

SARBANES-OXLEY UPDATE

NASDAQ: Summary of the Corporate Governance Proposals as of April 25, 2003

Executive Summary

Nasdaq has proposed several corporate governance reforms. As of April 25, 2003, the following proposals, as amended, were pending SEC approval:

- Board independence and committees
- Change of control definition for purposes of certain notification and shareholder approval requirements
- Shareholder approval of stock option plans
- Insider participation in discounted private placements
- Listing appeals process
- Codes of conduct
- Related party transactions
- Disclosure of exemptions by foreign issuers
- Disclosure of audit opinions with a going concern qualification

What are the primary changes to the existing corporate governance rules proposed by Nasdaq?

Board independence and committees

The SEC has published in the Federal Register Nasdaq's proposed rule change, and amendments thereto, for public comment regarding board independence and independent committees. (NASD Rules 4200 and 4350).

How does the proposal change the definition of Independent Director?

Nasdaq proposed to amend NASD Rule 4200(15) by changing the definition of "independent director" to exclude from the definition not only a person who is an officer or employee of the company or its subsidiaries or any individual having a relationship, which, in the opinion of the company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director, but also the following persons:

- A director who is, or during the past three years was, employed by the company or by any parent or subsidiary of the company.
- A director who accepts or has a family member (defined below) who accepts 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 (i) compensation for board service, (ii) payments arising solely from investments in the company's securities, (iii) compensation paid to a family member who is an employee of the company or a

parent or subsidiary of the company (but not if such person is an executive officer of the company or any parent or subsidiary of the company), (iv) benefits under a tax-qualified retirement plan or (v) non-discretionary compensation (provided, however, that audit committee members are subject to heightened requirements under Rule 4350(d) (see below)).

- A director who is a family member of an individual who is, or during the past three years was, employed by the company or by any parent of the company as an executive officer.
- A director 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 (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 greater, in the current fiscal year or any of the past three fiscal years.
- A director of a listed company who is 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, or if such relationship existed during the past three years.
- A director who is or was a partner or employee of the company's outside auditor, and worked on the company's audit, during the past three years.

The board of directors would be required to make an affirmative determination that individuals serving as independent directors do not have a relationship with the listed company that would impair their independence.

"Family member" would be defined as any person who is a relative by blood, marriage or adoption or who has the same residence. Note that this definition is more expansive than the SEC's term "indirect acceptance" by a board member as it relates to the member's family, which includes only a person's spouse, minor children or stepchildren, or children or stepchildren sharing the director's home.

The reference to "parent or subsidiary" is intended to cover entities that are consolidated with the issuer's financial statements.

What would be required of the board?

Nasdaq proposed to change NASD Rule 4350(c) to require the following:

- A majority-independent board;
- Regularly scheduled (perhaps at least twice a year) meetings at which only independent directors are present ("executive sessions");
- Compensation of officers to be set by a majority of independent directors or a compensation committee comprised solely of independent directors and, in either case, meeting in executive session with respect to the CEO's compensation; and
- Nomination of directors to be set by a majority of independent directors or a nominating committee comprised solely of independent directors.

Under exceptional and limited circumstances, a director who is not independent and not a current officer or employee or family member of such person may be appointed to a compensation or nominating committee of at least three members if the board determines that such individual's membership on the committee is required by the best interests of the company, and the board discloses, in the next annual meeting proxy statement subsequent to such determination, the nature of the relationship, and the reasons for the determination. A member appointed under this exception would not be allowed to serve longer than two years.

Also, if the nominating committee does not rely on the exception stated above and is comprised of at least three members, one director who owns 20% or more of the company's common stock or voting power outstanding, and is not independent because that director is also an officer, may be appointed to the nominating committee if the board makes the determination and disclosure mentioned immediately above.

There would be an exception to NASD Rule 4350(c) for “controlled companies,” which would be defined as a company of which more than 50% of the voting power is held by an individual, a group or another company. In order for a group to exist for purposes of this rule, the shareholders must have publicly filed a notice that they are acting as a group (e.g., a Schedule 13D). A controlled company relying on this exemption must disclose in its annual meeting proxy statement that it is a controlled company and the basis for that determination. This controlled company exception does not extend to the audit committee requirements under NASD Rule 4350.

What would the proposals add to the audit committee charter?

Under Nasdaq’s proposal, NASD Rule 4350(d) would require that an audit committee charter specify, in addition to the scope of the audit committee’s responsibilities, and how it carries out those responsibilities and its responsibility for ensuring independence of the outside auditors, including the receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the company, the following:

- The committee’s purpose of overseeing the accounting and financial reporting processes of the issuer and the audits of the financial statements of the issuer.
- The pre-approval of all audit services and permissible non-audit services.
- The sole authority to appoint, determine funding for and oversee the outside auditors.
- The responsibility to establish procedures for complaints regarding accounting, internal accounting controls or auditing matters.
- The authority to engage and determine funding for independent counsel and other advisors.

What are the requirements for audit committee structure?

Also under proposed NASD Rule 4350(d), issuers would be required to have, and to certify that they have, an audit committee of at least three members, each of whom:

- must (i) be independent as set forth in the NASD Rule 4200, (ii) satisfy the criteria for independence set forth in Section 10A(m)(3) of the Securities and Exchange Act of 1934 (*i.e.*, not accept any consulting, advisory or other compensation from the issuer or be an “affiliated person” of the issuer or any subsidiary thereof) and (iii) not own or control 20% or more of the issuer’s voting securities; and
- must be able to read and understand financial statements.

In addition, issuers must certify that they have, and will continue to have, at least one member of the audit committee who has financial sophistication due to past employment in finance, accounting or any other comparable experience, including being or having been a CEO, CFO or other senior officer with financial oversight responsibilities. This certification is in addition to the requirement that the company disclose whether it has an “audit committee financial expert” and if not, the reasons therefore, as required under Item 401(e) of Regulation S-K. Note that disclosure of whether a company has an “audit committee financial expert” serving on its audit committee is required only in an annual report, although a company may include such information in its proxy or information statement and incorporate that disclosure into its annual report if it complies with the applicable rules for incorporation by reference.

Nasdaq would allow the appointment to the audit committee of one director who (i) does not satisfy the NASD Rule 4200 definition of “independence” to be a member of the audit committee, (ii) satisfies the Section 10A(m)(3) criteria, (iii) does not own or control 20% or more of the issuer’s securities and (iv) is not a current officer or employee or family member of such person, if the board, “under exceptional and limited circumstances,”:

- determines that it is in the best interest of the corporation and its shareholders; and
- discloses the nature of the relationship and the reasons for its determination in the next annual proxy statement following such determination.

An audit committee member appointed in such a manner may not serve longer than two years, or chair the audit committee.

When would companies be required to comply with this rule?

By the first annual meeting occurring after January 1, 2004, companies would be required to comply with the board composition requirements, which include:

- Independent directors as defined by NASD Rule 4200(a)(15).
- A majority-independent board as required by NASD Rule 4350(c)(1).
- Independent director approval of executive compensation as required by NASD Rule 4350(c)(3).
- Independent director approval of director nominations as required by NASD Rule 4350(c)(4).
- Audit committee composition as required by NASD Rule 4350(d)(2).

All other independence-related corporate governance requirements, including the regularly scheduled executive sessions and the audit committee written charter, would be implemented six months after SEC approval.

Newly listed companies would be required to comply with all of the board composition requirements within two years after SEC approval of the rules, and will receive any remaining balance of the six month grace period to comply with all other requirements.

Companies transferring from other markets with substantially similar requirements would have the same period of time that they would have had if they remained with the other market.

Definition of “change of control” for purposes of certain notification and shareholder approval requirements

Under rules applicable to Nasdaq listed companies, issuers are required to notify Nasdaq no later than 15 calendar days prior to issuing securities that may potentially result in a change of control of the issuer. In addition, Nasdaq requires shareholder approval when an issuance or potential issuance will result in a change of control of an issuer.

Nasdaq proposed to clarify NASD Rule 4200(8) defining “change of control” by providing that a change of control will occur if an investor or group of investors acquires or obtains the right to acquire 20% or more of the common stock (or securities convertible into or exercisable for common stock) or of an issuer’s outstanding voting power on a post-transaction basis, unless, following the transaction, a larger ownership and/or voting position is held by: (i) a shareholder, or an identified group of shareholders, unaffiliated with the investor or (ii) the issuer’s directors and officers as a group that are unaffiliated with the investor.

For the purpose of this definition, a “group” will constitute two or more persons that have identified themselves as a group in a public filing made with the SEC. The definition will not apply in the context of reverse mergers.

When would this rule become effective?

This rule would become effective upon publication of SEC approval in the Federal Register. As of the date of this advisory, SEC approval has not been published.

Shareholder approval of stock option or purchase plans

Nasdaq proposed to amend NASD Rule 4350(i)(1)(A) to require issuers to obtain shareholder approval prior to the issuance of securities under the following circumstances:

- A stock option or purchase plan is to be established.
- A stock option or purchase plan is materially amended; the following is a non-exclusive list of amendments considered material:
 - o Any increase in the number of shares to be issued under the plan (other than to reflect a reorganization, stock split, merger, spinoff or similar transaction).

- o Any material increase in benefits to participants, including any change to:
 - (i) permit a repricing (or decrease in exercise price) of outstanding options,
 - (ii) reduce the price at which shares or options to purchase shares may be offered,
 - (iii) increase the number of shares that may be granted or sold under the plan, or
 - (iv) extend the duration of a plan.
- o Any expansion of the class of participants eligible to participate in the plan.
- o Any change in the types of options or awards provided under the plan.
- An arrangement is made pursuant to which options or stock may be acquired by officers, directors, employees or consultants.

While general authority to amend a plan would not obviate the need for the shareholder approval, if a plan permits a specific action without further shareholder approval, then no such approval would be required.

Would there be any exceptions to this shareholder approval requirement?

The proposal makes an exception for the following:

- Warrants or rights issued generally to all security holders of the company;
- Tax qualified, non-discriminatory employee benefit plans or “parallel nonqualified plans”;
- Inducement grants to new employees; and
- Plans relating to an acquisition or merger in two instances: (i) shareholder approval will not be required to convert, replace or adjust outstanding options or other equity compensation awards to reflect the transaction and (ii) shares available under certain plans acquired in acquisitions and mergers may be used for certain post-transaction grants without further shareholder approval.

Would board approval be required for the exceptions to this shareholder approval requirement?

Yes. Inducement grants, tax qualified non-discriminatory benefit plans, and parallel nonqualified plans are subject to approval by either the issuer’s compensation committee, or a majority of the issuer’s independent directors.

Also note that a company would not be permitted to use repurchased shares to fund option plans or grants without prior shareholder approval. However, plans that merely provide a convenient way to purchase shares on the open market or from the issuer at fair market value would not require shareholder approval.

Would there be a de minimis exception to this shareholder approval requirement?

No. Nasdaq proposed to eliminate the *de minimis* exception, which allows for the grant of the lesser of 1% of the number of shares of common stock or 25,000 shares, without shareholder approval because Nasdaq believes this exception is not in accord with the concept of restricting the use of unapproved options.

When would this rule become effective?

This rule would become effective upon publication of SEC approval in the Federal Register. As of the date of this advisory, SEC approval has not been published.

Insider participation in discounted private placements

Nasdaq proposed to amend NASD Rule 4350(i)(1)(D) to clarify that shareholder approval is required for stock issuances for less than the market value of the stock in private placements in which officers or directors participate, unless the total number of shares to be issued to all such officers and directors is less than 5% of the total shares issued in the transaction and less than 1% of the total shares outstanding before the issuance. Nasdaq believes that it is necessary to provide a *de minimis* exception in this rule because outside investors often require that a

company's officers and directors participate in private placements to demonstrate their continued support for the company, and that the exception is low enough to allay concerns of self-dealing.

"Market value" would be defined as the closing bid price immediately preceding, or the average of the closing bid prices for a period of up to five days immediately preceding, the execution of a fully binding definitive agreement that is not subject to any contingency other than a regulatory contingency. If the securities are not promptly issued after the execution of the binding definitive agreement for any reason other than a regulatory contingency, Nasdaq may use the closing bid price on the date that the securities are issued to determine market value in order to limit the possibility of circumventing the intent of the shareholder approval rules.

When would this rule become effective?

This rule would become effective upon publication of SEC approval in the Federal Register. As of the date of this advisory, SEC approval has not been published.

Listing appeals process

Nasdaq proposed to change NASD Rule 4810(e) to clarify the current rule that an issuer's failure to meet any quantitative standard or qualitative consideration may be considered at each level of the appeals process by adding an explicit statement that the Listing Council and the NASD Board have the authority to consider any action undertaken by an issuer during the appeals process that would constitute a violation of Nasdaq's corporate governance requirements. Before the Listing Council or the NASD Board considers any additional violation of Nasdaq's corporate governance rules that occurs during the appeals process, the issuer will be provided notice of the violation and an opportunity to respond.

When would this rule become effective?

This rule would become effective upon publication of SEC approval in the Federal Register. As of the date of this advisory, SEC approval has not been published.

Codes of conduct

Nasdaq proposed to change NASD Rule 4350(m) to require that each issuer adopt a code of conduct for all directors, officers and employees, which must be publicly available. Issuers can satisfy this obligation by adopting one or more codes of conduct. Waivers to the code of conduct for executive officers or directors can only be granted by the issuer's board and must be disclosed, along with the reasons for the waiver, in the issuer's public filings no later than in the next periodic report. An issuer may alternatively choose to include this disclosure in a report on Form 8-K filed before its next periodic report.

The code of conduct must:

- include those elements necessary to meet the "code of ethics" requirements, as defined by the SEC pursuant to Section 406(c) of the Sarbanes-Oxley Act of 2002 and any rules promulgated thereunder; and
- provide for an enforcement mechanism ensuring 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.

When would this rule become effective?

Nasdaq plans to implement the rule six months after publication of SEC approval in the Federal Register. As of the date of this advisory, SEC approval has not been published.

Related party transactions

Nasdaq proposed to change Nasd Rule 4350(h) to require that an issuer's audit committee or another independent body of the board of directors approve related party transactions.

For the purpose of this rule, "related party transaction" would be defined as transactions required to be disclosed pursuant to SEC Regulation S-K, Item 404.

When would this rule become effective?

This rule would become effective upon publication of SEC approval in the Federal Register. As of the date of this advisory, SEC approval has not been published.

Disclosure of exemptions by foreign issuers

Nasdaq proposed to change NASD Rule 4350(a) to require that non-U.S. issuers disclose any exemptions to Nasdaq's corporate governance requirements, permissible under the Sarbanes-Oxley Act of 2002 or rules promulgated by the SEC thereunder, at the time of their initial public offering or first U.S. listing on Nasdaq and annually (e.g., Forms F-1, 20-F, 40-F or 10-K), as well as any alternative measures taken in lieu of the waived requirements.

When would this rule become effective?

Nasdaq proposes that the rule take effect for new listings and filings made on or after January 1, 2004.

Disclosure of audit opinions with a going concern qualification

Nasdaq proposed to change NASD Rule 4350(b) by requiring issuers that receive an audit opinion containing a going concern qualification to make a public announcement through the news media disclosing the receipt of such qualification. Prior to the release of the public announcement, the issuer would be required to provide the text of the public announcement to the Stock Watch section of Nasdaq.

The public announcement and notice to Nasdaq would be required to be made no later than seven calendar days following the filing of such audit opinion in a public filing with the SEC.

When would this rule become effective?

This rule would become effective upon publication of SEC approval in the Federal Register. As of the date of this advisory, SEC approval has not been published.

For more information, please contact any of the following Jenner & Block attorneys:

Robert S. Osborne	rosborne@jenner.com	Tobias L. Knapp*	tknapp@jenner.com
Jerry J. Burgdoerfer	jburgdoerfer@jenner.com	David R. Bowman	dbowman@jenner.com
Charles J. McCarthy	cmccarthy@jenner.com	Edward G. Quinlisk	equinlisk@jenner.com
Robert Z. Slaughter	rslaughter@jenner.com	Bobby J. Hollis II*	bhollis@jenner.com
John E. Welch*	jwelch@jenner.com	David M. Neville	dneville@jenner.com
Thomas A. Monson	tmonson@jenner.com	Jill R. Sheiman	jsheiman@jenner.com
Thaddeus J. Malik	tmalik@jenner.com	Michael D. Thompson	mthompson@jenner.com
Donald E. Batterson	dbatterson@jenner.com	Cari M. Weber	cweber@jenner.com
		Jeffrey M. Wittenberg	jwittenberg@jenner.com

All attorneys may be contacted by phone at 312 222-9350, except * at 202 639-6000.

Additional Sarbanes-Oxley rule summaries can be found at:

http://www.jenner.com/practice/practice_detail.asp?ID=439&ParentID=29&ParentName=Corporate