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Update: NASDAQ Proposes Additional Corporate Governance Requirements

The Nasdaq Stock Market has filed additional proposed rule changes with the Securities and Exchange Commission to improve corporate governance and transparency among listed companies. These proposals, which are subject to public comment and SEC approval, contemplate the following new requirements:

- Foreign issuers would be required to disclose the receipt of an exemption from Nasdaq corporate governance standards in their annual reports and initial filing documents.
- Listed companies would be required to adopt a code of conduct for all directors, officers and employees.
- Listed companies would be required to disclose the receipt of an audit opinion with a “going concern” qualification in a press release promptly after such opinion is included with financial statements filed with the SEC.

This memorandum explains the proposed rule changes in further detail. For information on Nasdaq’s initial proposed corporate governance rule changes, please see our memorandum entitled “Nasdaq Reissues Corporate Governance Proposals with Modifications,” dated March 26, 2003.

I. Disclosure of Corporate Governance Exemptions for Foreign Issuers

Under the current rules, Nasdaq has the authority to grant exemptions to its corporate governance standards to foreign issuers where compliance with those standards may be construed as contrary to the laws, rules, regulations or accepted business practices in the issuer’s country of domicile. Nasdaq proposes to require foreign issuers listed on Nasdaq to disclose the receipt of a corporate governance exemption in their annual reports (Form 20-F, Form 40-F or Form 10-K) and in documents related to issuers’ initial listings in the United States (Form 20-F, Form 40-F or Form F-1). The proposed rule change also clarifies that any exemption from Nasdaq requirements in no way affects the issuer’s obligation to comply with applicable law and regulation.

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Disclosure of exemptions must include a description of each requirement from which the issuer is exempted and a statement of what alternative measures, if any, the issuer has taken in lieu of the particular requirement or requirements from which it has been exempted.

In its proposal, Nasdaq states that it believes that the disclosure requirement will not only alert investors that the issuer has been granted an exemption from certain Nasdaq rules, but may also cause foreign issuers to consider carefully their need for an exemption, rather than applying for one as a matter of course. If approved by the SEC, the proposal will take effect for new listings and filings made on or after January 1, 2004.

II. Code of Conduct Requirement

Nasdaq proposes to require listed companies to adopt a code of conduct for all directors, officers and employees. The code of conduct, which must be made publicly available, must also comply with the definition of a "code of ethics" set out in Section 406(c) of the Sarbanes-Oxley Act, although in contrast to the Sarbanes-Oxley Act requirements, the code of conduct must apply to all directors, officers and employees. Under the proposed rule, a code of conduct must include the following:

- such standards as are reasonably necessary to promote the ethical handling of conflicts of interest, full and fair disclosure and compliance with laws, rules and regulations as specified by the Sarbanes-Oxley Act;
- a requirement that any waiver of the code for executive officers or directors may be made only by the board and must be promptly disclosed to shareholders, along with the reasons for the waiver;
- an enforcement mechanism that ensures prompt and consistent enforcement of the code, protection for persons reporting questionable behavior, clear and objective standards for compliance and a fair process by which to determine violations.

In its proposal, Nasdaq states that the requirement of a publicly available code of conduct applicable to all directors, officers and employees of an issuer is intended to demonstrate to investors that the board and management of Nasdaq issuers have carefully considered the requirement of ethical dealing and have put in place a system to ensure that they become aware of and take prompt action against any questionable behavior. For company personnel, a code of conduct with enforcement provisions provides assurance that reporting of questionable behavior is protected and encouraged, and fosters an atmosphere of self-awareness and prudent conduct.

The waiver disclosure requirement is intended to provide shareholders with the comfort that waivers are not granted except when truly necessary and warranted, and that they are limited and qualified so as to protect the company to the greatest extent possible. Disclosure is to be made in the issuer's regular public filings, not later than the next periodic report (in the case of a domestic issuer, its next 10-K or 10-Q; in the case of a non-US issuer, its next semi-annual report or annual report).

Alternatively, an issuer may choose to include disclosure of a waiver in a Form 8-K filed before its next periodic report.

Although the code must apply to all directors, officers and employees, issuers may satisfy the obligation by adopting more than one code of conduct. This allows companies flexibility to design codes that are appropriate to various types of employees. For example, a company could adopt a simpler code for its hourly employees than for its senior management in recognition of the fewer ethical issues that hourly employees typically face.

Nasdaq proposes that the rule change will become effective six months from the date of SEC approval.

III. Audit Opinion Disclosure

A third Nasdaq proposed rule change requires issuers that receive audit opinions that contain “going concern” qualifications to make a public announcement through the news media of the receipt of such qualification. The issuer would be required to provide the text of any such announcement to the StockWatch section of Nasdaq’s MarketWatch Department prior to its release. The public announcement would be required to be released to the media no later than seven calendar days following the filing of a qualified audit opinion in a public filing with the SEC.

Ordinarily, the continuation of an entity as a going concern is assumed in financial reporting in the absence of significant evidence to the contrary. If an auditor concludes that substantial doubt exists about the entity’s ability to continue as a going concern for a reasonable period of time, however, the auditor provides this conclusion through an explanatory paragraph in the auditor’s report. While the audit opinion is available in the Form 10-K, Nasdaq believes that receipt of a going concern qualification is so material that it should be brought to the attention of investors and potential investors through a press release issued promptly after the filing of the Form 10-K. In the event that management has developed plans to address the going concern qualification, it would be free to discuss those plans in the press release.

Nasdaq proposes that this rule change become effective immediately upon SEC approval.

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any member of the Paul Weiss Securities Group, including:

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