CORPORATE GOVERNANCE ALERT: NYSE FILES REVISED PROPOSAL FOR CORPORATE GOVERNANCE LISTING STANDARDS WITH SEC

OCTOBER 14, 2003

On October 8, 2003, the New York Stock Exchange publicly filed with the SEC revised listing standards regarding the NYSE's corporate governance proposals. The NYSE has indicated that it expects the SEC to approve these revised listing standards by the middle of this month.

The revised standards filed by the NYSE last week represent the latest iteration in a process that began over a year ago. On August 16, 2002, the NYSE filed its initial corporate governance proposals with the SEC.[1] The NYSE then filed an amendment to these proposals in April 2003, which the SEC published for public comment. The amended listing standards filed last week are a result of the comment letters received, as well as comments made by the SEC staff.

This memorandum outlines the significant changes the NYSE made to its corporate governance proposals as part of this latest filing, as well pointing out a few important areas in which the NYSE did not amend its proposals. NASDAQ, on October 9, 2003, also filed revised corporate governance listing standards with the SEC, and this memorandum also highlights some of the notable aspects of NASDAQ's filing. The SEC had publicly stated for some time that it intended to work towards harmonizing the proposed NYSE standards and the proposed Nasdaq standards. We expect to distribute a more detailed memorandum regarding both sets of standards once the SEC formally approves them.

Director Independence and Responsibilities

Definition of "Independent Director". Although the revised standards did not change the baseline test for director independence—the board of directors must affirmatively determine that the director has no material relationship with the listed company—the NYSE did make several changes and clarifications to the types of relationships that disqualify a director from being considered independent.

- **Reduced Look-Back Periods**. The look-back periods, which apply to all of the NYSE's *per se* independence disqualifications, have been reduced from five years to three years.

  The NYSE has, however, accelerated the phase-in approach to the look-back periods. In its April 2003 amendments, the NYSE had proposed that the look-back periods be prospective only (*i.e.*, the *per se* bars to independence would not apply to the extent that the disqualifying relationship was ended prior to the effective date of the new standards). In response to comments from the SEC that this approach resulted in too long a delay until

1 Our August 23, 2002 memorandum regarding the initial NYSE proposals is available on our website, www.simpsonthacher.com.

full compliance was required, the NYSE revised this provision. Pursuant to the latest filing, a one-year look back will apply during the first year in which the revised listing standards are effective, and the full three-year look back would then apply after the end of the first year.

- **Employment Disqualification**. A director who is also an employee of the listed company, or has an immediate family member who is an executive officer of the listed company, is not independent until three years after the employment relationship has ended. This change merely clarifies the April 2003 amendments.

- **Compensation Disqualification.** A director who has received (or has an immediate family member in an executive officer position who has received) more than $100,000 in direct compensation from the listed company, other than for board service or pursuant to a pension or similar form of deferred compensation, is not independent until three years following the time the compensation was received. In its April 2003 amendments, the NYSE proposed that the receipt of such compensation would merely create a *rebuttable presumption* of non-independence. Based on comments from the SEC, the NYSE revised this provision to create a bright-line disqualification. NASDAQ has proposed a similar rule, except that the applicable threshold is $60,000.

- **Business Affiliation Disqualification**. A director who is an executive officer or employee (or has an immediate family member who is an executive officer) of another company that in any single fiscal year makes payments to, or receives payments from, the listed company for property or services in an amount that exceeds *the greater of* $1 million or 2% of *such other company's* consolidated gross revenues is not independent until three years have elapsed since the payment. Prior to this filing, the disqualifying payments were tested against the listed company's consolidated gross revenues. The applicable NASDAQ threshold is the greater of $200,000 or 5% of the *recipient's* consolidated gross revenues.

  In addition, the NYSE clarified that charitable organizations are *not* considered "companies" for purposes of this $1 million / 2% payment test. The NYSE has added commentary to this proposed standard, however, that requires listed companies to *disclose* contributions to charitable organizations that exceed the $1 million / 2% threshold in the event that one of its directors serves as an executive officer of the charitable organization.[2]

- **Additional Clarifications**. The NYSE filing clarified that the term "company" includes any parent or subsidiary in a consolidated group with the listed company. The filing also clarified that a person who ceases to be an immediate family member as a result of legal

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[2] Our July 11, 2003 memorandum regarding the impact of charitable contributions on an analysis of a director's independence is available on our website, www.simpsonthacher.com. NASDAQ's proposed standards do not adopt the NYSE's disclosure approach and instead would preclude a director from being deemed independent if the listed company makes payments to a non-for-profit entity where the director (or an immediate family member of the director) is an executive officer and the payments exceed the $200,000 / 5% threshold. NASDAQ's proposed standards do provide, however, an exception for payments made under non-discretionary charitable contribution matching programs.

separation or divorce, or by reason of death or incapacitation, would no longer need to be considered in evaluating the independence of a director.

Controlled Companies. The filing did not amend the controlled company exception. Accordingly, a company of which more than 50% of the voting power is held by an individual, a group or another company need not comply with the new standards that require a majority of the board be comprised of independent directors or those standards that require listed companies to have a nominating and corporate governance committee and a compensation committee. NASDAQ continues to propose a similar exception for controlled companies.

Executive Sessions. The NYSE standards would still require a listed company's non-management directors, whether or not directors of a controlled company, to meet at regularly scheduled executive sessions without management. At the SEC's request, however, the NYSE added commentary stating that a listed company with non-management directors who are not independent (*e.g.*, a non-employee director who is not independent by reason of the business affiliation disqualification) should have an executive session at least once a year with only independent directors.

Independent Board Committees

The revised standards did not alter the fundamental principle that listed companies need to maintain an audit committee, a compensation committee and a nominating and corporate governance committee, with each comprised solely of independent directors. The NYSE's latest filing, however, did amend and clarify certain of the standards regarding the audit and compensation committees.

Audit Committee. Rather than restating the audit committee independence and responsibility requirements recently adopted by the SEC pursuant to Section 301 of Sarbanes-Oxley, which the NYSE's April 2003 amendments had done, the NYSE's revised listing standards now contain one standard which simply states that listed companies must have an audit committee that satisfies the requirements of Rule 10A-3 under the Exchange Act. A separate listing standard then outlines the audit committee requirements that NYSE-listed companies must abide by in addition to the SEC requirements. These additional requirements have essentially remained unchanged since the NYSE first proposed them in August 2002 (*e.g.*, audit committee must discuss policies regarding risk management and risk assessment, meet separately with management, the internal auditors and the independent auditors, etc.).

Compensation Committee. The filing clarified that the compensation committee may work together with the other independent directors in determining and approving the CEO's compensation. The filing further clarified that the compensation committee's authority to determine and approve the CEO's compensation should not be read to preclude discussion of CEO compensation with the board generally or otherwise in any way impair communication among board members.

Additional Items

Corporate Governance Guidelines and Code of Ethics. The filing did not amend the proposed listing standards that require NYSE-listed companies to adopt corporate governance guidelines and a code of business conduct and ethics. The only amendment to these standards was a clarification that listed companies must state in their *Annual Report on Form 10-K filed with the SEC* that these codes have been adopted and are available on the company's website (previously the listing standards simply said "annual report").

Use of Public Reprimand Letters. The filing notes that the issuance of public reprimand letters, a type of sanction much less severe than suspension and delisting, is not intended for use in those cases in which a listed company either falls below the financial or other continued listing standards or fails to comply with the SEC-specified audit committee requirements.

Close-End Funds and ETFs. The NYSE's revised proposals lessen the degree to which close-end funds and Exchange Traded Funds are required to comply with the new corporate governance listing standards.

Foreign Private Issuers. No changes were made to the proposed listing standard that requires listed foreign private issuers to disclose any significant ways in which their corporate governance practices differ from those followed by domestic listed companies.

Effective Dates and Transition Periods

General Transition Periods. Listed companies will have until the *earlier* of their first annual meeting after January 15, 2004 or October 31, 2004 to comply with *all* of the new corporate governance listing standards. Prior to this filing, the NYSE had proposed an 18-month transition period in respect of the independence standards and a six-month transition period in respect of most other standards, but these periods were changed in response to SEC comments. The revised proposals continue, however, to contain an exception for listed companies with classified boards. These companies would not be required (unless otherwise mandated by the SEC's recently adopted audit committee rules) to change a director who would not normally stand for election in the first annual meeting after January 15, 2004. Instead, these companies may continue to have such a director in office until the second annual meeting after January 15, 2004, but no later than December 31, 2005.

Foreign Private Issuers. Foreign private issuers will have until July 31, 2005 to comply with the new audit committee standards required by the SEC's recently adopted rules. Foreign private issuers will have until the earlier of their first annual meeting after January 15, 2004 or October 31, 2004 to comply with the other corporate governance listing standards applicable to it (*i.e.*, disclosure of significant differences in home country corporate governance practices and CEO notification to the NYSE upon becoming aware of material non-compliance with the listing standards).

Initial Public Offerings, Transferring Companies and Other Special Situations. The filing provides that companies listing in conjunction with their initial public offerings may phase in their independent nominating and compensation committees on the same schedule as that mandated by the SEC's new rules for audit committees. Accordingly, IPO companies need to have one independent director on each of the audit, compensation and nominating and corporate governance committees at the time of listing, followed by majority independence within 90 days of listing and full independence within one year of listing. IPO companies also have one year following listing to comply with the majority independent board requirement.

These same transition rules applicable to IPOs apply to companies that are emerging from bankruptcy and to companies that have ceased to be a "controlled company". Companies transferring from another market will have one year from the date of transfer in which to comply with any requirement to which it had not previously been subjected.

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This memorandum is for general informational purposes and should not be regarded as legal advice. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as additional memoranda regarding recent corporate governance developments, can be obtained from our website, *www.simpsonthacher.com*.

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