



DM Extra!

Alert Edition

June 6, 2002
Alert Edition

Timely Commentary on Critical Events
and Regulatory Developments

New Listing Standards Proposed

Director
Summary >>>

In the past two weeks, both the **Nasdaq** and the **New York Stock Exchange (NYSE)** have produced reports recommending new listing standards. The reports from these self-regulatory organizations (SROs) responded to a February 13, 2002, administrative notice from **Securities and Exchange Commission (SEC)** chairman **Harvey L. Pitt** to “review corporate governance listing standards.”

While highly indicative of future changes, these recommendations do not yet form “hand-

writing on the wall” for boards of directors. The Nasdaq report has received Nasdaq board approval, but it is not the full report anticipated for later this summer. The NYSE report awaits final approval, which could come as late as August 1, 2002.

Furthermore, before these proposed listing standards become final, the SEC must approve them, following a comment period. To inform the views of NACD members who may wish to comment, here is a summary of the proposals.

Changes Ahead: A Commentary

At this critical time in corporate governance history, many players are urging many changes. The private sector, Congress, the White House, the NYSE, and Nasdaq are all “weighing in” with changes that will affect corporations in the future.

We have seen a lot of progress in the short four months since **SEC** chairman **Harvey Pitt** asked the exchanges to review their listing standards.

- On April 4, I testified before the **Corporate Accountability and Listing Standards Committee** of the **NYSE**. We discussed the NACD board’s recommendations to Congress, and the committee seemed very receptive to them.
- On May 13, I met with **Edward S. Knight**, the executive vice president of **Nasdaq**, as well as with his senior legal staff. As mentioned in my last *DMX* letter, most of our discussion revolved around opportunities to educate CEOs and boards.
- On June 5, with senior research staff, I visited the offices of **Hon. John LaFalce** (D-NY) and his senior legal staff. Rep. LaFalce, the ranking minority member of the **House Financial Services Committee**, reported on governance to a full house on the last day of our April 2002 NACD Annual Conference. He had requested this follow-up meeting to find out how our research and publications might help his committee in its efforts to reform corporate governance. We spent time discussing the anticipated **Nasdaq** and **NYSE** recommendations, agreeing that these would be valuable in the national effort to raise corporate governance standards. I described to Rep. LaFalce how responsive the Nasdaq and the NYSE had been to NACD views in my meetings with them.

These are truly exciting times for corporate directors and all those who are involved in corporate governance. It is a privilege for NACD to be an active participant in shaping the positive changes ahead.

Roger W. Raber, NACD President and CEO

A publication of the
National Association of
Corporate Directors
1828 L Street NW
Suite 801
Washington, D.C. 20036
(202) 775-0509
www.nacdonline.org



The Proposed Nasdaq Listing Standards

The **Nasdaq** proposals appeared Friday, May 24, 2002. As reported in the May 23 edition of *DMX*, these were based on rules originally proposed by the **Nasdaq Listing and Hearing Review Council** and approved by the executive committee of the board. on April 13, 2002.¹

Comparing the two sets of Nasdaq proposals, it is clear that the top priority for the Nasdaq (present in both proposals) is the *independence and effectiveness of audit committees*. The board-approved rules were similar to the rules approved by the executive committee in April, as reported in *DMX* on May 23. The Nasdaq gained support for these proposals, and clarified their details, following two Corporate Governance Summits—one on May 8 in San Jose, California, and the other on May 14 in New York City. Over 130 senior executives of Nasdaq-listed companies attended.

There were only two items “missing” from the board-approved recommendations, but previously approved by the board’s executive committee. First, the committee had okayed a ban on stock market executives holding board seats at companies listed on their exchange. The Nasdaq board apparently nixed that. Also missing was a requirement for *continuing education for board members*. NACD president **Roger Raber** wrote a letter on June 2 to Nasdaq CEO and chairman **Wick Simmons** urging the Nasdaq to consider such a requirement, as proposed by the NACD board on March 1.

The Nasdaq May 24 press release clarified some important points about the proposed listing standards, which, if approved, will affect all of its 4,000 listed companies.

- **Stock plans.** Nasdaq rules require shareholder approval for most equity-based pay plans except broadly based plans—that is, plans in which most participants are not officers or directors. The proposed listing rule would drop that exemption. The board also said that listed companies can continue to provide “inducement grants” to new executive officers without shareholder approval, but added that the grants would have to be approved by an independent compensation committee or a majority of the company’s independent directors.²

- **Independent directors.** The board strengthened the definition of an independent director. The current Nasdaq definition prohibits independent directors from receiving more than \$60,000 in compensation. The newly

proposed listing standards would extend this to any payments, including political contributions, in excess of \$60,000 and will extend to receipt of such payments by a family member of the director. Furthermore, a director will not be considered independent if the company makes payments to a charity where the director is an executive officer and such payments exceed the greater of \$200,000 or 5 percent of either the company’s or the charity’s gross revenues.

- **Related-party transactions.** Nasdaq’s conflict of interest review requirement was also expanded to require that a company’s audit committee or a comparable body of the board of directors *review and approve* all related-party transactions. (A related party is “one who can exercise control or significant influence over another party, to the extent that one of the parties may be prevented from pursuing its own separate interests.”) The current requirement is limited to *review*.

- **Misrepresentation.** The proposed listing standards clarified existing rules by saying that a company that makes an intentional misrepresentation to Nasdaq, intentionally omits necessary material information in a communication with Nasdaq, or otherwise fails to provide requested information, may be delisted.

- **Going concern disclosure.** Under current rules, if an auditor has doubts about the ability of a company to continue as a going concern for a reasonable period of time, the auditor must state this in an explanatory paragraph in the auditor’s report in the 10-K form. The new standard would require, in addition, a statement in a press release.

- **Disclosure of material information.** The newly proposed rules brought listing standards up to par with the standards of Regulation FD (effective October 23, 2000).³

The Nasdaq’s effort to improve listing standards is on a rolling schedule, so we can expect more changes to come. For example, on June 5, the Nasdaq adopted rules that would ban analysts from appearing at meetings to choose underwriters.

The Proposed NYSE Listing Standards

On Friday, May 30, the NYSE board’s **Corporate Accountability and Listing Standards Committee** chaired by **H. Carl McCall**, **Gerald H. Levin**, and **Leon E. Panetta**, sent the NYSE board a draft proposal of recommendations.

¹ Source: SEC and Nasdaq websites. Note: the Nasdaq press release of May 24 reports a much earlier date for this approval, but that date appears to be an error, since it coincides with the date of the original assignment from SEC chairman Pitt.

² The proposed rules did not eliminate (hence retained) an existing exception for employee stock ownership plans (ESOP) and rights and warrants offered generally to all shareholders.

³ See for example *DMX* May 23, 2002, or *Director’s Monthly*, October 2000, p. 22.

These recommendations, submitted to the NYSE board on Thursday, June 6, are not yet official. Based on the report posted today on the [NYSE website \(nyse.com\)](http://nyse.com), they are both rigorous—requiring conformity, not merely disclosure of conformity—and comprehensive—containing all but one of the [10 recommendations proposed by the NACD board on March 1, 2002](#), as well as many recommendations proposed by other groups. (The report does not recommend requiring board engagement in strategic planning, as our board recommended.)

Otherwise, NYSE standards include items consistent with NACD recommendations. Among other items, the rules would (like the guidelines the NACD board sent the NYSE for consideration): require listed companies to have a board composed of a *majority of independent directors*; tighten the *definition of independence* for all directors and for members of the audit committee; require regular *executive sessions* of independent directors; have *independent audit, compensation, and nominating/governance committees with charters*; and require companies to adopt and disclose *codes for corporate governance* and for *business conduct*. Importantly, the new standards would require that the governance codes include provisions relating to *director education and orientation*, a key NACD recommendation.

In addition, the proposed new listing standards would require CEOs to certify to the NYSE each year that the company has set up a process to verify the accuracy and completeness of the information provided to investors. The proposed standards also include items relating to the monitoring and enforcement of these listing standards.

Overall, the NACD is extremely impressed with the comprehensive and responsive nature of these proposed new standards. We urge directors of NYSE companies (now numbering nearly 3,000) to study them carefully and to comment on them.

Note well: The standards will require conformity (rather than merely requiring disclosure of conformity). As such, directors will want to

make sure that each and every one of these proposed standards represents the very best standard for all boards. If, for example, the proposed listing standards require a committee to oversee an area that might be better left to a separate committee, it will be important to flag that concern before it becomes a rigid rule.

To develop its views on independence, the NYSE asked the [Investor Responsibility Research Center \(IRRC\) \(irrc.org\)](#) to conduct a study on the topic. About 25 percent of the corporate boards IRRC analyzed at the NYSE's request fell short of the proposed requirement that a majority of directors qualify as independent, based on information disclosed in their 2001 proxy statements. This is not as discouraging as the information reported in the [Public Company Corporate Governance Survey 2001-2002](#), conducted by the NACD in collaboration with [Institutional Shareholder Services \(issproxy.com\)](#). The NACD study, based on more than 5,000 proxies in the ISS data base, found that only 61 percent of the 5,000 public companies studied had boards that were composed of more than 50 percent or more independent directors.

Comparison

The **Nasdaq** and **NYSE** proposals were developed separately, and do not have much in common other than their shared recommendation that stockholders should approve (or have a say in) equity plans involving senior executives and directors. The Nasdaq proposal emphasizes audit committees and compensation plans, while the NYSE recommendations address board operations.

The NYSE recommendations, while much more comprehensive and detailed than the NACD recommendations of March 1, bear a striking (and gratifying) resemblance to them. Taken on the whole, the proposed listing standards at both exchanges respond to concerns advanced by NACD as well as other groups—and there is good reason to believe that the **SEC** will respond to the views of these same groups during the comment period for these listing standards. ■

National Association of Corporate Directors (NACD), an independent not-for-profit organization founded in 1977, is the country's only membership organization devoted exclusively to improving corporate board performance. The NACD conducts educational programs and standard-setting research, and provides information and guidance on a variety of board governance issues and practices. Membership comprises board members from U.S. and overseas companies ranging from large publicly held corporations to small over-the-counter, private, and closely held firms. NACD lists all interested members on The Director's Registry, which is used by member companies and others that seek qualified directors. With chapters in many major cities providing educational programs and networking opportunities, NACD operates at both a national and local level. To educate the corporate community and to provide networking links among NACD chapter members, the NACD holds an annual Corporate Governance Conference, where it presents a Director of the Year Award.

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