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## The View From NASDAQ

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Two years ago former Securities and Exchange Commission (SEC) Chairman Harvey Pitt called on The Nasdaq Stock Market (NASDAQ) and the New York Stock Exchange (NYSE) to take a fresh look at their corporate governance listing standards in light of the burgeoning number of accounting scandals. Simply put, the markets were challenged to develop and adopt enhanced listing standards to address the crisis in investor confidence, while at the same time maintaining the risk-taking and entrepreneurial nature which are a key feature of the American economy.

Since then, much has changed. The Sarbanes Oxley Act of 2002 (SOX) was enacted. It, in turn, gave rise to sweeping SEC initiatives cutting across many aspects of the securities laws. And, in November 2003, the SEC approved the many rule changes put forward by NASDAQ and the NYSE in response to Chairman Pitt's original call to action. These regulatory changes have effected a fundamental shift in the balance of power in corporate America, away from management and in favor of independent directors, audit committees and shareholders. We expect that these changes, coupled with a renewed corporate focus on the importance of setting the appropriate "tone at the top," will provide a significant check against the fraud and excess which gave rise to the recent scandals.

NASDAQ's response to this crisis was influenced by a variety of sources, including the views of President George Bush, as reflected in his ten-point program to restore investor confidence; the 18-member NASDAQ Board of Directors; our listed companies, which met at East and West Coast forums on corporate governance; important shareholder constituent groups, such as venture capitalists and institutional shareholders; and the NASDAQ Listing and Hearing Review Council (Listing Council), a standing advisory committee to the NASDAQ Board which devoted countless hours to working with NASDAQ staff. NASDAQ's approach was also directly influenced by the fact that we, too, are a public, reporting company. Our goal was to not only craft the best possible listing standards, but to make sure that we could "eat our own

cooking” — to meet the same conduct we expect of our listed issuers.

Investors care deeply about these issues. Survey after survey confirms this point. For example, in July 2002 McKinsey & Company did a Global Investor Opinion Survey, which concluded: “[a]n overwhelming majority of investors are prepared to pay a premium for companies exhibiting high governance standards.”<sup>1</sup> While some believe that better governance leads to better economic performance, the economic benefits of good governance has its limits. Economic performance alone without ensuring trust in the system of corporate governance and a belief in its fundamental fairness would be shortsighted. It is to that latter goal — restoring trust — that our regulatory approach is directed.

Four core principles guided us. The first was a determination to adopt significant listing standards, not best-practice recommendations. In so doing, our goals were to empower shareholders, independent directors and audit committees and enhance disclosure. While it may not be possible to legislate morality, it is possible to create a

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framework that encourages and supports future compliance. Under our proposals, the preparation of issuer financial statements will be much more closely scrutinized and independent directors and audit committees will be better able, where appropriate, to serve as a fair and effective counterweight to management or the outside auditors.

Our second core principle was to make these listing standards clear and objective, so they would be easy for issuers to understand and apply, and transparent to investors. To the extent practicable, NASDAQ’s proposals are based on bright-line tests, not subjective determinations. In keeping with having clear listing standards, NASDAQ is committed to providing transparency to its ongoing interpretive process. NASDAQ’s regulatory staff has a Legal/Compliance site on the NASDAQ.com home

page. This site already has a wealth of valuable information: the marketplace rules, including all our new rules on corporate governance, listing forms and procedures, proposed rules and hundreds of frequently asked questions about all aspects of our rules, with an emphasis on corporate governance. We intend to provide regular updates to the content of these pages and urge practitioners and listed issuers alike to become regular visitors to that site.

NASDAQ is home to issuers with an astonishing diversity, including some of the largest and smallest public companies. Not surprisingly, our third principle was that a “one size fits all” approach is not appropriate. Instead, we sought to structure our rules to preserve flexibility, particularly for smaller issuers, while assuring accountability.

Finally, NASDAQ has been guided by a desire to “do no harm.” Thus, our fourth core principle was to avoid overly prescriptive rules, and, hopefully, the law of unintended consequences. Most public companies have not been tainted by accounting irregularities and are managed by well-intentioned individuals. We felt it important that any proposed solutions not encumber management, so that the business of doing business suffers, and not effectively foreclose listing opportunities for small companies, thereby limiting the investment opportunities for investors.

After the NASDAQ and NYSE rules were initially filed with the SEC, there was an extended period in which interested parties provided comments to the markets and to the SEC. Similarly, the staff of the SEC and the markets engaged in a broad and constructive dialog on many of these issues. The SEC sought, where possible, to harmonize the two rule proposals. At the end of the day, NASDAQ’s model of bright-line definitional tests for independence was adopted, with slight variants, by each market.

As noted above, the new rules shift power from corporate management to shareholders, independent directors and audit committees. Shareholders have been empowered because they are now required to approve all new stock option plans and material amendments to existing plans, typically those involving material enhancements to the benefits available to plan participants. The new rules preserve the ability of an issuer to continue to grant “inducement” options to new employees without seeking prior shareholder approval, something which has traditionally been of particular importance to issuers in the technology sector, but only if those grants are first

approved by the independent compensation committee or a majority of the independent directors, and are promptly disclosed thereafter. While NASDAQ does not believe that the existence of stock options gave rise to the recent accounting scandals, we believe that shareholders ought to have a direct say in the level of potential dilution to which they will be exposed. In this area, the final rules at the two markets are very similar.

Independent directors have been empowered by several new rules. First, a majority of the board of directors of a NASDAQ-listed issuer must be comprised of independent directors. Further, these independent directors must meet regularly in executive sessions apart from management and other non-independent directors. While NASDAQ has not prescribed a fixed number of such meetings, NASDAQ's internal practice is to have its independent directors meet in executive session at each board meeting, and we suggest that all issuers consider that option.

Finally, NASDAQ proposes to expand the role of independent directors by requiring that executive officer compensation and the critically important board nominations process be subject to the approval of independent directors.<sup>2</sup>

Our new rules take into account the differences in size among issuers by allowing companies to satisfy this requirement *either* by having an independent compensation or nominations committee *or* by allowing the independent directors to approve these matters. This recognizes that some smaller issues may have difficulty attracting and supporting larger boards. In fact, many of our companies have boards of as few as seven directors; requiring these issuers to support three independent committees without offering an alternative compliance mechanism would prove unduly burdensome.

NASDAQ also allows issuers to appoint one non-independent director who can serve, under "exceptional and limited circumstances," for up to two years, on the compensation, nominations or audit committee provided such appointment is disclosed to investors, and that, in the case of audit committees, the exception is limited to the application of NASDAQ's rules, and not the rules of the SEC, which also apply to audit committees.

To help companies identify independent directors and to provide overall

transparency, NASDAQ has defined “independence” through a series of bright-line tests. Thus, no family member of an executive officer can be considered independent.<sup>3</sup> Also, a director, or family member of a director, who receives payments of more than \$60,000 a year from a company, other than director fees, is not considered independent. Similarly, a director, or family member of a director, cannot be independent if he or she is affiliated with an entity to which the company made or received payments exceeding the greater of \$200,000 or 5% of the recipient’s revenues. These numerical tests are based on SEC disclosure requirements, so that it will also be easy for issuers to monitor and for NASDAQ to enforce compliance. Similar tests, with different numerical thresholds, were adopted by the NYSE.

## **NASDAQ’s new rules include numerous changes to empower audit committees.**

NASDAQ’s rules contain a three-year “cooling off” period, for example, for former employees of the issuer or employees of the outside auditor who worked on the company’s audit.<sup>4</sup> We believe this is a sufficiently long period of time to dissipate concerns about independence. The NYSE also adopted a three-year cooling off period.

In evaluating independence, NASDAQ determined that share ownership alone should not disqualify anyone from being deemed independent. Thus, venture capitalists and other large shareholders may qualify as independent directors for all purposes under our rules, except as a member of the audit committee. SEC rules adopted pursuant to the requirements of SOX preclude an “affiliate” from serving on an audit committee and provide a “safe harbor” ownership threshold of 10%.

NASDAQ’s new rules include numerous changes to empower audit committees, most of which mirror various provisions of SOX. Audit committees are, for example, empowered to hire and fire independent auditors; pre-approve non-audit services; determine funding for legal, accounting and other advisers; establish procedures for the receipt and confidential treatment of complaints; and review *and approve* related-

party transactions. Members of audit committees would be prohibited from accepting *any* compensation, outside of director's fees, and would all be required to be financially literate (able to read and understand fundamental financial statements) immediately upon appointment, with one member being required to be financially sophisticated.<sup>5</sup>

Lastly, NASDAQ's new rules incorporate steps to increase transparency and disclosure. Today, for example, non-U.S. issuers are eligible to apply for waivers from corporate governance rules that would be contrary to home country law or business practice. However, these waivers are not readily transparent. Our rules now require non-U.S. issuers to disclose in their annual SEC filings any such waivers. Similarly, issuers are required to adopt codes of conduct conforming to the requirements of SOX<sup>6</sup> for all employees and directors, and to disclose any waivers granted to executive officers and directors. More generally, NASDAQ is the only U.S. market to have fully endorsed the spirit behind the adoption of SEC Regulation FD by recognizing that any Regulation FD-compliant public disclosure by an issuer will satisfy its NASDAQ disclosure obligations.

## **NASDAQ's new rules incorporate steps to increase transparency and disclosure.**

Our new rules concerning board independence and audit committees are effective at an issuer's first annual meeting occurring after January 15, 2004, but in no event later than October 31, 2004. Companies with staggered boards are provided one additional year, up to December 31, 2005, to reconstitute their boards and committees. Small Business (SB) filers and non-U.S. issuers are allowed up to July 31, 2005, to come into compliance with these requirements. Companies listing as part of initial public offerings are allowed one year to come into compliance with the majority independent board requirement and one year to come into compliance with the three independent committee requirements, subject to the following phase-in, which is based upon similar SEC rules: one independent director upon listing; a majority independent

committee within 90 days; and a fully independent committee within one year. The new rule requiring a code of conduct is effective on May 4, 2004.

As mentioned previously, the NASDAQ and NYSE rules have substantial commonalities. Both require shareholder approval of equity compensation and expand the role of independent directors and audit committees. Both recognize the unique needs of controlled companies and that large shareholders should be able to serve as independent directors.

Overall, however, NASDAQ's approach continues to offer greater flexibility, especially for smaller issuers, and is less prescriptive.

By providing alternative compliance mechanisms for the compensation and nominations committees, NASDAQ remains firmly in the camp of "one size does NOT fit all." NASDAQ is also less prescriptive by not requiring corporate governance guidelines, a charter for the compensation committee or an internal audit function. Similarly, NASDAQ only empowers one committee — the audit committee — to retain legal and other experts.

In other respects, NASDAQ's rules are more stringent than those of the NYSE. Only NASDAQ requires audit committee approval of related party transactions. NASDAQ requires that the compensation committee approve all Section 16 officer compensation, not just that of the chief executive officer. And, importantly, NASDAQ believes that the new rules will only be effective if they are vigorously enforced and that the best deterrent against future misconduct is the realization that non-compliance will come at a high cost. Thus, NASDAQ's rules provide that the new corporate governance rules will be enforced through the threat of delisting, rejecting the notion, adopted by the NYSE, that corporate governance violators could instead be issued a "letter of reprimand."

On the other hand, NASDAQ provides an active program of counseling issuers on the meaning and application of its listing standards. Similar to the SEC's "no action" letters, a company can provide a written letter to NASDAQ and, for a small fee, receive binding interpretive guidance. We strongly encourage listed issuers to take advantage of this opportunity. NASDAQ plans to use its legal/compliance web page to post anonymous summaries of such interpretations.

NASDAQ's commitment to transparency and vigorous regulation characterizes its entire business model. Started in 1971, NASDAQ was the world's first electronic, screen-based market. Today, our market is structured to deliver, through electronic facilities, four qualities to investors: openness, flexibility, transparency and speed. Any number of firms, with different business models and trading technologies, can plug into our network and compete on an equal basis, and NASDAQ trading systems offer unparalleled displays of price quotations and speed of execution. And, NASDAQ acted several years ago to separate out its regulator, the NASD, from the market. We recognized, and acted upon this potential conflict of interest, years before this concern became a national priority. And, as noted at the outset, NASDAQ "ate its cooking;" our overall internal governance is designed to meet our own stringent listing requirements.

As we all look ahead, several issues still need to be addressed. Will companies be able to find a sufficient number of qualified independent directors to satisfy all of the new requirements imposed by SOX, the SEC, NASDAQ and the other markets? How can the markets best facilitate the process of recruiting and then educating new directors? In furtherance of this objective, NASDAQ has entered into a joint venture with the National Association of Corporate Directors. Will the U.S. markets continue to attract and retain listings from overseas companies? Will the new regulatory scheme discourage companies from initial public offerings and will we see an increase in companies engaging in "going private" transactions? So far, the "early returns" on these issues are positive: IPO's have been somewhat resurgent, and companies do not seem to be going private in increasing numbers. And, ultimately, will these steps prove sufficient to restore investor confidence and reinvigorate the U.S. capital markets? As to the latter question, NASDAQ certainly hopes that the answer will prove to be a resounding "yes."

<sup>1</sup> “Global Investor Opinion Survey,” McKinsey & Company, July 2002

<sup>2</sup> In recognition of the inherent ownership right of very large shareholders, NASDAQ and the NYSE allow a “controlled company,” that is a company which is controlled by a 50% or greater shareholder or group of shareholders not to be subject to the requirements that there be a majority of independent directors or an independent compensation or nominations process. Similarly, third party rights to nominate directors are not subject to the independent nominations requirement.

<sup>3</sup> A “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.

<sup>4</sup> In addition, partners of the current auditor or their family members would not be considered independent.

<sup>5</sup> It is important to note that this is not the same definition as was adopted by the SEC with respect to “financial experts.” Under NASDAQ’s existing rules, one member of the audit committee must 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.

<sup>6</sup> Such codes must include elements concerning, at a minimum, conflicts of interest, compliance with applicable laws and full and fair disclosure.

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