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STAY TUNED... to Nasdaq-Listed Company Rules & More

By Hank Boerner

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STAY TUNED … to Nasdaq-Listed Company Rules & More

By Hank Boerner

Nasdaq Exchange-listed companies are about to enter "a brave new world," recalling author Aldous Huxley's famous book with visions of an ideal society. Important changes to a package of proposed listed company rules took place in October as the SEC responded to the Nasdaq Exchange's request for accelerated approval of measures intended to address stock option and purchase plans and other equity compensation arrangements.

The adjusted rules will apply when a stock option or purchase plan is to be *established* by a Nasdaq company, or when an existing plan is *"materially amended"* or other equity compensation arrangements are either arrived at or amended.

While the entire package of rules continues to move through the approval system, the SEC and Nasdaq management believe that rapid approval of the options part of the new rules is in everyone's interest, thus the peeling off of options-related provisions for more rapid adoption.

Here's what you need to know about the recent changes to the proposed rules on options and compensation — technically, Rule 4350(i)(1)(A):

❖ "Material amendment" could include any significant increase in the number of shares to be issued under the plan (certain exceptions include reorganization, stock split, merger, spinoff and certain other transactions). Material increases include benefits to employees and others, such as repricing or a decrease in exercise price, reducing the price at which shares or options to buy are offered and stretching out the duration of the plan.

❖ Expansion of "classes" of participants in a plan.

❖ Expansion of the type of options or awards included in a plan.

❖ Use of company-repurchased shares to fund option plans or grants (these transactions must have prior shareholder approval).

Important exceptions to the proposed rule:

❖ The familiar tax-qualified employee benefit plan that meets strict IRS requirements and plans that allow employees to purchase shares on the open market or directly from the issuer at fair market value.

❖ Inducement grants offered to employees in connection with a merger or acquisition.

❖ Inducement grants, tax-qualified, non-discriminatory benefit plans and "parallel" non-qualified plans, which don't have to go to the shareholders for a vote but must be approved by the issuer's independent compensation committee or a majority of independent directors.

New hires, for the most part, are also to be exempt. An individual being wooed is assumed to have an "arm's length" relationship as he or she comes aboard. The important change here: The option or stock purchase grant, including the number of shares involved, must be announced to investors immediately. And the SEC wants to see the announcement crafted in language investors can easily understand. The grant must be approved by the board's independent compensation committee or a majority of the company's independent directors.

No shareholder approval would be necessary if there were options or purchase plans offered

to employees of acquired companies (to level the playing field with the benefits enjoyed by the acquirer's employees) to replace, convert or adjust shares. These transactions must also be approved by a majority of independent directors.

These changes will present challenges for companies that have traditionally used generous stock grants to attract and hold directors and executives, especially when cash for salaries is limited.

Stay Tuned … to Nasdaq's Other Listed Company Rules. For more than a year, a comprehensive package of rules for Nasdaq Exchange-listed companies has been steadily chugging through the regulatory approvals system. These are similar in some ways to the NYSE-listed company rules (see October 2003 *IR Update*) but do vary in other ways. [As we go to press, the SEC announced that it had approved the final versions of both the New York Stock Exchange's and the Nasdaq's corporate governance proposals. For more information, go to http://www.sec.gov/rules/sro/34-48745.htm.]

Nasdaq and the SEC fine-tuned the critical portion of the pending rules to deal with director independence, and especially the role of independent committees.

"Independent director" will soon mean someone other than an officer or employee, or a person not having a relationship with the company that would interfere with the exercise of independent judgment as a member of the board. The role of independent directors is spelled out in detail — it's worth a read if you are an IRO of a Nasdaq company.

❖ "Non-independents," or insiders, would include anyone who was employed during the past three years by the company or a parent or subsidiary company, or who has a family member who is paid by the company in excess of $60,000 during the current or past three fiscal years; who is a partner, controlling shareholder or officer of any business that does significant business with the company; or who was a partner or employee of the company's outside auditors during the past three years.

❖ Audit committees must have a majority of independent directors.

❖ Independent directors must schedule meetings without executive members of the board present.

❖ Compensation of the CEO and other company officers will be decided by a majority of the independent directors meeting in executive session, or a compensation committee made up entirely of independent directors meeting in executive session. The CEO can be present during discussions, but he or she cannot vote.

❖ Directors are to be nominated by a majority of the independent directors or a nominations committee made up of independent directors.

❖ The audit committee must have a formal written charter, which is to be reviewed by the board each year. Outside audit services and allowable non-audit services will be approved in advance by this committee, which will have at least three members, all independent directors. And they must be able to read (and understand) a company's balance sheet, income statement and cash flow statement. At least one member should have a strong background in corporate finance or accounting.

There are other aspects of the new rules that are worth your time to gauge the impact on your own company.

To sum up: Nasdaq and SEC believe boards should be made up of a majority of independent directors and have spelled out "independence" criteria; these independent directors should meet regularly without corporate management present; the independents will have responsibility for setting executive compensation, overseeing director nominations and staffing the audit committee, which will approve all outside auditor activities.

Stay Tuned … to boardroom changes, including composition of Nasdaq company boards and the way in which boards will operate. (Provisions of Sarbanes-Oxley also create a new environment for public company boards, including potential financial, civil and criminal penalties for certain behaviors.) Smaller Nasdaq companies could initially face some difficulties in attracting qualified, quality board candidates.

And, as more financial analysts look to the "qualitative" aspects of company management, the quality, performance and accountability of the board could become an important part of a dashboard scan.

Stay Tuned … to new SEC rules that expand the notion of "shareholder democracy" and give not only voice but decision-making powers under very qualified conditions to certain shareholders at annual proxy time.

In early October, the SEC approved rule proposals that will require companies to include the names of nominees for directors in proxy materials submitted not by the company but by certain qualified shareholders. This rulemaking process got a boost in July when SEC staff published

Review of the Proxy Process Regarding Nomination and Election of Directors.

This new rule will require companies subject to proxy rules (including mutual funds) to include the names and other information regarding security holder nominees in proxies. This would hold true in states that have laws that establish the right of shareholders to nominate candidates, or where "one or more" events occurred that provided evidence that shareholders were dissatisfied with the effectiveness of a company's current proxy process. Foreign issuers would be exempt.

What would these "events" be? Well, keep in mind that shareholder activists who bring proxy resolutions to a vote consider 5 percent of total votes counted the first time around as a beachhead and achieving 8 percent-10 percent of votes the second year a reason to continue the effort. A greater number of shareholder activist resolutions received majority or close to majority votes in 2003 — and any management or board that ignores this outpouring of support, even if non-binding, would be foolish to ignore either the expression (the vote results) or the generator of the resolution.

The wiser course of action could be to engage with proxy-generating shareholders and especially activist institutional holders. The future is becoming somewhat predicable on all this; in August, the SEC proposed rules that would require "more robust disclosure" of the nominating process, including consideration of shareholder-advanced candidates, and disclosure of the process by which shareholders can communicate with the board directly.

You can find details of this complicated rule at www.sec.gov, releases 34-48301, IC-26145 and S7-14-03.

Stay Tuned … to a fast-changing world in which shareholders and directors begin direct conversation … where directors are nominated by institutional investors … where nominating committees begin more open and public deliberation on board succession … where greatly expanded disclosure will surround many — if not all — board discussions and decision-making. *A Brave New World,* indeed, for IROs, even if not ideal! IRU

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