

defining issues[®]

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New Corporate-Governance Listing Standards

Companies face more challenging listing rules from the New York Stock Exchange and NASDAQ, with requirements for boards of directors and audit committees that go beyond the requirements the SEC mandated earlier this year.¹ The listing standards just approved by the SEC expand director independence requirements and mandatory board and audit-committee responsibilities. The added requirements reflect in part “best practices” recommended over the years in studies of corporate governance. Most listed U.S. companies must comply with the new rules by the first annual meeting after January 15, 2004, but no later than October 31, 2004. Foreign private issuers and companies with staggered boards have more time to comply with some of the new listing standards.

This edition of *Defining Issues* describes the corporate-governance listing requirements that have been added to those already mandated by the SEC. The new NYSE rules are available at the Exchange’s Web site.² The final NASDAQ rules were not available as of this writing, except as described in the SEC’s approving release.

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(1) The SEC requirements were adopted by SEC Release No. 33-8220, Standards Relating to Listed Company Audit Committees, April 9, 2003. For the new listing requirements, see Section 303(A) of the NYSE Listed Company Manual and NASDAQ Rules 4200, Definitions, and 4350, Qualitative Listing Requirements for Nasdaq National Market and Nasdaq SmallCap Market Issuers Except for Limited Partnerships.

(2) The NYSE Web site is <http://www.nyse.com>.

DIRECTOR INDEPENDENCE — NYSE

A majority of the board members of companies listed on the NYSE must be independent, and no director will be considered independent unless the board has affirmatively determined that he or she has no material direct or indirect relationship with the listed company. Companies must disclose the determinations in their annual proxy statements or, if none is filed, on Form 10-K. The disclosures must include the basis for concluding a relationship is not material.

The objective of the new independence rules is independence from management. Ownership of a significant amount of stock does not by itself preclude independence. On the other hand, it can be material to render consulting, legal, or accounting services to the listed company; receive charitable donations from the listed company; or have a familial relationship with a key executive. Being a current employee of the listed company is always incompatible with independence. Boards should assess the materiality of a director's relationship with the company both from the standpoint of the director and from the standpoint of persons or organizations affiliated with the director.

Under the NYSE rules, the following conditions are incompatible with a director's independence unless they have been absent for three years, except during a one-year transition period.

- Being employed by the listed company, any parent, or any subsidiary, or having an "immediate family member" who is an executive officer of the listed company.
- Receiving, or an immediate family member's receiving, more than \$100,000 per year in direct compensation from the listed company (excluding director and committee fees and pension or other forms of deferred compensation for prior service that are not contingent on continued service).
- Being affiliated with or employed by a present or former internal or external auditor of the company or having an immediate family member who is affiliated with or employed in a professional capacity by either of those parties.

- Being employed as an executive officer of another company, or having an immediately family member so employed, if any of the listed company's present executives serves on the employer company's compensation committee.
- Being an executive officer of another company that pays the listed company, in any single year, amounts exceeding the greater of \$1 million or 2% of the other company's consolidated gross revenues or that receives such amounts from the listed company (or having an immediate family member that makes or receives such payments).

During the transition period, these conditions cannot have been in place for more than one year. After the one-year transition, the three-year period applies.

DIRECTOR INDEPENDENCE — NASDAQ

The new NASDAQ listing standards also require that a majority of directors on a listed company's board must be independent. Companies must disclose the directors that the board has determined to be independent in their annual proxy statements or, if none is filed, on Form 10-K. Consistent with the NYSE rules, the NASDAQ rules clarify that owning a significant amount of stock does not by itself preclude independence.

The additional rules are generally on the same subjects as the NYSE rules, but differ in specifics. The following conditions are incompatible with a director's independence under the NASDAQ rules unless they have been absent for three years.

- Being employed by the listed company, any parent, or any subsidiary, or having a "family member" who is employed as an executive officer. The NASDAQ standards define "family member" differently from the way the NYSE standards define "immediate family member."³
- Receiving more than \$60,000 in payments from the listed company (including any parent or subsidiary) or having a family member who received payments in that amount. The

(3) Under the NYSE's definition, an "immediate family member" is a person's spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, and anyone (other than domestic employees) who shares the person's home. Under the NASDAQ's definition, a "family member" is a person's spouse, parents, children, and siblings, whether by blood, marriage or adoption, or anyone residing in the person's home.

payments referred to here exclude director and committee fees, payments from investments in the listed company's securities, compensation to a family member who is not an executive officer of the listed company (or a parent or subsidiary of the company), loans permitted under Section 13(k) of the Securities Exchange Act of 1934, and pension or other deferred compensation for prior service that is not contingent on continued service.

- Being an executive officer of another entity that has had any of the listed company's executive officers serve on its compensation committee or having a family member who was an executive officer of another entity under such conditions.
- Being a current partner of the company's independent auditor or a partner or employee of the company's independent auditor who worked on the company's audit any time in the past three years or having a family member who has such a relationship.
- Being a partner, controlling shareholder, or executive officer of another company that pays or receives from the listed company, in any single year, amounts exceeding the greater of \$200,000 or 5% of the recipient company's consolidated gross revenues (or having a family member that makes or receives such payments). This excludes payments from investments in the listed company's securities and payments under non-discretionary charitable contribution matching programs.

Under both the NASDAQ and NYSE requirements for director independence, three years must have elapsed for the conditions incompatible with independence under the listing standards to be inapplicable. This is the so-called "look-back" period. However, the two sets of director-independence requirements differ in their transition provisions. Under the NASDAQ listing standards, the three-year look-back provision applies immediately. But in the first year after adoption of the NYSE standards by the SEC, only a one-year look-back period applies, to be followed by the full, three-year look-back period effective November 4, 2004.

The final transition provisions depart significantly from earlier rulemaking proposals on director independence. The proposed requirements would have applied only prospectively in the first year.

AUDIT COMMITTEE REQUIREMENTS — NYSE

Under the NYSE requirements, the audit committees of all companies, except those that list only debt securities and foreign private issuers, must have at least three members, all of whom are independent directors. All three must be financially literate or must become financially literate within a reasonable period of time after becoming audit-committee members. At least one member must have expertise in accounting or related financial management. A board may presume that a person who meets the SEC's definition of an "audit committee financial expert" has the accounting or related financial-management expertise required under the new listing standards. However, if the audit committee does not have a member who meets the SEC's definition of an "audit committee financial expert," that fact must be disclosed even if the listing requirement is met.

Boards must determine whether audit-committee members have excessive commitments to other audit-committee work. If an audit-committee member simultaneously serves on the audit committees of more than three public companies, the board must determine that the member can still serve effectively on the listed company's audit committee. The determination must be disclosed in the annual proxy statement or, if none is filed, on Form 10-K.

The audit committee of each NYSE-listed company must have a written charter that states the committee's purpose, requires an annual performance evaluation of the committee, and sets out the committee's duties and responsibilities. In addition to existing audit-committee responsibilities required by the SEC, the following duties and responsibilities are mandatory.

- Obtain and review at least annually a report from the independent auditors that describes: the audit firm's quality control procedures, all relationships between the independent auditor and the company, and material issues raised by the

firm's most recent internal quality control review or by any governmental or professional inquiry or investigation in the most recent five years relating to the firm's audits.

- Assess the independent auditor's qualifications, performance, and independence. In making its evaluation, the audit committee should consider auditor rotation, the opinions of management, and the company's internal auditors. The audit committee's conclusions should be presented to the full board.
- Discuss annual and quarterly financial statements with management and the independent auditor, including disclosures in MD&A.
- Discuss earnings press releases and financial information provided to analysts and rating agencies at least generally and not necessarily in advance of each release of information.
- Discuss the policies that govern the company's risk assessment and risk management, including the company's major financial risks and actions taken by management to monitor and control those risks.
- Periodically, meet separately with management, independent auditors, and internal auditors.
- Discuss with the independent auditor any problems or difficulties that were encountered during the course of the audit and any significant disagreements with management. The audit committee may review, for example, waived audit adjustments, communications between the audit team and the audit firm's national office, and internal-control matters.
- Establish policies to govern the company's decisions on hiring employees or former employees of its independent auditor.
- Report regularly to the board of directors any "issues" with respect to the quality or integrity of the company's financial statements, compliance with legal or regulatory requirements, the external auditor's independence, and the performance of the external and internal auditors.

AUDIT COMMITTEE REQUIREMENTS — NASDAQ

NASDAQ's listing requirements specify fewer audit-committee duties than do the NYSE's, relying more heavily on the SEC requirements. Not surprisingly, since so many of the requirements derive from published "best practice" recommendations, there are similarities between NASDAQ's and the NYSE's requirements.

NASDAQ-listed companies' audit committees must have no fewer than three members. Except in limited circumstances, all must be independent, must not have participated in preparing the company's financial statements within the past three years, and must be able to read and understand financial statements. At least one member of the audit committee must have past employment experience in accounting or finance, professional certification in accounting, or comparable experience that results in the individual's "financial sophistication" (including serving as a senior executive officer with financial oversight responsibilities). A NASDAQ-listed company's board may presume that a person who meets the SEC's definition of an "audit committee financial expert" qualifies as a financially sophisticated audit committee member. However, if the audit committee does not have a member who meets the SEC's definition of an "audit committee financial expert," that fact must be disclosed even if the listing requirement is met.

The audit committee is required to have a written charter that addresses the committee's purpose, specific responsibilities, and authority. The responsibilities and authority must be sufficient to comply with the SEC's audit-committee requirements. Each year the company must certify that it has adopted a formal written audit-committee charter and that the audit committee has reviewed and reassessed the charter's adequacy.

The new NASDAQ listing standards also provide for "cure" periods if an issuer fails to comply with the requirements for audit-committee composition. A member who ceases to be independent for reasons outside his or her "reasonable" control may remain on the committee until the earlier of the next annual shareholders meeting or for a maximum of one year. A company that plans to rely on the cure periods permitted by SEC rules must notify NASDAQ immediately upon learning of noncompliance.

NON-MANAGEMENT DIRECTORS

Both the NYSE and NASDAQ listing standards require “regularly scheduled,” separate meetings of non-management directors. Under the new NYSE listing standards, if the non-management directors include directors who are not independent, the independent directors must also meet separately at least once a year. The NASDAQ listing standards specify that independent directors must meet separately at least twice a year.

NYSE-listed companies must disclose a method for employees and other interested parties to communicate directly with their non-management directors. Companies may rely on the processes established for communicating accounting-related complaints and concerns to the audit committee, which were mandated by the Sarbanes-Oxley Act.

COMPENSATION & “NOMINATING/ CORPORATE GOVERNANCE” COMMITTEES

Under the NYSE listing standards, companies must have chartered compensation and “nominating/corporate governance” committees, both composed entirely of independent directors. Each written charter must state the committee’s purpose and responsibilities and establish an annual performance evaluation. Boards may allocate the responsibilities of the compensation or “nominating/corporate governance” committee to another committee that has a published charter and is composed entirely of independent directors. The provisions on compensation committees are not intended to impair communication among board members and do not preclude discussion of the CEO’s compensation with the board. The standards clarify that when a company is legally required to have third parties nominate directors, the legal requirement supersedes the nominating-committee process.

Except in limited circumstances, the NASDAQ listing standards require officer compensation to be determined (or recommended to the board) either by a majority of independent directors or by a compensation committee composed solely of independent directors. The CEO may not be present when his or her compensation is deliberated or decided.

Nominees for director must be selected (or recommended for the board’s selection) either by a majority of independent directors or by a nominations committee of independent directors, again, except in limited circumstances. The NASDAQ listing standards also make an exception for situations in which third parties have the legal right to nominate or appoint a director. However, boards with third-party appointees must comply with independence and other board-composition requirements. The NASDAQ listing standards require companies to certify that a formal written charter addressing the nominations process and related matters has been adopted. One member who is not independent may be appointed to the compensation or nominations committee of a NASDAQ-listed company under specified circumstances.

CODES OF CONDUCT

Both the NYSE and NASDAQ standards require listed companies to adopt codes of business conduct and ethics and make them available publicly. The NYSE standards specify subjects that must be addressed by the code, including conflicts of interest, corporate opportunities, confidentiality, fair dealing, proper use of company assets, compliance with regulations (including insider trading laws), and reporting illegal and unethical behavior. The NASDAQ standards require that the code include enforcement provisions and that any waivers of the code for directors or executive officers be reported on Form 8-K within five days.

NOTIFICATION REQUIREMENTS AND CEO CERTIFICATIONS

Both the NYSE and the NASDAQ listing standards require listed companies to promptly notify the exchange or association after an executive officer becomes aware of any material noncompliance with specified listing standards. The CEO of each NYSE-listed company must certify annually to the NYSE whether or not he or she is aware of any violation by the company of the exchange’s corporate governance listing standards.

CORPORATE GOVERNANCE PRACTICES BY FOREIGN PRIVATE ISSUERS

NYSE-listed foreign private issuers may follow home-country practice in lieu of the new listing standards, except for any listing standards that overlap with the SEC rules. Foreign private issuers are required to disclose differences between home-country corporate governance practices and those followed by U.S. companies under the new NYSE listing standards. The disclosure need only be a brief, general summary of significant differences and can be presented in the company's annual report or on the company's Web site.

NASDAQ-listed foreign private issuers may request exemptions from the new listing standards, to the extent consistent with compliance with the SEC rules. Foreign private issuers that receive such an exemption will be required to disclose in their annual reports each requirement from which they are exempt and the related home-country practice, if any.

NYSE-ONLY REQUIREMENTS

The NYSE listing standards contain several requirements not in the NASDAQ listing standards. The NYSE requirements, for example, mandate that all NYSE-listed companies have an internal audit function and permit it to be provided by an outside party other than its independent auditor.

Corporate-Governance Guidelines. The NYSE standards require companies to adopt corporate-governance guidelines and make them available on the company Web site. The guidelines must cover management succession; the board's annual self-evaluation; and director qualifications, responsibilities, compensation, orientation, continuing education, and access to management and independent advisors.

Sanctions for Noncompliance. The NYSE standards permit public reprimand letters in lieu of delisting for many violations. The lesser sanction does not apply to failures to comply with the financial and other continued listing provisions of the Listed Company Manual or to failures to comply with audit-committee requirements.

NASDAQ-ONLY REQUIREMENTS

Several NASDAQ listing standards are not in the NYSE additions to the SEC requirements.

Related-Party Transactions. Under the NASDAQ listing standards, companies must review all related-party transactions for potential conflict-of-interest situations. All related-party transactions must be approved by the company's audit committee or another independent body of the board.

Going-Concern Disclosure. A NASDAQ-listed company that receives an auditor's report containing a paragraph expressing substantial doubt about the company's continuation as a going concern must issue a public news release disclosing the event within seven days.

APPLICABILITY

The NYSE listing standards apply to companies listing equity securities on the Exchange, with these exceptions that are exempt from specific provisions: controlled companies, limited partnerships and companies in bankruptcy, closed-end and open-end funds, foreign private issuers, and some specified entities (e.g., passive business organizations in the form of trusts). Companies listed on the NASDAQ must comply with its new corporate-governance listing standards, also with some exemptions from specific provisions. For example, controlled companies are exempt from the NASDAQ requirements to have a majority of independent directors on the board, the compensation-committee requirements, and the nominating committee requirements, except as required to comply with SEC rules.

The NYSE's new listing standards apply to companies that list only debt or preferred securities only to the extent that the listing standards overlap with SEC Rule 10A-3 and for purposes of CEO notifications of known material noncompliance with the listing rules.



EFFECTIVE DATES

Most listed companies will have until the earlier of their first annual meeting after January 15, 2004, or October 31, 2004, to comply with the new listing standards. Companies with staggered (classified) boards generally would have until their second annual meeting after January 15, 2004 (but not later than December 15, 2005) to comply with the independence provisions for directors who would not normally stand for election in the first annual meeting after January 15, 2004, with the exception of the independence provisions already applicable to audit committee members under SEC Rule 10A-3.

NYSE-listed foreign private issuers and NASDAQ-listed foreign private issuers who receive an exemption are required to comply with the new listing standards no later than July 31, 2005. NASDAQ-listed small business issuers also have until July 31, 2005 to comply with the new listing standards.

The NASDAQ listing standards contain accelerated implementation requirements with respect to codes of conduct, related-party transactions, and disclosure requirements that are applicable to foreign private issuers who receive an exemption.

The new listing standards have separate transition provisions for companies listing in connection with an initial public offering, companies transferring from another market, and companies emerging from bankruptcy.



The listing standards complete a series of steps originating in the Sarbanes-Oxley Act, which led to the SEC's requirements and its directive to the securities-market regulatory bodies to adopt corporate-governance listing requirements. Additional changes could come, but for now, most will be interested in observing how the new requirements work.

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Companies and their audit committees should not treat the descriptive and summary statements in this presentation as a substitute for the actual rules or listing requirements. They should consult the text of the rules, the relevant listing requirements, and their accounting and legal advisors. Relevant listing requirements go beyond both the obligations established in SEC Release No. 33-8220 and the listing requirements summarized above.

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