

## New NYSE and Nasdaq Listing Standards Designed to Enhance Corporate Governance at Public Companies

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In the midst of still more financial scandals involving public companies, the Securities and Exchange Commission (SEC) recently approved long-awaited corporate governance listing standards proposed by the New York Stock Exchange (NYSE) and the Nasdaq Stock Market (Nasdaq). These listing standards impose a broad array of additional requirements on NYSE and Nasdaq listed companies and are designed to enhance corporate governance at public companies. Along with a multitude of regulations resulting from Sarbanes-Oxley, these standards are part of a national move to reform the way corporations are governed in the wake of Enron and other highly publicized business scandals.

The new rules, approved by the SEC on November 4, 2003, establish a stricter, more detailed definition of independence for company directors and require the majority of a company's board to satisfy this new independence standard. The rule changes also require independent director oversight of processes relating to corporate governance, auditing, board of director nominations and compensation.

### Director Independence

The NYSE and Nasdaq rules require that "independent" directors make up a majority of a company's board. The listed company's board must make an affirmative determination that a director is independent and must provide information to investors about the board's determination.

Generally, to be considered independent, a director may not have any relationship that, in the board's view, would interfere with the director's independent judgment in carrying out his or her responsibilities as director. The board must determine that a director has no material relationship with the listed company.

Although the rules note that it is not possible to provide explicitly for all circumstances that might signal potential conflicts of interest, the NYSE rules list five circumstances under which a director will not be deemed independent. These circumstances include the following and apply both to the director and to his or her immediate family members<sup>1</sup>:

- (i) a director who is an employee or an executive officer of the company;
- (ii) a director who receives more than \$100,000 per year in direct compensation from the listed company, other than director or committee fees or other forms of deferred compensation for prior services;
- (iii) a director who is affiliated with or employed by a present or former internal or external auditor of the company;
- (iv) a director who is employed as an executive officer of another company where any of the listed company's present executives serve on that company's compensation committee;

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(v) a director who is an executive officer or an employee of a company that makes payments to, or receives payments from, the listed company for property or services in an amount which, in any single fiscal year, exceeds the greater of \$1 million, or 2% of such other company's consolidated gross revenue.

Any director who has had such a relationship within the past three years will not be considered independent, except that, as a transitional matter, until the first anniversary of the effectiveness of the new standards, a "look-back" period of only one year will apply for a NYSE-listed company.

The new rules also require non-management directors to meet at regularly scheduled executive sessions without any management members present. This provision is meant to empower non-management directors to serve as a more effective check on management.

## Board Committees

All listed companies must have an audit committee, a nominating/corporate governance committee and a compensation committee. Each of these committees must be composed of directors who meet the definition of independence described above. Each committee must also have a charter setting forth the committee's specific purpose, goals and responsibilities.

The audit committee must have at least three members and must be composed entirely of independent directors. The audit committee must satisfy the requirements of Rule 10A-3 under the Exchange Act. Rule 10A-3 requires that each member of the committee be independent according to a separate set of criteria<sup>2</sup>, that the audit committee directly appoint, retain, compensate, evaluate and terminate

the company's independent auditors, oversee the independent auditors, and pre-approve all non-audit services. The committee must also establish procedures for handling confidentially complaints from company employees on accounting or auditing matters. Each member of the committee must also be financially literate and at least one member must have accounting or related financial management expertise.

At a minimum, the audit committee must be responsible for assisting the board in overseeing the integrity of the company's financial statements, compliance with legal and regulatory requirements, the independent auditor's qualifications and independence and the performance of the company's internal audit function. The committee must also prepare an audit committee report to be included in the company's annual proxy statement. The duties and responsibilities of the audit committee must include, at least annually, obtaining and reviewing a report by the independent auditor. The committee must also discuss the company's financial statements with management and the independent auditor, the company's earnings press releases and other financial information provided to analysts and rating agencies, and policies with respect to risk assessment and risk management. The committee must meet separately with management, with internal auditors and with independent auditors, review with the independent auditor any audit problems or difficulties and management's response, set clear hiring policies for employees or former employees of the independent auditors, and report regularly to the board. In addition, each listed company must have an internal audit function.

The nominating/corporate governance

committee must identify individuals qualified to become board members, select, or recommend that the board select, the director nominees for the next annual meeting, develop and recommend to the board a set of corporate governance principles, and oversee the evaluation of the board and management.

The compensation committee must review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of these goals, and, either as a committee or together with the other independent directors, determine and approve the CEO's compensation level. The committee should also make recommendations to the board regarding non-CEO compensation, incentive compensation plans and equity based plans. Finally, the committee must produce a report on executive compensation to be included in the company's annual proxy statement or annual report.

## Corporate Governance Guidelines

All listed companies must adopt and disclose corporate governance guidelines, which must be posted on the company's website. The new rules note that no single set of guidelines would be appropriate for every company but that there are certain "key areas of universal importance" that must be addressed in these guidelines, including the following:

- Director qualification standards, which should, at a minimum, reflect the independence requirements but may also address limits on the number of boards on which a director may sit, and director tenure, retirement and succession;
- Director responsibilities, which should articulate what is expected from a director, including responsibility for attending board meetings and advance review of board materials;

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- Director access to management, and, as necessary and appropriate, independent advisors;
- Director compensation, which should include general principles for determining the form and amount of director compensation;
- Director orientation and continuing education;
- Management succession, which should include policies and principles for CEO selection and performance review and policies regarding succession in the event of an emergency or the CEO's retirement;
- Annual performance evaluation of the board to determine whether the board and its committees are functioning effectively.

## Code of Business Conduct and Ethics

Listed companies must adopt and disclose a code of business conduct and ethics for directors, officers and employees.

Companies must post their codes on their websites, and their annual reports must indicate that the code is available on the website and in print for any shareholder who requests it. Any waiver of the code for executive officers or directors may be made only by the board of directors and must be promptly disclosed to shareholders. Each code must also contain compliance standards and procedures that will facilitate the effective operation of the code and ensure prompt and consistent action against code violations.

The rules provide that each listed company may determine its own policies but all listed companies should address the following most important topics:

- Conflicts of interest: companies must have a policy for preventing conflicts and a means for employees, officers and directors to communicate potential conflicts to the company;
- Corporate opportunities: employees, officers and directors should be prohibited from taking for themselves personally opportunities that are discovered through the use of corporate property, information or position, using corporate property, information or position for personal gain, and competing with the company;
- Confidentiality of corporate information must be maintained;
- Fair dealing: employees, officers and directors must endeavor to deal fairly with the company's customers, suppliers, competitors and employees;
- Protection and proper use of company assets;
- Compliance with laws, rules and regulations (including insider trading laws);
- Encouraging the reporting of any illegal or unethical behavior.

## CEO Certification and Notification

The CEO must certify to the NYSE each year that he or she is not aware of any violation by the company of NYSE corporate governance listing standards. The CEO

must also promptly notify the NYSE in writing after any executive officer of the listed company becomes aware of any material non-compliance with the corporate governance listing standards.

## ENDNOTES

1. An "immediate family member" includes a person's spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, and anyone (other than domestic employees) who shares such person's home.
2. Members of the audit committee must satisfy the general definition of independence discussed above as well as two threshold requirements for a finding of independence. A director may not accept directly or indirectly any consulting, advisory or other compensatory fee from the company, other than a director fee or fixed compensation under a retirement plan for prior services, and, a director may not be an "affiliated person" of the company. An affiliated person is someone who directly or indirectly through intermediaries controls or is controlled by, or is under common control with, the company.

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