

December 3, 2003

**Timely Commentary on Critical Events
and Regulatory Developments**

New Governance Standards: A Guide for 2004

Attention directors and advisors: If you are responsible for setting governance standards, your work is almost cut out for you. Starting next year, companies reporting to the **Securities and Exchange Commission (SEC)** will be *required* to:

- Make new disclosures re *nominating committees and communications with shareholders* (effective January 1, 2004).
- Follow new **New York Stock Exchange (NYSE)** and **NASDAQ listing standards for board composition and operations** (effective for 2004 annual meetings, with certain exceptions).¹

Also, companies next year *may* have to grant some shareholders access to director nominations (see Box 1).

Even if the board you serve is not a public company, these new and proposed rules are likely to affect your board procedures in predictable ways. Similar or identical governance changes are affecting all aspects of the financial spectrum, including *mutual funds* (see Box 2).

This *DMX* contains brief summaries of the new and proposed rules—as well as links to practical NACD guidance.

Disclosures re Nominating Committees and Shareholder Communications

Nominating committees are at the crux of governance reform. In a final rule effective January 1, 2004, “Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors,”² <http://www.sec.gov/rules/final/33-8340.htm>, the SEC requires companies to disclose:

- Whether or not they have (or plan to form) a nominating committee;
- The nominating committee’s charter, if any;
- The nominating committee’s processes for identifying and evaluating candidates; and
- The minimum qualifications for a nominee recommended by the nominating committee and any qualities and skills that the nominating committee believes are necessary or desirable for board members to possess.

The rule also requires that boards disclose how shareholders may communicate with directors—if at all. These rules require disclosure but do not mandate any particular action by a company or its board of directors.

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¹ Generally, the deadline for compliance with the new corporate governance standards, for both NYSE- and NASDAQ-listed companies, will be the company’s first annual meeting occurring after January 15, 2004, but not later than October 31, 2004, with some exceptions. NASDAQ-listed companies will need to adopt a code of conduct by May 2004 and must have related party transactions approved by their audit committee effective January 15, 2004. Source of date summary: Weil, Gotshal & Manges.

² 17 CFR Parts 228, 229, 240, 249, 270 and 274 [Release Nos. 33-8340; 34-48825; IC-26262; File No. S7-14-03] RIN 3235-AI90.

For guidance, directors can consult the *Report of the Council of Institutional Investors-National Association of Corporate Directors Joint Task Force on Board-Shareowner Communications*, to be released January 1, 2004. Also recommended from NACD: *The Governance Committee Handbook* (2003) <http://www.nacdonline.org/publications>. (Most nominating committees today also serve as governance committees—and are often called by this name.)

NYSE and NASDAQ Listing Standards

Next year also brings new listing standards for public companies listed on the NYSE (<http://nyse.com/pdfs/finalcorpgovrules.pdf>) and NASDAQ (<http://www.nasdaq.com/about/RecentRuleChanges.stm>).

The new rules, both approved by the SEC in early November, cover a variety of board functions. For a side-by-side comparison, see a chart by Weil, Gotshal & Manges (WGM), [http://www.weil.com/wgm/cwgmhomep.nsf/Files/CorpChart_11-03/\\$file/CorpChart_11-03.pdf](http://www.weil.com/wgm/cwgmhomep.nsf/Files/CorpChart_11-03/$file/CorpChart_11-03.pdf).

Box 1: Shareholder Access

On October 14, 2003, the SEC proposed new rules on "Security Holder Director Nominations,"³ <http://www.sec.gov/rules/proposed/34-48626.htm>. The proposed rules, which have a comment deadline of December 22, 2003,⁴ would require companies under some circumstances to include shareholder-nominated board candidates in their proxy materials, where allowable under state law.

The proposed rules would enable security holders to engage in limited solicitations to form nominating security holder groups and engage in solicitations in support of their nominees without disseminating a proxy statement. The rules apply only to the nominees of long-term security holders, or groups of long-term security holders, with significant holdings. Inclusion would be required only where "evidence suggests that the company has been unresponsive to security holder concerns as they relate to the proxy process."

The NACD board of directors has already expressed its views to the SEC. In a letter dated June 13, 2003 (responding to the SEC's first request for comments on shareholder access), the NACD board noted that shareholder access could be achieved through amending of company bylaws, and urged the SEC to focus on nominating committee independence and operations. Following receipt of this letter and others, the SEC did propose expanded disclosure requirements, as summarized in this issue of *DMX* (see p. 1).

Board independence, independent committee requirements, and codes of conduct are common to both the New York Stock Exchange and NASDAQ, with limited exceptions. They are summarized from a memorandum by WGM, [http://weil.com/wgm/cwgmhomep.nsf/Files/SOXA_11-4-03_CorpGovListingStnds/\\$file/SOXA_11-4-03_CorpGovListingStnds.pdf](http://weil.com/wgm/cwgmhomep.nsf/Files/SOXA_11-4-03_CorpGovListingStnds/$file/SOXA_11-4-03_CorpGovListingStnds.pdf).

Board Independence

- Boards must have a majority of independent directors.
- Boards must determine their members' independence, in accordance with a general standard and specific requirements.
 - In the case of the NYSE, the board must conclude that the director has no "material relationship" with the company either directly or "as a partner, shareholder or officer of an organization that has a relationship with the company."
 - In the case of NASDAQ, the board must conclude that a director does not have any relationship that would interfere with his or her exercise of independent judgment. These include relationships as an employee, a director who receives any compensation from the company or its affiliates above a threshold level (except for service as a director), and a director who is materially associated with a provider of professional services or a material provider of other services or goods or a material customer (as determined under specified materiality criteria).
- Any director who has had such a relationship within the past three years will not be considered independent, with some exceptions. (Until the first anniversary of the effectiveness of the new standards, a "look-back" period of one year only will apply for a NYSE-listed company).

3 Securities and Exchange Commission, 17 CFR Parts 240, 249 and 274 [Release Nos. 34-48626; IC-26206; File No. S7-19-03] RIN 3235-AI93.

4 All comment letters should refer to File No. S7-19-03.

- Independent directors must meet regularly without any management members present. NYSE companies must disclose the name of the director who will preside at such meetings (or the way the board selects the presiding director) and the way shareholders may use to communicate with the independent directors. This item is similar to the new SEC rules effective January 1, 2004, pertaining to all public companies (see above).

Independent Committee Requirements

- Both NYSE- and NASDAQ-listed companies must now have an audit committee of at least three members and composed entirely of independent directors and having specified authority and responsibility. (For more details, see [http://www.weil.com/wgm/cwgmhomep.nsf/Files/SOXA301FinalRules/\\$file/SOXA301FinalRules.pdf](http://www.weil.com/wgm/cwgmhomep.nsf/Files/SOXA301FinalRules/$file/SOXA301FinalRules.pdf).)
- In addition, NYSE-listed companies must have an independent nominating/corporate governance committee and an independent compensation committee. NASDAQ companies also must have such a committee, or, if not, must have a majority of their independent directors approve director nominations and executive officer compensation. For guidance on audit, compensation, and governance committees, see the following NACD publications: *Report of the NACD Blue Ribbon Commission on the Audit Committee* (2000—with update to appear January 2004), *Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee* (December 2003), and the *Governance Committee Handbook* (2003) <http://www.nacdonline.org/publications>.
- Audit committees must have and disclose a board-approved charter. NYSE-listed companies must adopt and disclose charters for their compensation and nominating/governance committees, providing these committees with certain minimum authority and responsibility. A NASDAQ-listed

Box 2: Mutual Fund Governance

Mutual fund governance reform is a hot issue for 2004. The recently proposed SEC rule permitting shareholder access to board nominations would apply to mutual funds, as would the new rules about nominating committee disclosures. And although NYSE and NASDAQ rules do not affect mutual funds, similar changes are coming funds' way.

Following charges of fraud at some mutual funds, Congress and the SEC are considering a number of possible reforms.

- In **Congress**, the first shot across the bow was the Mutual Funds Integrity and Fee Transparency Act (HR 2420). This bill, originally introduced by capital markets subcommittee chairman **Rep. Richard Baker** (R-LA), passed the House on November 19, 2003, heading to the Senate side, where **Sen. Peter Fitzgerald** (R-IL) has held recent hearings on mutual fund problems.
- The **SEC** has been cracking down on mutual funds. Last month, Chairman **William Donaldson** said that the agency intends to "overhaul" the regulation of the mutual fund industry by adopting measures to curtail abusive trading, clarify rules on conflicts of interests, and compel better disclosure of fees. He has asked the **Mutual Fund Directors Forum** (<http://mfd.com>) for help in this regard. The Forum was co-founded by former SEC Commissioner **David Ruder** of **Northwestern University School of Law** and **Allan Mostoff**, partner emeritus with **Dechert LLP** in Washington, D.C.

Reform ideas circulating in Congress and the SEC include:

- Independent chairman*
- A higher percentage of independent directors on boards*
- Board authority to retain staff**
- Annual board self-evaluation*
- Improved documentation*
- Chief compliance officer to report solely to independent directors
- Limit on number of funds that can be overseen by a single director. In some fund families, a single board oversees many funds—even 80 or more.
- Limit on the fees that a director can get for multiple fund oversight (compensation can be per fund).

Meanwhile, the beat goes on. On December 2, 2003, the SEC announced civil fraud charges against **Invesco Funds Group, Inc.** (IFG), of Denver, and its CEO—the eighth such action against a mutual fund in the past four weeks. According to the charges, IFG and its CEO fraudulently accepted investments by dozens of market timers in Invesco mutual funds to increase the management fees earned by IFG. The SEC charged Invesco and its CEO with a breach of fiduciary duties to fund shareholders.

* On December 3, the SEC held an open meeting to announce its reform agenda for 2004, providing details on the areas above.

Procedure to Send Comments to the SEC

The NACD is a not-for-profit organization and does not engage in lobbying. However, we encourage our members to express their views concerning corporate governance matters. Here are instructions for providing comments to the SEC.

Send by one method—U.S. mail or electronic mail—only. Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. Comments also may be submitted electronically at the following e-mail address: rule-comments@sec.gov. Include the "File No." for the rule on the subject line of your e-mail. This is the number that begins "S7-" or "SR-". Electronically submitted comment letters will be posted on the Commission's Internet website (<http://www.sec.gov>).

For further information contact: Lillian C. Brown or Grace K. Lee, Division of Corporation Finance, at (202) 824-5250, or, with regard to investment companies, John M. Faust, Division of Investment Management, at (202) 942-0721, U.S. Securities and Exchange Commission, 450 Fifth Street, NW, Washington DC 20549-0402.

company must either establish a charter for its nominating committee or else have formal (board-approved) processes for selecting director nominees and for addressing such other related responsibilities as the board may be required to address under the federal securities laws. For sample charters for all committees, see the NACD's *Governance Policy Workbook* (2003) <http://www.nacdonline.org/publications>.

Codes of Conduct

- Listed companies are required to adopt and disclose a code of business conduct for

their directors, officers, and employees and to make prompt disclosure of any waivers from the code's requirements granted to directors and executive officers. The code of conduct must address conflict of interest transactions, legal compliance, and a reporting and enforcement mechanism, among other matters. Also, NASDAQ-listed companies must review all related party transactions for conflicts of interest. These transactions will require audit committee or independent director approval.

- NYSE-listed companies are also required to adopt and disclose corporate governance guidelines, which generally must address any qualifications established for election as a director, director compensation policies, policies respecting director access to management and independent advisors, policies respecting management succession, and an annual board self-evaluation. For guidance on codes of conduct, see the NACD's *Ethics and Compliance Handbook* (2003) <http://www.nacdonline.org/publications>.

Test of Time

The rules are timely—and with proper implementation may well stand the test of time. To quote SEC Chairman William Donaldson, "Investors will recognize significant benefits from these actions today and long into the future."⁵ This will be especially true if directors can avoid a "cookie cutter" approach. Directors' work may be "almost" cut out for them, but now boards must do the hard work of practical implementation. ■

5 The release approving the new rules may be found on the Commission's website at <http://www.sec.gov/rules/sro/34-48745.htm>. Source: <http://www.sec.gov/news/press/2003-150.htm>

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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