

Proposed Changes in Composition and Operation of Boards of Directors of Public Companies

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Part 2 of a Series from the
Corporate Group

This Advisory is the second in our series dealing with proposed and pending changes to regulations affecting public companies. This Advisory specifically addresses those proposals that will impact the composition and operation of public company boards. We consider specifically the New York Stock Exchange ("NYSE") proposed changes to its listing requirements as recommended by its Corporate Accountability and Listing Standards Committee (the "NYSE Listing Committee"), The Nasdaq Stock Market ("Nasdaq") proposals to change its corporate governance standards, The Business Roundtable's Principles of Corporate Governance and recommendations from the Council of Institutional Investors (the "Council").

Please refer to our **Corporate Responsibility Redefined** Advisory for information on how proposed rules become enacted through action by the Securities and Exchange Commission (the "SEC"), Congress or the self-regulatory organizations.

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On June 6, 2002 the NYSE Listing Committee formally unveiled a set of proposals aimed at strengthening corporate governance and restoring investors' confidence in the credibility of companies. These recommendations are to be considered by the NYSE Board of Directors on August 1, 2002 and, if adopted, will be forwarded to the SEC for its approval.

NYSE Proposal for Independence of the Board of Directors

The NYSE Listing Committee proposals would require all NYSE listed companies to have a majority of independent directors, in contrast to the current NYSE listing standard requiring three independent directors, on each listed company's board of directors.

Under the proposals, for a director to be deemed "independent," the board of directors must affirmatively determine that the director has no material relationship with the listed company. In addition to the board's affirmative determination that a director is independent, a five-year "cooling off" period applies, during which time the following persons are not considered independent:

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- a former employee of the listed company;
- a former employee of the listed company's present or former (within the past five years) outside auditor;
- a former employee of any company whose compensation committee includes an executive office of the listed company; and
- any immediate family member of the above.

The NYSE Listing Committee does not view ownership, or affiliation with the owner, of a less than controlling amount of the company's stock as a *per se* bar to an independence finding.

Powers of Non-Management Directors

The proposals also would require that the non-management directors of each listed company meet at regularly scheduled executive sessions without management and that the non-management directors must designate, and publicly disclose the name of, the director who will preside at the executive sessions. The regular scheduling of these meetings is intended to foster better communication among non-management members of the board and to prevent any negative inference from attaching to the calling of such an executive session.

Committees and Charter Requirements

In addition to the current NYSE rule requiring a listed company to have an audit committee, the proposed changes will require a listed company to have a nominating/governance committee and a compensation committee. Each committee must be composed entirely of independent directors (applying the revised definition of independence). Each committee must have a written charter and the company must post the charters for the audit committee, the nominating/governance committee and the compensation committee (along with any other important charters) on the company's website.

NASDAQ RULES AND PROPOSALS

On June 5, 2002, Nasdaq announced that its first round of corporate governance rule proposals would be submitted to the SEC. Like the NYSE proposals, Nasdaq's reforms include requiring corporate boards of Nasdaq listed companies to be comprised of a majority of independent directors, and requiring compensation and audit committees to be comprised solely of independent directors. Nasdaq has not yet proposed mandating a corporate governance or nominating committee.

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Nasdaq proposes to define an "independent director" as "a person other than an officer or employee of the company or its subsidiaries or any other 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." Nasdaq proposes five situations that preclude independence, which are:

- employment with the listed company or any of its affiliates for the current year or within any of the previous three years (as contrasted to five years for NYSE);
- familial relationships with officers;
- payments between the listed company and another entity with which the director is associated that exceed 5% of the listed company's gross revenues for that year or \$200,000, whichever is more;
- receipt of any payments other than for board service (including political contributions) in excess of \$60,000 paid to a director or a director's family member; and
- relationships arising from interlocking service on another company's compensation committee.

In contrast to the NYSE's proposed five-year "cooling-off" period, Nasdaq would require that potential directors and their family members meet only a three-year cooling-off period with respect to the first three bullet points listed above before they can be considered independent.

THE BUSINESS ROUNDTABLE'S PRINCIPLES OF CORPORATE GOVERNANCE

In May 2002, The Business Roundtable released a set of guiding principles intended to assist corporate management and boards of directors in their efforts to implement corporate governance best practices. NYSE and Nasdaq have followed many of the principles in their proposals.

The Business Roundtable principles state that effective directors are monitors, not managers, of business operations and that the board's most important function is the selection, compensation and evaluation of a well-qualified and ethical CEO. Additionally, the board should have contingency plans to provide for transitional board leadership if questions arise concerning management's conduct, competence or integrity or if the CEO dies or is incapacitated.

The principles also state that a "substantial" majority of directors of the board of a publicly owned corporation should be independent of management (in contrast to the simple majority suggested in the NYSE and Nasdaq proposals). The principles do not specifically define the term "substantial."

independent committees responsible for addressing

investment-related firms responsible for more than \$2 trillion of pension assets. On April 15, 2002, the Council provided testimony to the NYSE Listing Committee prior to the NYSE Listing Committee

The Council urged NYSE to modernize its current independence requirement and suggested that listed companies should have boards composed of a substantial majority of independent directors. This statement, like the suggestion by The Business Roundtable, is broader than the proposals suggested by NYSE and Nasdaq. While the Council does not specifically define "substantial," the Council's report noted that one of its core corporate governance policies states that "at least two-thirds of a board's directors should qualify as independent." The essence of the Council's definition of an independent director is a person whose directorship constitutes his or her only connection to the company. Specifically, the Council does not believe that a director can generally be considered independent if he or she:

- is, or in the past five years has been, employed by the company or an affiliate in an executive capacity;
- is, or in the past five years has been, an employee or owner of a firm that is one of the company's or its affiliate's paid advisers or consultants;
- is, or in the past five years has been, employed by a significant customer or supplier of the company;
- has, or in the past five years has had, a personal services contract with the company, its chairman, CEO or other executive officer or any affiliate of the company;
- is, or in the past five years has been, an employee, officer or director of a foundation, university or other non-profit organization that receives significant grants or endowments from the company or one of its affiliates;
- is, or in the past five years has been, a relative of an executive of the company or one of its affiliates; and
- is, or in the past five years has been, part of an interlocking directorate in which the CEO or other executive officer of the company serves on the board of another corporation that employs the director.

The Council stated that it, along with many leading investors in the corporate governance community, including CalPERS and TIAA-CREF, calls for all-independent audit, nominating and compensation committees.

As noted above, the NYSE Listing Committee's proposals await action by the NYSE Board of Directors. If adopted by the NYSE Board, the proposals will be presented to the SEC for approval, just as Nasdaq's proposals are being presented to the SEC for approval. Because we anticipate that the SEC will adopt the proposals in some form, we believe that there are a number of actions that companies should undertake at this time to prepare for the changes that will be mandated when the proposals are adopted:

- Review the qualifications of present directors and the standards employed for nomination of directors.
- Compare your company's present standards of independence to those proposed by the exchange on which your company is listed.
- Review the present committee structure of your company's board of directors.
- Review the existing committee charters, as well as any guidelines adopted for the operations of committees, and consider relevant amendments to the charters and guidelines.

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