

It is therefore ordered, pursuant to section 19(b)(2) of the Act,⁴³ that the amendment proposed rule change (SR-Amex-99-38) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁴⁴

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-42231; File No. SR-NASD-99-48]

Self-Regulatory Organizations; Order Approving Proposed Rule Change by the National Association of Securities Dealers, Inc. Amending Its Audit Committee Requirements and Notice of Filing and Order Granting Accelerated Approval of Amendments No. 1 and No. 2 Thereto

December 14, 1999.

I. Introduction

On September 20, 1999, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its wholly owned subsidiary, the Nasdaq Stock Market, Inc. ("Nasdaq"), submitted to the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a proposed rule change amending Nasdaq's audit committee requirements.

The **Federal Register** published the proposed rule change for comment on October 13, 1999.³ In response, the Commission received fourteen comment letters. On November 15, 1999 and December 9, 1999, the Association submitted Amendments No. 1⁴ and No.

2,⁵ respectively, to the proposed rule change. This order approves the proposed rule change and grants accelerated approval to Amendments No. 1 and No. 2. The Commission is also soliciting comment on Amendments No. 1 and No. 2 to the proposed rule change.

II. Description of the Proposed Rule Change

A. Background

In February 1999, the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees ("Blue Ribbon Committee") issued a report containing recommendations aimed at strengthening the independence of the audit committee; making the audit committee more effective; and addressing mechanisms for accountability among the audit committee, the outside auditors, and management.⁶ In response to the Blue Ribbon Committee's recommendations, Nasdaq proposes to amend its listing standards regarding audit committee requirements. The proposed changes cover three general areas: (1) The definition of independence; (2) the structure and membership of the audit committee; and (3) the audit committee charter.

The text of the proposed rule change, as amended by Amendments No. 1 and No. 2, is as follows. Language deleted by Amendments No. 1 and No. 2 is in brackets. Language added by

audit committee charter within six months of the effective date of the proposed rule change. As originally filed, the proposed rule change required issuers to adopt the charter within eighteen months of the effective date of the proposed rule change. Amendment No. 1 also states that issuers that applied for listing prior to the effective date of the proposed rule change would qualify for listing under the listing standards in force at the time of their application, and receive the same grace periods provided to currently listed issuers. Finally, Amendment No. 1 modifies proposed Rule 4320(e)(21) to provide that the requirement that each issuer execute a listing agreement will not be construed to require any foreign issuer to do any act that is contrary to a law of any public authority exercising jurisdiction over the foreign issuer.

⁵ Letter from Sara Nelson Bloom, Associate General Counsel, Nasdaq-Amex Market Group, to Richard Strasser, Assistant Director, Division, Commission, dated December 8, 1999 ("Amendment No. 2"). The Association submitted Amendment No. 2 to revise proposed Rules 4310(c)(26)(A)(ii), 4320(e)(22)(A)(ii), and 4460(d)(1)(B) to provide that the audit committee is required to oversee the independence of the outside auditor, rather than ensure the independence of the outside auditor. Amendment No. 2 also revises Nasdaq's definition of immediate family found in Rule 4200(a)(15)(c) to include sons-in-law and daughters-in-law.

⁶ *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (1999)*. A copy of this Report can be found on-line at www.nasdaqnews.com.

Amendments No. 1 and No. 2 is in italics.

Rule 4200. Definitions

(a) For purposes of the Rule 4000 Series, unless the context requires otherwise:

(1)-(14) No change.

(15) "Independent director" means 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. The following persons shall not be considered independent:

(a) a director who is employed by the corporation or any of its affiliates for the current year or any of the past three years;

(b) a director who accepts any compensation from the corporation or any of its affiliates in excess of \$60,000 during the previous fiscal year, other than compensation for board service, benefits under a tax-qualified retirement plan, or non-discretionary compensation;

(c) a director who is a member of the immediate family of an individual who is, or has been in any of the past three years, employed by the corporation for any of its affiliates as an executive officer. Immediate family includes a person's spouse, parents, children, siblings, mother-in-law, father-in-law, brother-in-law, sister-in-law, *son-in-law*, *daughter-in-law*, and anyone who resides in such person's home;

(d) a director who is a partner in, or a controlling shareholder or an executive officer, of, any for-profit business organization to which the corporation made, or from which the corporation received, payments (other than those arising solely from investments in the corporation's securities) that exceed 5% of the corporation's or business organization's consolidated gross revenues for that year, or \$200,000, whichever is more, in any of the past three years;

(e) a director who is employed as an executive of another entity where any of the company's executive's serve on that entity's compensation committee.

(15)-(36) renumbered as (16)-(37).

(b) No change.

Rule 4310. Qualification Requirements for Domestic and Canadian Securities

To qualify for inclusion in Nasdaq, a security of a domestic or Canadian issuer shall satisfy all applicable requirements contained in paragraphs (a) or (b), and (c) hereof.

(a)-(b) No change.

⁴³ 15 U.S.C. 78s(b)(2).

⁴⁴ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 41982 (Oct. 6, 1999), 64 FR 55510. The American Stock Exchange LLC and The New York Stock Exchange, Inc. have proposed rule changes relating to audit committees. See Securities Exchange Act Release No. 41981 (Oct. 6, 1999), 64 FR 55505 (Oct. 13, 1999) ("Amex Proposal"), and Securities Exchange Act Release No. 41980 (Oct. 6, 1999), 64 FR 55514 (Oct. 13, 1999) ("NYSE Proposal").

⁴ Letter from Robert E. Aber, Senior Vice President and General Counsel, Nasdaq-Amex Market Group, to Richard Strasser, Assistant Director, Division of Market Regulation, Commission, dated November 12, 1999 ("Amendment No. 1"). The Association submitted Amendment No. 1 to require issuers listed as of the effective date of Commission approval of the proposed rule change to adopt a formal written

(c) In addition to the requirements contained in paragraph (a) or (b) above, and unless otherwise indicated, a security shall satisfy the following criteria for inclusion in Nasdaq:

(1)–(24) No change.

(25) Corporate Governance Requirements.

* * * * *

(A) No change.

(B) Independent Directors.

Each issuer shall maintain a sufficient number of independent directors on its board of directors to satisfy the audit committee requirement set forth in Rule 4310(c)(26)(B).

(D)–(H) renumbered as (C)–(G).

(26) *Audit Committee*.

(A) *Audit Committee Charter*.

Each Issuer must certify that it has adopted a formal written audit committee charter and that the Audit Committee has reviewed and reassessed the adequacy of the formal written charter on an annual basis. The charter must specify the following:

(i) the scope of the audit committee's responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements;

(ii) the audit committee's responsibility for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the company, consistent with Independence Standards Board Standard 1, and the audit committee's responsibility for actively engaging in a dialogue with the auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the auditor and for taking, or recommending that the full board take, appropriate action to [ensure] *oversee* the independence of the outside auditor; and

(iii) the outside auditor's ultimate accountability to the board of directors and the audit committee, as representatives of shareholders, and these shareholder representatives' ultimate authority and responsibility to select, evaluate, and, where appropriate, replace the outside auditor (or to nominate the outside auditor to be proposed for shareholder approval in any proxy statement).

(B) *Audit Committee Composition*.

(i) Each issuer must have, and certify that it has and will continue to have, an audit committee of at least three members, comprised solely of independent directors, each of whom is able to read and understand fundamental financial statements, including a company's balance sheet,

income statement, and cash flow statement or will become able to do so within a reasonable period of time after his or her appointment to the audit committee. Additionally, each issuer must certify that it has, and will continue to have, at least one member of the audit committee that has past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.

(ii) Notwithstanding paragraph (i), one director who is not independent as defined in Rule 4200, and is not a current employee or an immediate family member of such employee, may be appointed to the audit committee, if the board, under exceptional and limited circumstances, determines that membership on the committee by the individual is required by the best interests of the corporation and its shareholders, and the board discloses, in the next annual proxy statement subsequent to such determination, the nature of the relationship and the reasons for that determination.

(iii) Exception for Small Business Filers—Paragraphs (B)(i) and (B)(ii) do not apply to issuers that file reports under SEC Regulation S–B. Such issuers must establish and maintain an Audit Committee of at least two members, a majority of the members of which shall be independent directors.

(26)–(28) renumbered as (27)–(29).

(d) No change.

Rule 4320. Qualification Requirements for Non-Canadian Foreign Securities and American Depositary Receipts

To qualify for inclusion in Nasdaq, a security of a non-Canadian foreign issuer, an American Depositary Receipt (ADR) or similar security issued in respect of a security of a foreign issuer shall satisfy the requirements of paragraphs (a), (b) or (c), and (d) and (e) of this Rule.

(a)–(d) No change.

(e) In addition to the requirements contained in paragraphs (a), (b) or (c), and (d), the security shall satisfy the following criteria for inclusion in Nasdaq:

(1)–(20) No change.

(21) *Corporate Governance Requirements*—No provisions of this subparagraph or of subparagraph (24) shall be construed to require any foreign issuer to do any act that is contrary to a law, rule or regulation of any public

authority exercising jurisdiction over such issuer or that is contrary to generally accepted business practices in the issuer's country of domicile. Nasdaq shall have the ability to provide exemptions from the applicability of these provisions as may be necessary or appropriate to carry out this intent.

Nasdaq shall review the issuer's past corporate governance activities. This review may include activities taking place while the issuer is listed on Nasdaq or an exchange that imposes corporate governance requirements, as well as activities taking place after the issuer is no longer listed on Nasdaq or an exchange that imposes corporate governance requirements. Based on such review, Nasdaq may take any appropriate action, including placing of restrictions on or additional requirements for listing, or the denial of listing of a security if Nasdaq determines that there have been violations or evasions of such corporate governance standards. Determinations under this subparagraph shall be made on a case-by-case basis as necessary to protect investors and the public interest.

(A) No change.

(B) Independent Directors.

Each issuer shall maintain a sufficient number of independent directors on its board of directors to satisfy the audit committee requirement set forth in Rule 4320(e)(22)(B).

(D)–(H) renumbered as (C)–(G).

(22) *Audit Committee*.

(A) *Audit Committee Charter*.

Each Issuer must certify that it has adopted a formal written audit committee charter and that the Audit Committee has reviewed and reassessed the adequacy of the formal written charter on an annual basis. The charter must specify the following:

(i) the scope of the audit committee's responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements;

(ii) the audit committee's responsibility for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the company, consistent with Independence Standards Board Standard 1, and the audit committee's responsibility for actively engaging in a dialogue with the auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the auditor and for taking, or recommending that the full board take, appropriate action to [ensure] *oversee* the independence of the outside auditor; and

(iii) the outside auditor's ultimate accountability to the board of directors and the audit committee, as representatives of shareholders, and these shareholder representatives' ultimate authority and responsibility to select, evaluate, and, where appropriate, replace the outside auditor (or to nominate the outside auditor to be proposed for shareholder approval in any proxy statement).

(B) Audit Committee Composition.

(i) Each issuer must have, and certify that it has and will continue to have, an audit committee of at least three members, comprised solely of independent directors, each of whom is able to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement or will become able to do so within a reasonable period of time after his or her appointment to the audit committee. Additionally, each issuer must certify that it has, and will continue to have, at least one member of the audit committee that has past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.

(ii) Notwithstanding paragraph (i), one director who is not independent as defined in Rule 4200, and is not a current employee or an immediate family member of such employee, may be appointed to the audit committee, if the board, under exceptional and limited circumstances, determines that membership on the committee by the individual is required by the best interests of the corporation and its shareholders, and the board discloses, in the next annual proxy statement subsequent to such determination, the nature of the relationship and the reasons for that determination.

(iii) Exception for Small Business Filers—Paragraphs (B)(i) and (B)(ii) do not apply to issuers that file reports under SEC Regulation S-B. Such issuers must establish and maintain an Audit Committee of at least two members, a majority of the members of which shall be independent directors.

(22)–(24) renumbered as (23)–(25).

(f) No change.

Rule 4460. Non-Quantitative Designation Criteria for Issuers Excepting Limited Partnerships

(a)–(b) No change.

(c) Independent Directors.

Each NNM issuer shall maintain a sufficient number of independent directors on its board of directors to satisfy the audit committee requirement set forth in Rule 4460(d)(2).

(d) Audit Committee.

(1) Audit Committee Charter.

Each Issuer must certify that it has adopted a formal written audit committee charter and that the Audit Committee has reviewed and reassessed the adequacy of the formal written charter on an annual basis. The charter must specify the following:

(A) the scope of the audit committee's responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements;

(B) the audit committee's responsibility for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the company, consistent with Independence Standards Board Standard 1, and the audit committee's responsibility for actively engaging in a dialogue with the auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the auditor and for taking, or recommending that the full board take, appropriate action to [ensure] *oversee* the independence of the outside auditor; and

(C) the outside auditor's ultimate accountability to the board of directors and the audit committee, as representatives of shareholders, and these shareholder representatives' ultimate authority and responsibility to select, evaluate, and, where appropriate, replace the outside auditor (or to nominate the outside auditor to be proposed for shareholder approval in any proxy statement).

(2) Audit Committee Composition.

(A) Each issuer must have, and certify that it has and will continue to have, an audit committee of at least three members, comprised solely of independent directors, each of whom is able to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement or will become able to do so within a reasonable period of time after his or her appointment to the audit committee. Additionally, each issuer must certify that it has, and will continue to have, at least one member of the audit committee that has past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background

which results in individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.

(B) Notwithstanding paragraph (i), one director who is not independent as defined in Rule 4200, and is not a current employee or an immediate family member of such employee, may be appointed to the audit committee, if the board, under exceptional and limited circumstances, determines that membership on the committee by the individual is required by the best interests of the corporation and its shareholders, and the board discloses, in the next annual proxy statement subsequent to such determination, the nature of the relationship and the reasons for that determination.

(C) Exception for Small Business Filers—Paragraphs (2)(A) and (2)(B) do not apply to issuers that file reports under SEC Regulation S-B. Such issuers must establish and maintain an Audit Committee of at least two members, a majority of the members of which shall be independent directors.

(e)–(n) No change.

B. Independence

Nasdaq proposes to narrow its current definition of "independent director" by specifying five new relationships that could impair a director's independent judgment as a result of financial, familial, or other material ties to management or the corporation. The proposed definition will apply to all directors, not just those serving on audit committees. Under the proposed rule change, directors with any of the following five relationships will not be considered independent: (1) Employment by the corporation or any of its affiliates for the current year or any of the past three years; (2) acceptance of any compensation from the corporation of any of its affiliates in excess of \$60,000 during the previous fiscal year, other than compensation for board service, benefits under a tax-qualified retirement plan, or non-discretionary compensation; (3) member of the immediate family of an individual who is, or has been in any of the past three years, employed by the corporation or any of its affiliates as an executive officer; (4) partnership in, or a controlling shareholder or an executive officer of, any for-profit business organization to which the corporation made, or from which the corporation received, payments (other than those arising solely from investments in the corporation's securities) that exceed five percent of

the corporation's or business organization's consolidated gross revenues for that year, or \$200,000, whichever is more, in any of the past three years; or (5) employment as an executive of another entity where any of the company's executives serve on that entity's compensation committee.

C. Structure and Membership of the Audit Committee

Nasdaq also proposes to change the structure and membership qualifications of the audit committee. Specifically, Nasdaq proposes to change the required composition of the audit committee from at least two to at least three members. Furthermore, the audit committee must be comprised solely of independent directors rather than a majority of independent directors. Nasdaq is conscious of the fact that in exceptional circumstances, issuers may appropriately conclude that it would be in the best interests of the corporation for a non-independent director to serve on the audit committee. In such exceptional and limited circumstances, a non-independent director can serve on the audit committee, provided that the board determines that it is required by the best interests of the corporation and its shareholders, and the board discloses its reasons for the determination in the next annual proxy statement. Due to the nature of this exception, however, a corporation could have no more than one non-independent director serving on its audit committee. Also, current employees or officers, or their immediate family members, may not serve on the audit committee under this exception.

As a result of the audit committee's responsibility for a corporation's accounting and financial reporting, Nasdaq believes that audit committee members should have a basic understanding of financial statements. Therefore, the proposed rule change requires each member of the audit committee to be able to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement, or become able to do so within a reasonable period of time after his or her appointment to the audit committee. Furthermore, in order to further enhance the effectiveness of the audit committee, at least one member of the audit committee must have past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer,

chief financial officer, or other senior officer with financial oversight responsibilities.

Nasdaq is sensitive to the potential burden that the proposed changes to the audit committee composition requirements may place on small companies. Therefore, Nasdaq proposes to exempt those corporations that file under SEC Regulation S-B ("Small Business Filers").⁷ Small Business Filers will be held to Nasdaq's existing requirements with respect to audit committee composition. That is, they must maintain an audit committee of at least two members, a majority of whom are independent.

D. Charter

Nasdaq believes that a written charter will help the audit committee as well as management and the corporation's auditors recognize the function of the audit committee and the relationship among these parties. The proposed rule change requires each issuer to adopt a formal written charter. This charter must specify the scope of the audit committee's responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements. In addition, the charter must specify the audit committee's responsibility for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the company, consistent with Independence Standards Board Standard 1.⁸ The charter must also specify the audit committee's responsibility for actively engaging in a dialogue with the auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the auditor and for taking, or recommending that the full board take, appropriate action to oversee the independence of the outside auditor. Finally, it must specify the outside auditor's ultimate accountability to the board of directors and the audit committee, as representatives of shareholders, and these shareholder representatives' ultimate authority and responsibility to select, evaluate, and, where appropriate, replace the outside auditor (or to nominate an outside auditor for shareholder approval in any proxy statement). The proposed rule

⁷ Small Business Filer is defined by Regulation S-B as an issuer that: (i) has revenue of less than \$25,000,000; (ii) is a U.S. or Canadian issuer; and (iii) if a majority owned subsidiary, the parent corporation is a small business issuer. 17 CFR 228.10(a)(1).

⁸ Independence Standard No. 1, Independence Discussions with Audit Committees (January 1999), which can be found on-line at www.cpaindependence.org.

change requires issuers to review their charter on an annual basis.

E. Implementation

In order to minimize disruption to existing issuer audit committees, to permit current audit committee members to serve out their terms, and to allow adequate time to recruit the requisite members, Nasdaq proposes to provide its issuers listed as of the effective date of the proposed rule change eighteen months after the proposed rule change is approved by the Commission to meet the audit committee structure and membership requirements.

Additionally, Nasdaq proposes that issuers listed as of the effective date of the rule change be provided six months following the date of Commission approval of the proposed rule change to adopt a formal written audit committee charter in compliance with proposed Rules 4310(c)(26)(A), 4320(e)(22)(A), or 4460(d)(1).

Further, for issuers that applied for listing prior to the effective date of the proposed rule change, Nasdaq proposes that they be able to qualify for listing under the listing standards in force at the time of their application, and to receive the same grace periods provided to currently listed issuers, as described above. Also, in order to avoid prejudicing issuers that transfer to Nasdaq from the American Stock Exchange and the New York Stock Exchange, Nasdaq proposed that these issuers be afforded the same grace periods they would have received under their previous market's implementation schedule.

III. Comments

As of December 9, 1999, the Commission received 14 comment letters on the proposed rule change.⁹ In general, the commenters favored the

⁹ See letters from: Ernst & Young LLP ("E&Y") dated November 1, 1999; Deloitte & Touche LLP ("Deloitte") dated November 3, 1999; Council of Institutional Investors ("CII") dated November 8, 1999; Brian T. Borders on behalf of the National Venture Capital Association ("NVCA") dated November 12, 1999; PricewaterhouseCoopers LLP ("Price") dated November 1, 1999; Gary P. Kreider ("Kreider") dated November 5, 1999; American Federation of Labor and Congress of Industrial Organizations ("AFL-CIO") dated November 29, 1999; Mayer, Brown & Platt on behalf of Morgan Stanley Dean Witter ("MSDW") dated November 29, 1999; Investment Company Institute ("ICI") dated November 3, 1999; Arthur Andersen LLP ("Arthur Andersen") dated December 3, 1999; Association of Publicly Traded Companies ("APTC") dated December 6, 1999; Robert A. Profusek ("Profusek") dated December 3, 1999; Stanley Keller and Richard Rowe ("Keller and Rowe") dated December 7, 1999; and The Committee on Securities Regulation of the Business Law Section of the New York State Bar Association ("NYSBA") dated December 1, 1999.

proposed rule change but recommended certain modifications. Two commenters opposed the proposed rule change.¹⁰

In particular, the CII supports the new requirements, but stated that the proposed override provision, which allows a company's board to include a non-independent director on the audit committee is not appropriate because companies should not have a problem finding financially literate, truly independent directors.¹¹ In addition, the AFL-CIO stated that the restriction period for former employees, or relatives of former employees, should be five years instead of three years.¹² The AFL-CIO also stated that the \$60,000 threshold to disqualify a candidate because of a significant business relationship is not stringent enough.¹³ Another commenter, on the other hand, stated that a quantitative test is too inflexible.¹⁴ Keller and Rowe stated that former non-executive employment should be treated as a significant business relationship.¹⁵ This commenter also stated that consultants who receive from the company more than a *de minimis* amount of compensation should be treated as employees, while consultants who do not should be treated as having a business relationship with the company.¹⁶ According to this comment letter, the company's board should be permitted to determine that the compensation does not impair the director's objectivity.¹⁷ Keller and Rowe also objected to the financial expertise requirement and stated that no director will want to be designated the financial expert because of the added exposure to liability.¹⁸

Deloitte and Price each stated that requiring a company's board or audit committee to "ensure" the independence of the outside auditor goes beyond what can reasonably be expected of the board and the audit committee in their oversight role.¹⁹ Deloitte suggested that Nasdaq replace the word "ensure" with "monitor" or

"actively oversee."²⁰ E&Y supported the proposed rule change, but stated that Nasdaq should not exempt Small Business Filers from the financial literacy and expertise requirements and also should expand its definition of immediate family member to include sons-in-law and daughters-in-law.²¹ NYSBA stated that the company's board should be required to adopt the audit committee charter, rather than the audit committee adopting the charter subject to board approval.²²

In addition, the NVCA stated that the proposed rule change should exclude venture capital investors from the independence qualifications.²³ The NVCA also stated that the proposed rule change should give companies that have just completed an initial public offering eighteen months to comply with the new requirements and that the exemption for Small Business Filers should be expanded to apply to companies with less than \$50 million in revenue.²⁴

APTC stated that the proposed rule change will be counter productive to the goal of better audit committees.²⁵ In addition, APTC stated that the proposed rule change will disadvantage smaller companies more than larger companies, but concluded that it is appropriate to apply the proposed rule change to all companies, regardless of size.²⁶ Moreover, APTC is opposed to the proposal's financial literacy requirement.²⁷ APTC believes that the financial literacy requirement may deprive audit committees of the service of individuals with "exceptional character and/or operational experience."²⁸ The commenter suggested that the Exchange replace this requirement with a requirement that the committee as a whole possess a certain level of financial acumen.²⁹

Finally, two commenters stated that the proposed rule change should not apply to closed-end investment companies.³⁰ These commenters noted that closed-end investment companies

are adequately regulated under the 1940 Act.³¹ The commenters also stated that the potential abuses that the proposed rule change is designed to address do not exist with closed-end investment funds.³² Finally, the commenters noted that because the assets of these funds consist exclusively of investment securities, there is no opportunity to "manage" earnings or results through selective application of accounting policies.³³

IV. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association,³⁴ and, in particular, the requirements of Section 15(A)(b)(6) of the Act.³⁵ The Commission believes that the proposed rule change will protect investors by improving the effectiveness of audit committees of companies listed on Nasdaq. The Commission also believes that the new requirements will enhance the reliability and credibility of financial statements of companies listed on Nasdaq by making it more difficult for companies to inappropriately distort their true financial performance.

Specifically, the Commission believes that the proposed definition of independence will promote the quality and reliability of a company's financial statements. The Commission believes that directors without financial, familial, or other material personal ties to management will be more likely to objectively evaluate the propriety of management's accounting, internal control, and financial reporting practices. The Commission believes that the proposal's prohibition against employees serving on the audit committee is appropriate and that the Exchange should not be required to distinguish between executive and non-executive employees.³⁶ The Commission also believes that the proposed provision that permits a company to appoint one director to its audit committee who is not independent, if the board determines that membership on the committee by the individual is required by the best interests of the corporation and its

¹⁰ See Kreider Letter; APTC Letter at 2. Kreider stated that the proposed rule change "represent[s] an awkward attempt to circumvent state corporate law and micro-manage the functions of audit committees." *Id.* at 2.

¹¹ CII Letter, at 2; *see also* AFL-CIO Letter at 2.

¹² AFL-CIO Letter at 2.

¹³ *Id.*

¹⁴ Profusek Letter at 2. In addition, Keller and Rowe stated that this provision might preclude a number of highly qualified candidates from serving on audit committees. Keller and Rowe Letter at 3.

¹⁵ Keller and Rowe Letter at 2.

¹⁶ *Id.* at 3.

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ Deloitte Letter at 1; Price Letter at 1.

²⁰ *Id.* at 2.

²¹ E&Y Letter at 4.

²² NYSBA Letter at 2.

²³ NVCA Letter at 5.

²⁴ *Id.* at 4.

²⁵ APTC Letter at 2.

²⁶ *Id.* at 3.

²⁷ *Id.* at 4-5.

²⁸ *Id.*

²⁹ *Id.* at 5.

³⁰ ICI Letter at 2; MSDW Letter at 1. In addition, Keller and Rowe stated that the proposed rule change should exempt all investment companies because their audit committee members are already required not to be "interested persons" as that term is defined in Section 2(a)(9) of the Investment Company Act of 1940 ("1940 Act"). Keller and Rowe Letter at 5.

³¹ ICI Letter at 3-4; MSDW Letter at 2.

³² ICI Letter at 3; MSDW Letter at 1. ICI and MSDW also noted that the independent accountants of investment funds are selected by the independent directors of the fund.

³³ ICI Letter at 3; MSDW Letter at 1.

³⁴ In approving the proposal, the Commission has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

³⁵ 15 U.S.C. 78o-3(b)(6).

³⁶ *See* Keller and Rowe Letter at 2.

shareholders, adequately balances the need for objective, independent directors with the company's need for flexibility in exceptional and unusual circumstances. The Commission believes that the requirement that the company disclose in its next annual proxy statement the nature of the director's relationship with the company and the board's reasons for determining the appointment was in the best interests of the corporation will adequately guard against abuse of the proposed exception to the independence requirement. Moreover, the Commission believes that the \$60,000 threshold to determine if a potential audit committee director has a significant business relationship with the company is a reasonable measure to balance the company's need to recruit audit committee members with the independence requirement.

The Commission does not believe that venture capital investors should be excluded from Nasdaq's definition of independence. The Commission does not believe that the proposed rule change will pose an undue hardship on venture capital firms or companies listed on Nasdaq. The Commission notes that the proposed rule change will only prohibit venture capital investors from sitting on a company's audit committee if the investor does not fall within Nasdaq's definition of independent. The proposed rule change will not prohibit previously eligible investors from serving on the company's board. The Commission also notes that a venture capital investor that is not considered independent may serve on the company's audit committee, if the board determines it is in the best interests of the corporation and its shareholders and the company discloses its reasons for the determination and the nature of the director's relationship to the company in its next annual proxy statement.

In addition, the Commission believes that requiring companies to adopt formal written charters specifying the audit committee's responsibilities, and how the committee carries out those responsibilities, will help the audit committee, management, investors, and the company's auditors recognize the function of the audit committee and the relationship among the parties. Moreover, the Commission believes that requiring the charter to specify that the audit committee is responsible for taking, or recommending that the company's full board take, appropriate action to oversee the independence of the outside auditor will make it more likely that companies will select objective, unbiased auditors.

The Commission believes that the proposed rule change's compositional requirement that each issuer have an audit committee composed of three independent directors who are able to read and understand fundamental financial statements will enhance the effectiveness of the audit committee and help to ensure that audit committee members are able to adequately fulfill their responsibilities. The Commission believes that requiring each audit committee member to satisfy this standard will help to ensure that the committee as a whole is financially literate.³⁷ Moreover, the Commission considers that requiring one member of the audit committee to have past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background that indicates the individual's financial sophistication, will further enhance the effectiveness of the audit committee in carrying out its financial oversight responsibilities. In addition, the Commission does not believe that companies will experience undue difficulty recruiting an audit committee member that satisfies the financial expertise requirements. Moreover, the Commission believes that the proposed rule change appropriately exempts Small Business Filers from the proposed composition requirements because these companies may experience more difficulty meeting these enhanced requirements. The Commission notes that these companies will remain subject to Nasdaq's existing rules on audit committees, which require an audit committee to have at least two members, a majority of whom are independent.

Moreover, the Commission does not believe that the proposed rule change circumvents state law.³⁸ The Commission notes that Nasdaq is amending its own qualification requirements governing an issuer's listing on Nasdaq, which is an appropriate function for Nasdaq as long as those requirements are consistent with the Act.

Moreover, the Commission has concluded that Nasdaq's decision to include investment companies in the proposed rule change is warranted. While the Commission recognizes that the opportunity for some types of financial reporting abuses may be limited by the nature of fund assets,³⁹ it believes that audit committees do play

an important role in overseeing the financial reporting process for investment companies.

The Commission finds good cause for approving Amendments No. 1 and No. 2 to the proposed rule change prior to the thirtieth day after publication in the **Federal Register**. The Commission notes that Amendment No. 1 merely revises the implementation time periods for the proposed rule change to provide greater clarity to issuers and to investors. The Commission believes that Amendment No. 1 will enable issuers to determine when they must comply with the new requirements and will enable investors to determine when to rely on the protections afforded by the proposed rule change. The Commission notes that Amendment No. 2 simply clarifies that the audit committee is required to oversee, rather than ensure, the independence of the company's outside auditors, and expands Nasdaq's definition of "immediate family." The Commission believes that accelerated approval will allow Nasdaq to simultaneously make all relevant modifications to its Rules and will avoid potential confusion. Accordingly, the Commission finds good cause to accelerate approval of Amendments No. 1 and No. 2 to the proposed rule change, consistent with Sections 6(b)(5)⁴⁰ and 19(b)⁴¹ of the Act.

V. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to the File No. SR-NASD-99-48 and should be submitted by January 11, 2000.

³⁷ See APTC Letter at 5.

³⁸ Kreider Letter at 2.

³⁹ See Keller and Rowe Letter at 5; ICI Letter at 3; MSDW Letter at 1.

⁴⁰ 15 U.S.C. 78f(b)(5).

⁴¹ 15 U.S.C. 78s(b).

VI. Conclusion

For the foregoing reasons, the Commission finds that Nasdaq's proposal to amend its audit committee requirements is consistent with the requirements of the Act and the rules and regulations thereunder.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,⁴² that the amended proposed rule change (SR-NASD-99-48) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁴³

Jonathan G. Katz,
Secretary.

[FR Doc. 99-33050 Filed 12-20-99; 8:45 am]

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-42233; File No. SR-NYSE-99-39]

Self-Regulatory Organizations; Order Approving Proposed Rule Change by the New York Stock Exchange, Inc. Amending the Exchange's Audit Committee Requirements and Notice of Filing and Order Granting Accelerated Approval of Amendments No. 1 and No. 2 Thereto

December 14, 1999.

I. Introduction

On September 20, 1999, the New York Stock Exchange, Inc. ("NYSE" or "Exchange") submitted to the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a proposed rule change amending the Exchange's audit committee requirements.

The **Federal Register** published the proposed rule change for comment on October 13, 1999.³ In response, the Commission received 25 comment letters.⁴ On October 15, 1999 and December 8, 1999, the Exchange submitted Amendments No. 1⁵ and No.

2,⁶ respectively, to the proposed rule change. This order approves the proposed rule change and grants accelerated approval to Amendments No. 1 and No. 2. The Commission is also soliciting comment on Amendments No. 1 and No. 2 to the proposed rule change.

II. Description of the Proposed Rule Change

A. Background

In February 1999, the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees ("Blue Ribbon Committee") issued a report containing recommendations aimed at strengthening the independence of the audit committee, making the audit committee more effective, and addressing mechanisms for accountability among the audit committee, the outside auditors, and management.⁷

The Exchange distributed to its listed companies the Exchange staff's suggestions for rule changes in response to the Blue Ribbon Committee's report. The comments from the Exchange's listed companies were generally supportive of the suggestions put forth by the Exchange, with some commenters expressing concerns about "financial literacy" requirement.

Director, Division of Market Regulation ("Division"), Commission, dated October 14, 1999 ("Amendment No. 1"). The Exchange submitted Amendment No. 1 to require issuers to adopt a formal written audit committee charter within six months of the effective date of the proposed rule change. As originally filed, the proposed rule change required issuers to adopt the charter within eighteen months of the effective date of the proposed rule change. Amendment No. 1 also extends the definition of "officer" in Rule 16a-1(f) under the Act to Paragraph 303 of the Exchange's *Listed Company Manual*. Previously, the Exchange permitted each company's by-laws and charter to define this term.

⁶ Letter from James E. Buck, Senior Vice President and Secretary, NYSE, to Richard Strasser, Assistant Director, Division, Commission, dated December 6, 1999 ("Amendment No. 2"). Amendment No. 2 revises proposed rule 303.01(B)(1) to require the board to adopt the audit committee charter. Under the original proposal, the audit committee adopted the charter, subject to board approval. Amendment No. 2 also revises proposed Rule 303.01(B)(1)(c) to replace the provision that required the board to take appropriate steps to ensure the independence of the outside auditors. The revised provision requires the board "to take appropriate action in response to the outside auditors report to satisfy itself of the outside auditor's independence." Finally, Amendment No. 2 revises proposed Rule 303.02 to require companies listing on the Exchange in conjunction with an initial public offering to have two qualified audit committee members in place within three months of listing, and a third qualified member within twelve months of listing.

⁷ *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (1999)*. A copy of this Report can be found on-line at www.nasdaqnews.com.

In response to the Blue Ribbon Committee's recommendations, the Exchange proposes to revise its listing standards regarding audit committees. The proposed rule change specifies four requirements for a qualified audit committee and defines the terms "Immediate Family" and "Affiliate" for purposes of the proposed audit committee requirements.

The text of the proposed rule change, as amended by Amendments No. 1 and No. 2, is as follows. Language deleted by Amendments No. 1 and No. 2 is in brackets. Language added by Amendments No. 1 and No. 2 is in italics.

NYSE Listed Company Manual

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Section 3

Corporate Responsibility

303.00 Corporate Governance Standards

In addition to the numerical listing standards, the Exchange has adopted certain corporate governance listing standards. These standards apply to all companies listing common stock on the Exchange. However, the Exchange does not apply a particular standard to a non-U.S. company if the company provides the Exchange with a written certification from independent counsel of the company's country of domicile stating that the company's corporate governance practices comply with home country law and the rules of the principal securities market for the company's stock outside the United States.

303.01 Audit Committee

(A) *Audit Committee Policy*. Each company must have a qualified audit committee.

(B) *Requirements for a Qualified Audit Committee*.

(1) *Formal Charter*. [Each audit committee must adopt a formal written charter that is approved by the Board of Directors.] *The Board of Directors must adopt and approve a formal written charter for the audit committee*. The audit committee must review and reassess the adequacy of the audit committee charter on an annual basis. The charter must specify the following:

(a) The scope of the audit committee's responsibilities and how it carries out those responsibilities, including structure, processes and membership requirements;

(b) That the outside auditor for the company is ultimately accountable to the Board of Directors and audit committee of the company, that the

⁴² 15 U.S.C. 78s(b)(2).

⁴³ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 41980 (Oct. 6, 1999), 64 FR 55514 (Oct. 13, 1999). The Nasdaq Stock Market, Inc. and The American Stock Exchange LLC have proposed rule changes relating to audit committees. See Securities Exchange Act Release No. 41982 (Oct. 6, 1999), 64 FR 55510 (Oct. 13, 1999) ("Nasdaq Proposal"), and Securities Exchange Act Release No. 41981 (Oct. 6, 1999), 64 FR 55505 (Oct. 13, 1999) ("Amex Proposal").

⁴ The comment letters are discussed in Section III of this order.

⁵ Letter from James E. Buck, Senior Vice President and Secretary, NYSE, to Richard Strasser, Assistant