuer will have until the earlier of the next annual shareholders meeting or one year from the occurrence of the vacancy to again comply with the composition requirement. An issuer relying on either of these exemptions would be required to provide notice to Nasdaq immediately upon learning of the event or circumstance that caused the non-compliance.

Notification of Noncompliance

A listed issuer will have to provide Nasdaq with prompt notification after an executive officer of the issuer becomes aware of any material noncompliance by the issuer with the qualitative listing requirements of NASD Rule 4350.

⁷ *Id.* The Exchange Act requires that to be independent for audit committee purposes, the director can not accept any compensation from the company, except for director fees, and may not be an "affiliated person" of the company or any subsidiary.

⁸ *Id.*

⁹ *Id.*

Code of Conduct

Each listed company must adopt a code of conduct for all directors, officers and employees, and make such code publicly available. This requirement will become effective May 4, 2003. The code of conduct must satisfy the requirements of Section 406(c) of the Sarbanes-Oxley Act and Item 406 of Regulation S-K and may be adopted as one form or separate forms with differing provisions may be applicable to different classes of employees. The code must provide for an enforcement mechanism that ensures prompt and consistent enforcement of the code, protection for persons reporting questionable behavior, clear and objective standards for compliance, and a fair process by which to determine violations. Any waivers of the code for directors or executive officers must be approved by the board and disclosed in a Form 8-K filed within five days of the waiver. Foreign private issuers shall disclose such waivers either in a Form 6-K or the next Form 20-F.

Public Announcement of Audit Opinions with Going Concern Qualifications

The new Nasdaq rules require each Nasdaq-listed company that receives an audit opinion containing a going concern qualification to issue a press release disclosing the receipt of such qualification. The issuer, prior to the release of the public announcement, must provide the text of the public announcement to the StockWatch section of Nasdaq's MarketWatch Department. The public announcement must

be provided to Nasdaq StockWatch and released to the media not later than seven calendar days following the filing of the audit opinion in a public filing with the SEC. This requirement became operative on November 4, 2003, the date of adoption of these new listing standards.

Related Party Transactions

Nasdaq currently requires each listed company to review all related party transactions on an ongoing basis and requires that the Audit Committee or another appropriate committee review potential conflict of interest situations where appropriate. Effective January 15, 2004, this rule will be amended to require that the Audit Committee or another independent committee of the board approve all related party transactions. In addition, the revised rule defines a "related party transaction" as any transaction required to be disclosed pursuant to Item 404 of Regulation S-K.

Controlled Companies Exemption

Nasdaq has exempted any Controlled Company¹⁰ from certain of the listing requirements discussed above. A Controlled Company does not need to have a majority of independent directors nor does it need to meet the compensation and nomination committee requirements discussed above. However, the independent directors must still meet periodically in executive session and have an audit committee with at least three independent directors. A company relying upon the Controlled Company exemption would be required to

disclose in its annual proxy statement (or, if the issuer does not file a proxy statement, in its Form 10-K or 20-F) that it is a Controlled Company and the basis for that determination.

Application to Foreign Private Issuers

Currently, Nasdaq is authorized to grant exemptions from its listing standards to foreign private issuers if the requirement is contrary to a law, rule or regulation of any public authority exercising jurisdiction over such issuer or that is contrary to generally accepted business practices in the issuer's country of domicile. The revised Nasdaq rules limit Nasdaq's exemptive authority. Exemptions will no longer be granted to the extent that such exemption would be contrary to the federal securities laws, including, without limitation, Section 10A(m) of the Exchange Act and Rule 10A-3 thereunder. In addition, any foreign private issuer that receives an exemption would also be required to disclose in its annual reports filed with the SEC each requirement from which it is exempted and describe the home country practice, if any, followed by the issuer in lieu of these exempted requirements. In addition, a foreign private issuer making its initial public offering or first U.S. listing on Nasdaq would be required to disclose any such exemptions in its registration statement. Although foreign private issuers will have a longer grace period to comply with the new listing requirements, they must disclose the receipt of any corporate governance exemption from Nasdaq in filings made after January 1, 2004.

¹⁰ "Controlled Company" means a company of which more than 50% of the voting power is held by an individual, a group, or another company. To determine whether a group exists for purposes of this exception, the shareholders must have publicly filed a notice that they are acting as a group (e.g., a Schedule 13D).

Special Transition Rules

If a company has a staggered board and would need to change a director that would not otherwise stand for election in 2004 to satisfy the new Nasdaq requirements, it will have until its second annual meeting after January 15, 2004, but not later than December 31, 2005, to implement all new requirements relating to board composition, other than the audit committee requirements. Such issuers would be required to comply with the audit committee requirements pursuant to the implementation schedule noted above.

Companies listing for the first time in conjunction with their initial public offering will only be required to have one independent member on any committee established by the board at the time of listing. They will

then need a majority of independent members within 90 days of listing, and all independent members within one year. Companies could choose not to adopt a compensation or nominations committee and could instead rely upon a majority of the independent directors to discharge responsibilities under the rules. These issuers would be required to meet the majority independent board requirement within one year of listing.

Companies transferring from other markets with a substantially similar requirement would be afforded the balance of any grace period afforded by the other market. Companies transferring from other listed markets that do not have a substantially similar requirement would be afforded one year from the date of listing on Nasdaq.

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Please contact the Mintz Levin attorney who handles your corporate and securities law matters if you have any questions or concerns regarding this information or your company's compliance with the new Nasdaq listing requirements.