

production property, plant and equipment.

Supply, an interstate pipeline company, transports and stores natural gas for Distribution and for other utilities, pipelines, marketers and large industrial customers in the northeastern United States. Supply owns and operates a 2,900-mile pipeline network that extends generally from southwestern Pennsylvania to the U.S.-Canadian border at Niagara Falls. It is regulated by the Federal Energy Regulatory Commission as a natural gas company under the Natural Gas Act of 1938.

Empire, an intrastate pipeline company, transports natural gas for Distribution and for other utilities, large industrial customers and power producers in New York State. The company owns a 157-mile pipeline that extends generally from the U.S.-Canadian border at the Chippawa Channel of the Niagara River near Buffalo, N.Y. to near Syracuse, N.Y., and is regulated by the New York Public Service Commission.

Seneca is engaged in the business of exploration and development of natural gas and oil producing reserves in California, in the Appalachian region of the United States, in Wyoming and in the Gulf Coast region of Texas and Louisiana. In addition, Seneca conducts exploration and production operations through subsidiaries in the provinces of Manitoba, Alberta, Saskatchewan and British Columbia in Canada.

Resources markets natural gas to approximately 22,000 industrial, commercial and residential customers under long-term agreements, and provides other related energy services to those end-use customers. Upstate Energy engages through subsidiaries in gas marketing and related activities, and is a "gas-related company" within the meaning of rule 58. Neither Resources nor Upstate Energy owns or operates facilities for the distribution of gas at retail or for the generation, transmission or distribution of electricity for sale.

#### B. Existing Authority

By order dated December 16, 1999 (HCAR No. 27114, "December 1999 Order"), the Commission authorized National Fuel Gas, through Supply, Resources, Seneca and Upstate, to acquire the equity and debt securities of one or more companies that are engaged in or are formed to engage in certain categories of non-utility gas-related operations outside the United States ("Foreign Energy Affiliates"). Specifically, the Commission authorized National and the Nonutility Subsidiaries (except as described below) to invest up

to \$300 million through December 31, 2003 in the securities of Foreign Energy Affiliates, and authorized Resources and Upstate Energy to engage directly in marketing and brokering and related activities in Canada.<sup>2</sup>

By order dated December 27, 2000 (HCAR No. 27320, "December 2000 Order"), the Commission modified the December 1999 Order to authorize National Fuel Gas to invest up to an aggregate amount of \$800 million (from \$300 million) in Foreign Energy Affiliates.

#### II. Requests for Authority

Applicants now request authority for National Fuel Gas to acquire directly, or indirectly through the Nonutility Subsidiaries, one or more newly organized direct subsidiaries of National Fuel Gas or one or more subsidiaries of the Nonutility Subsidiaries ("Intermediate Subsidiaries"), the securities of or other interests in Foreign Energy Affiliates through December 31, 2006 ("Authorization Period"). The aggregate amount invested by National Fuel Gas and its subsidiaries in Foreign Energy Affiliates would not exceed \$800 million. Applicants state that, generally, the operations of Foreign Energy Affiliates would be substantially similar to those that the Nonutility Subsidiaries are now directly engaged in within the United States.

Applicants request authority for Resources and Upstate to engage directly in marketing and brokering and related activities in Canada.

Applicants request authority during the Authorization Period for the Nonutility Subsidiaries, Intermediate Subsidiaries, and Foreign Energy Affiliates to: (1) Pay dividends out of capital and unearned surplus; and (2) retire or reacquire any securities that have been issued to an associate company.

For the Commission, by the Division of Investment Management, pursuant to delegated authority.

**Jill M. Peterson,**

*Assistant Secretary.*

[FR Doc. 03-28335 Filed 11-10-03; 8:45 am]

**BILLING CODE 8010-01-P**

<sup>2</sup> The Commission reserved jurisdiction, pending completion of the record, over: (1) Investments by Seneca in Foreign Energy Affiliates that are engaged in exploration and production activities outside of the United States and Canada; (2) any investment by Supply in a Foreign Energy Affiliate; (3) direct energy commodity marketing and brokering by Resources and Upstate Energy outside the United States and Canada; and (4) investments by Resources and Upstate Energy in Foreign Energy Affiliates that are engaged in Energy Commodity marketing and brokering activities outside of the United States and Canada.

#### SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-48745; File Nos. SR-NYSE-2002-33, SR-NASD-2002-77, SR-NASD-2002-80, SR-NASD-2002-138, SR-NASD-2002-139, and SR-NASD-2002-141]

**Self-Regulatory Organizations; New York Stock Exchange, Inc. and National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Changes (SR-NYSE-2002-33 and SR-NASD-2002-141) and Amendments No. 1 Thereto; Order Approving Proposed Rule Changes (SR-NASD-2002-77, SR-NASD-2002-80, SR-NASD-2002-138 and SR-NASD-2002-139) and Amendments No. 1 to SR-NASD-2002-80 and SR-NASD-2002-139; and Notice of Filing and Order Granting Accelerated Approval of Amendment Nos. 2 and 3 to SR-NYSE-2002-33, Amendment Nos. 2, 3, 4 and 5 to SR-NASD-2002-141, Amendment Nos. 2 and 3 to SR-NASD-2002-80, Amendment Nos. 1, 2, and 3 to SR-NASD-2002-138, and Amendment No. 2 to SR-NASD-2002-139, Relating to Corporate Governance**

November 4, 2003.

#### I. Introduction

On August 16, 2002, the New York Stock Exchange, Inc. ("NYSE" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change (SR-NYSE-2002-33) to amend its Listed Company Manual ("NYSE Manual") to implement significant changes to its listing standards that are aimed to ensure the independence of directors of listed companies and to strengthen corporate governance practices of listed companies ("NYSE Corporate Governance Proposal"). On April 4, 2003, the NYSE submitted Amendment No. 1 to the NYSE Corporate Governance Proposal.<sup>3</sup> On April 17, 2003, the proposed rule change, as amended by NYSE Amendment No. 1, was published for comment in the **Federal Register**.<sup>4</sup> The

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See letter from Darla C. Stuckey, Corporate Secretary, NYSE, to Nancy J. Sanow, Assistant Director, Division of Market Regulation ("Division"), Commission, dated April 3, 2003 ("NYSE Amendment No. 1"). NYSE Amendment No. 1 replaced the original filing in its entirety. Telephone call between Annemarie Tierney, Office of General Counsel, NYSE, and Jennifer Lewis, Special Counsel, Division, Commission, on April 9, 2003.

<sup>4</sup> See Securities Exchange Act Release No. 47672 (April 11, 2003), 68 FR 19051 ("NYSE Notice").

Commission received 68 comment letters on the NYSE proposal.<sup>5</sup> On October 8, 2003, the NYSE filed Amendment No. 2 to the NYSE Corporate Governance Proposal.<sup>6</sup> On October 20, 2003, the NYSE filed Amendment No. 3 to the NYSE Corporate Governance Proposal.<sup>7</sup>

On October 9, 2002, the NASD, through its subsidiary, The Nasdaq Stock Market, Inc. ("Nasdaq"), filed with the Commission, pursuant to section 19(b)(1) of the Exchange Act, and Rule 19b-4 thereunder, a proposed rule change (SR-NASD-2002-141) to amend NASD Rules 4200 and 4350(c) and (d) to modify requirements relating to board independence and independent committees ("Nasdaq Independent Director Proposal"). On March 11, 2003, NASD, through Nasdaq, filed Amendment No. 1 to the Nasdaq Independent Director Proposal.<sup>8</sup> On March 25, 2003, the proposed rule change, as amended by Amendment No. 1 to the Nasdaq Independent Director Proposal, was published for comment in the **Federal Register**.<sup>9</sup> The Commission received 24 comment letters on the Nasdaq Independent Director Proposal.<sup>10</sup> On July 16, 2003, Nasdaq filed Amendment No. 2 to the Nasdaq Independent Director Proposal.<sup>11</sup> On

October 10, 2003, Nasdaq filed Amendment No. 3 to the Nasdaq Independent Director Proposal.<sup>12</sup> On October 16, 2003, Nasdaq filed Amendment No. 4 to the Nasdaq Independent Director Proposal.<sup>13</sup> On October 30, 2003, Nasdaq filed Amendment No. 5 to the Independent Director Proposal.<sup>14</sup> On June 11, 2002, the NASD, through Nasdaq, filed with the Commission, pursuant to section 19(b)(1) of the Exchange Act, and Rule 19b-4 thereunder, a proposed rule change (SR-NASD-2002-77) to amend NASD Rule 4350(b) to add a requirement for issuers to announce publicly any audit opinions with going concern qualifications ("Nasdaq Going Concern Proposal"). On July 10, 2003, the NASD Going Concern Proposal was published for comment in the **Federal Register**.<sup>15</sup> The Commission received no comments on the proposal.

On June 11, 2002, the NASD, through Nasdaq, filed with the Commission, pursuant to section 19(b)(1) of the Exchange Act, and Rule 19b-4 thereunder, a proposed rule change (SR-NASD-2002-80) to amend NASD Rule 4350(h) to require an issuer's audit committee or another independent body of the board of directors to approve related party transactions ("Nasdaq Related Party Transactions Proposal"). On December 30, 2002, the NASD, through Nasdaq, submitted Amendment No. 1 to the Nasdaq Related Party Transactions Proposal.<sup>16</sup> On July 16, 2003, the proposed rule change, as

amended, was published for comment in the **Federal Register**.<sup>17</sup> The Commission received no comments on the proposal. On October 3, 2003, the NASD, through Nasdaq, submitted Amendment No. 2 to the Nasdaq Related Party Transactions Proposal.<sup>18</sup> On October 6, 2003, the NASD, through Nasdaq, submitted Amendment No. 3 to the Nasdaq Related Party Transactions Proposal.<sup>19</sup>

On October 9, 2002, the NASD, through Nasdaq, filed with the Commission, pursuant to section 19(b)(1) of the Exchange Act, and Rule 19b-4 thereunder, a proposed rule change (SR-NASD-2002-138) to amend NASD Rule 4350(a) to require foreign issuers to disclose any exemptions they may receive from Nasdaq's corporate governance listing standards ("Nasdaq Issuer Applicability Proposal"). On July 10, 2003, the Nasdaq Issuer Applicability Proposal was published for comment in the **Federal Register**.<sup>20</sup> The Commission received one comment letter on the Nasdaq Issuer Applicability Proposal.<sup>21</sup> On August 15, 2003, the NASD, through Nasdaq, submitted Amendment No. 1 to the Nasdaq Issuer Applicability Proposal.<sup>22</sup> On October 10, 2003, the NASD, through Nasdaq, submitted Amendment No. 2 to the Nasdaq Issuer Applicability Proposal.<sup>23</sup>

<sup>5</sup> A list of commenters on the rule proposals of the NYSE and the National Association of Securities Dealers, Inc. ("NASD"), who submitted correspondence as of October 13, 2003, is attached as Exhibit A to this order. The public files for the NYSE and NASD rule proposals, including all comment letters received on the proposals, are located at the Commission's Public Reference Room, 450 Fifth Street, NW, Washington DC 20549-0102. See *infra*, note.

<sup>6</sup> See letter from Darla C. Stuckey, Corporate Secretary, NYSE, to Nancy J. Sanow, Assistant Director, Division, Commission, dated October 8, 2003 ("NYSE Amendment No. 2"). NYSE Amendment No. 2 amended portions of the proposal as described below.

<sup>7</sup> See letter from Darla C. Stuckey, Corporate Secretary, NYSE, to Nancy J. Sanow, Assistant Director, Division, Commission, dated October 17, 2003 ("NYSE Amendment No. 3"). In Amendment No. 3, NYSE proposed to require that the audit committee charter of a closed-end or open-end management investment company address the responsibility of the audit committee to establish procedures for the confidential, anonymous submission of concerns regarding questionable accounting or auditing matters, but not to require the procedures to be set forth in the charter, as would have been required under Amendment No. 2.

<sup>8</sup> See letter from Mary M. Dunbar, Vice President and Deputy General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division, Commission, dated March 11, 2003. Amendment No. 1 to the Nasdaq Independent Director Proposal replaced the original filing in its entirety.

<sup>9</sup> See Securities Exchange Act Release No. 47516 (March 17, 2003), 68 FR 14451.

<sup>10</sup> See *supra* note.

<sup>11</sup> See letter from Sara Nelson Bloom, Associate General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division, Commission, dated July 15, 2003.

<sup>12</sup> See letter from Mary M. Dunbar, Vice President and Deputy General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division, Commission, dated October 9, 2003. Amendment No. 3 to the Nasdaq Independent Director Proposal replaced in full the Nasdaq Independent Director Proposal and Amendment Nos. 1 and 2 thereto. See Section IV. *infra*, describing aspects of the proposed revisions.

<sup>13</sup> See letter from Mary M. Dunbar, Vice President and Deputy General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division, Commission, dated October 15, 2003. Amendment No. 4 to the Nasdaq Independent Director Proposal made several revisions to the narrative section of the previous amendment.

<sup>14</sup> See letter from Sara Nelson Bloom, Associate General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division, Commission, dated October 29, 2003. Amendment No. 5 to the Nasdaq Independent Director Proposal related to the proposed requirement that investment company audit committees establish procedures for the confidential, anonymous submission of concerns regarding questionable accounting or auditing matters. Amendment No. 5 removed a sentence in the narrative section of the proposal that stated that the procedures would be required to be set forth in the audit committee charter.

<sup>15</sup> See Securities Exchange Act Release No. 48123 (July 2, 2003), 68 FR 41191 ("Nasdaq Notice").

<sup>16</sup> See letter from John D. Nachman, Senior Attorney, Nasdaq, to Katherine A. England, Assistant Director, Division, Commission, dated December 30, 2002.

<sup>17</sup> See Securities Exchange Act Release No. 48137 (July 8, 2003), 68 FR 42152.

<sup>18</sup> See letter from John D. Nachman, Senior Attorney, Nasdaq, to Katherine A. England, Assistant Director, Division, Commission, dated October 2, 2003. In Amendment No. 2 to the Nasdaq Related Party Transactions Proposal, Nasdaq proposed to (1) add language to NASD Rule 4350(h) to clarify that each issuer shall conduct an appropriate review of all related party transactions for potential conflict of interest situations, and (2) require that the rule change become effective 60 days following Commission approval.

<sup>19</sup> See letter from John D. Nachman, Senior Attorney, Nasdaq, to Katherine A. England, Assistant Director, Division, Commission, dated October 3, 2003. In Amendment No. 3 to the Nasdaq Related Party Transactions Proposal, Nasdaq proposed that the rule change become effective on January 15, 2004.

<sup>20</sup> See Securities Exchange Act Release No. 48124 (July 2, 2003), 68 FR 41193.

<sup>21</sup> See *supra* note.

<sup>22</sup> See letter from Mary M. Dunbar, Vice President and Deputy General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division, Commission, dated August 15, 2003. Amendment No. 1 replaced in full the Nasdaq Issuer Applicability Proposal. In Amendment No. 1 to the Nasdaq Issuer Applicability Proposal, Nasdaq proposed to exempt registered management investment companies, asset-backed issuers and other passive issuers, and cooperatives from most provisions of NASD Rule 4350.

<sup>23</sup> See letter from Mary M. Dunbar, Vice President and Deputy General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division, Commission, dated October 9, 2003. Amendment No. 2 replaced in full the Nasdaq Issuer Applicability Proposal and Amendment No. 1

On October 23, 2003, the NASD, through Nasdaq, submitted Amendment No. 3 to the Nasdaq Issuer Applicability Proposal.<sup>24</sup>

On October 10, 2002, the NASD, through Nasdaq, filed with the Commission, pursuant to section 19(b)(1) of the Exchange Act, and Rule 194-4 thereunder, a proposed rule change (SR-NASD-2002-139) to amend NASD Rule 4350(m) to require listed companies to adopt a code of conduct for all directors, officers, and employees ("Nasdaq Code of Conduct Proposal"). On January 15, 2003, the NASD, through Nasdaq, submitted Amendment No. 1 to the Nasdaq Code of Conduct Proposal.<sup>25</sup> On July 10, 2003, the proposed rule change, as amended, was published for comment in the **Federal Register**.<sup>26</sup> The Commission received two comment letters on the Nasdaq Code of Conduct Proposal.<sup>27</sup> On October 6, 2003, the NASD, through Nasdaq, submitted Amendment No. 2 to the Nasdaq Code of Conduct Proposal.<sup>28</sup> This order

thereto. In Amendment No. 2 to the Issuer Applicability Proposal, Nasdaq proposed to clarify that (1) investment companies (including business development companies) are subject to all the requirements of NASD Rule 4350, except that registered management investment companies are exempt from the requirements of NASD Rule 4350(c); (2) asset-backed issuers and certain other passive issuers are exempt from the requirements of NASD Rule 4350(c) and (d); and (3) certain cooperative entities are exempt from NASD Rule 4350(c), however, each of these entities must comply with all federal securities laws, including without limitation, section 10A(m) of the Exchange Act and Rule 10A-3 thereunder.

<sup>24</sup> See letter from Mary M. Dunbar, Vice President and Deputy General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division, Commission, dated October 23, 2003. Amendment No. 3 replaced in full the Nasdaq Issuer Applicability Proposal and Amendment Nos. 1 and 2 thereto. In Amendment No. 3 to the Nasdaq Issuer Applicability Proposal, Nasdaq proposed to set forth the dates by which companies would be required to come into compliance with the proposed rule changes that are the subject of this Order; add new Rules 4200A and 4350A to incorporate the sections of Rules 4200 and 4350 that would continue to apply until the proposed rule changes become effective; and exempt registered management investment companies, asset-backed issuers, and unit investment trusts from the requirement of proposed subsection (n) of NASD Rule 4350 regarding codes of conduct.

<sup>25</sup> See letter from Mary M. Dunbar, Vice President and Deputy General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division, Commission, dated January 15, 2003.

<sup>26</sup> See Securities Exchange Act Release No. 48125 (July 2, 2003), 68 FR 41194.

<sup>27</sup> See *supra* note.

<sup>28</sup> See letter from Mary M. Dunbar, Vice President and Deputy General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division, Commission, dated October 3, 2003. In Amendment No. 2 to the Nasdaq Code of Conduct Proposal, Nasdaq proposed to re-letter the section of NASD Rule 4350 addressing the code of conduct requirement as subsection (n), add cross-references to 17 CFR 228.406 and 17 CFR 229.406, and clarify that any waivers of the code for directors or

approves the NYSE Corporate Governance Proposal, as amended by NYSE Amendment Nos. 1, 2, and 3; the Nasdaq Independent Director Proposal, as amended by Amendment Nos. 1, 2, 3, 4, and 5 to the Nasdaq Independent Director Proposal; the Nasdaq Going Concern Proposal; the Nasdaq Related Party Transactions Proposal, as amended by Amendment Nos. 1, 2, and 3 to that proposal; the Nasdaq Issuer Applicability Proposal, as amended by Amendment Nos. 1, 2, and 3 to that proposal; and the Nasdaq Code of Conduct Proposal, as amended by Amendment Nos. 1 and 2 to that proposal. The Commission is granting accelerated approval to Amendment Nos. 2 and 3 to the NYSE Corporate Governance Proposal, Amendment Nos. 2, 3, 4, and 5 to the Nasdaq Independent Director Proposal, Amendment Nos. 2 and 3 to the Nasdaq Related Party Transactions Proposal, Amendment Nos. 1, 2, and 3 to the Nasdaq Issuer Applicability Proposal, and Amendment No. 2 to the Nasdaq Code of Conduct Proposal, as discussed below, and is soliciting comments from interested persons on these amendments.

## II. Description of the NYSE and Nasdaq Proposals

### A. History

In 1998, the NYSE and NASD sponsored a committee to study the effectiveness of audit committees. This committee became known as the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees ("Blue Ribbon Committee"). In its 1999 report, the Blue Ribbon Committee recognized the importance of audit committees and issued ten recommendations to enhance their effectiveness.<sup>29</sup> In response to these recommendations, the NYSE and the NASD, as well as other exchanges, revised their listing standards relating to audit committees.<sup>30</sup> In February 2002, in light of several high-profile corporate failures, the Commission's Chairman at that time requested that the NYSE and NASD, as well as the other exchanges, review their listing standards, with an

executive officers would be required to be disclosed in a Form 8-K within five days.

<sup>29</sup> See Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (February 1999). The Blue Ribbon Committee Report is available at <http://www.nyse.com>.

<sup>30</sup> See Securities Exchange Act Release Nos. 42233 (December 14, 1999), 64 FR 71529 (December 21, 1999) (NYSE); 42231 (December 14, 1999), 64 FR 71523 (December 21, 1999) (NASD); 42232 (December 14, 1999), 64 FR 71518 (December 21, 1999) (American Stock Exchange); 43941 (February 7, 2001), 66 FR 10545 (February 15, 2001) (Pacific Exchange).

emphasis this time on all corporate governance listing standards, and not just those provisions relating to audit committees.<sup>31</sup> After reviewing their corporate governance listing standards, the NYSE and the NASD, through Nasdaq, filed corporate governance reform proposals with the Commission in 2002.<sup>32</sup>

In January 2003, pursuant to the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley Act"),<sup>33</sup> the Commission proposed Rule 10A-3 under the Exchange Act,<sup>34</sup> which directs each national securities exchange and national securities association to prohibit the listing of any security of an issuer that is not in compliance with the audit committee requirements specified in Rule 10A-3. Because the provisions concerning audit committees in the NYSE and Nasdaq corporate governance reform proposals, as filed with the Commission, did not conform in all respects with the audit committee requirements set forth in Rule 10A-3 as proposed by the Commission, both the NYSE and Nasdaq revised their proposals.<sup>35</sup> In April 2003, the Commission adopted Rule 10A-3.<sup>36</sup> In order to conform their proposals to the requirements of final Rule 10A-3, and to incorporate comments from the public and revisions suggested by the Commission's staff, the NYSE and Nasdaq each filed further amendments to their proposals.<sup>37</sup> Significant aspects of the proposed rule changes, as amended, are described below.

### B. NYSE Proposals

According to the NYSE, the NYSE Corporate Governance Proposal is designed to further the ability of honest and well-intentioned directors, officers, and employees of listed issuers to perform their functions effectively. The NYSE believes that the proposal also will allow shareholders to more easily and efficiently monitor the performance of companies and directors in order to reduce instances of lax and unethical behavior.<sup>38</sup>

<sup>31</sup> See Commission Press Release No. 2002-23 (February 13, 2002).

<sup>32</sup> See File Nos. SR-NYSE-2002-33, SR-NASD-2002-77, SR-NASD-2002-80, SR-NASD-2002-138, SR-NASD-2002-139, SR-NASD-2002-141.

<sup>33</sup> Pub. L. 107-204, 116 Stat. 745 (2002).

<sup>34</sup> See Securities Exchange Act Release No. 47137 (January 8, 2003), 68 FR 2637, (January 17, 2003).

<sup>35</sup> See NYSE Amendment No. 1, *supra* note 3, and Amendment No. 1 to the Nasdaq Independent Director Proposal, *supra* note 8.

<sup>36</sup> 17 CFR 240.10A-3.

<sup>37</sup> See NYSE Amendment Nos. 2 and 3, *supra* notes 6 and 7; and NASD Amendment Nos. 2, 3, and 4, *supra* notes 11, 12, and 13 respectively.

<sup>38</sup> See NYSE Corporate Governance Proposal.

## 1. Independence of Majority of Board Members

NYSE section 303A(1) of the NYSE Manual would require the board of directors of each listed company to consist of a majority of independent directors.<sup>39</sup> Pursuant to NYSE section 303A(2) of the NYSE Manual, no director would qualify as “independent” unless the board affirmatively determines that the director has no material relationship with the company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company). The company would be required to disclose the basis for such determination in its annual proxy statement or, if the company does not file an annual proxy statement, in the company’s annual report on Form 10-K<sup>40</sup> filed with the Commission.<sup>41</sup> In complying with this requirement, a board would be permitted to adopt and disclose standards to assist it in making determinations of independence, disclose those standards, and then make the general statement that the independent directors meet those standards.<sup>42</sup>

## 2. Definition of Independent Director

In addition, the NYSE proposes to tighten its current definition of independent director as follows. First, a director who is an employee, or whose immediate family member is an executive officer, of the company would not be independent until three years after the end of such employment relationship (“NYSE Employee Provision”).<sup>43</sup> Employment as an interim Chairman or CEO would not disqualify a director from being considered independent following that employment.<sup>44</sup> Second, a director who receives, or whose immediate family member receives, more than \$100,000

per year in direct compensation from the listed company, except for certain permitted payments,<sup>45</sup> would not be independent until three years after he or she ceases to receive more than \$100,000 per year in such compensation (“NYSE Direct Compensation Provision”).<sup>46</sup>

Third, a director who is affiliated with or employed by, or whose immediate family member is affiliated with or employed in a professional capacity by, a present or former internal or external auditor of the company would not be independent until three years after the end of the affiliation or the employment or auditing relationship.<sup>47</sup>

Fourth, a director who is employed, or whose immediate family member is employed, as an executive officer of another company where any of the listed company’s present executives serve on that company’s compensation committee would not be independent until three years after the end of such service or the employment relationship (“NYSE Interlocking Directorate Provision”).<sup>48</sup>

Fifth, a director who is an executive officer or an employee, or whose immediate family member is an executive officer, of a company that makes payments to, or receives payments from, the listed company for property or services in an amount which, in any single fiscal year, exceeds the greater of \$1 million, or 2% of such other company’s consolidated gross revenues, would not be independent until three years after falling below such threshold (“NYSE Business Relationship Provision”).<sup>49</sup> The NYSE proposes to clarify this proposal with respect to charitable organizations by adding a commentary noting that charitable organizations shall not be considered “companies” for purposes of

the NYSE Business Relationship Provision, provided that the listed company discloses in its annual proxy statement, or if the listed company does not file an annual proxy statement, in its annual report on Form 10-K filed with the Commission, any charitable contributions made by the listed company to any charitable organization in which a director serves as an executive officer if, within the preceding three years, such contributions in any single year exceeded the greater of \$1 million or 2% of the organization’s consolidated gross revenues.<sup>50</sup>

The NYSE also proposes to clarify this proposal by adding commentary explaining that both the payments and the consolidated gross revenues to be measured shall be those reported in the last completed fiscal year, and that the look-back provision applies solely to the financial relationship between the listed company and the director or immediate family member’s current employer. A listed company would not need to consider former employment of the director or immediate family member.<sup>51</sup>

The NYSE proposes to define “immediate family member” to include 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 such person’s home.<sup>52</sup> The NYSE also proposes that references to “company” include any parent or subsidiary in a consolidated group with the company.<sup>53</sup>

The NYSE further proposes to revise the phase-in of the look-back requirement that the NYSE had previously proposed by applying a one-year look-back for the first year after adoption of these new standards.<sup>54</sup> The NYSE also proposes to change all of the look-back periods from five years to three years.<sup>55</sup> The three-year look-back would begin to apply from the date that

<sup>39</sup> See NYSE section 303A(1). See *infra* Section II.B.12. concerning Controlled Companies and other entities that would be exempt from this requirement.

<sup>40</sup> The NYSE proposes that for all provisions of NYSE section 303A that call for disclosure in a company’s Form 10-K, if a company subject to such a provision is not a company required to file a Form 10-K, then the provision shall be interpreted to mean the annual periodic disclosure form that the company files with the Commission. If a company is not required to file either an annual proxy statement or an annual periodic report with the Commission, the disclosure shall be made in the annual report required under NYSE section 203.01. See NYSE Amendment No. 2, *supra* note, and NYSE section 303A—General Application—References to Form 10-K.

<sup>41</sup> See Commentary to NYSE section 303A(2)(a).

<sup>42</sup> *Id.*

<sup>43</sup> See NYSE section 303A(2)(b)(i). In NYSE Amendment No. 2, *supra* note, the NYSE proposes the NYSE Employee Provision.

<sup>44</sup> See Commentary to NYSE section 303A(2)(b)(i).

<sup>45</sup> Permitted payments would include director and committee fees and pension or other forms of deferred compensation for prior service, provided such compensation is not contingent in any way on continued service. See NYSE section 303A(2)(b)(ii). In addition, compensation received by a director for former service as an interim Chairman or CEO would not be required to be considered. See Commentary to NYSE section 303A(2)(b)(ii). In NYSE Amendment No. 2, *supra* note, the NYSE proposes to add that compensation received by an immediate family member for service as a non-executive employee of the listed company would also not be required to be considered. In NYSE Amendment No. 2, *supra* note, the NYSE also proposes to revise various look-back provisions from five years to three years.

<sup>46</sup> See NYSE section 303A(2)(b)(ii). In NYSE Amendment No. 2, *supra* note, the NYSE proposes to revise the NYSE Direct Compensation Provision to be a bright-line test, rather than a rebuttable presumption.

<sup>47</sup> See NYSE section 303A(2)(b)(iii).

<sup>48</sup> See NYSE section 303A(2)(b)(iv).

<sup>49</sup> See NYSE section 303A(2)(b)(v).

<sup>50</sup> See NYSE Amendment No. 2, *supra* note 6, and Commentary to NYSE section 303A(2)(b)(v).

<sup>51</sup> *Id.*

<sup>52</sup> See General Commentary to NYSE section 303A(2)(b). In NYSE Amendment No. 2, *supra* note 6, the NYSE proposes to add that when applying the look-back provisions in NYSE section 303A(2)(b), listed companies need not consider individuals who are no longer immediate family members as a result of legal separation or divorce, or those who have died or become incapacitated.

<sup>53</sup> See NYSE Amendment No. 2, *supra* note 6, and General Commentary to section 303A(2)(b).

<sup>54</sup> See NYSE Amendment No. 2, *supra* note 6, and General Commentary to NYSE section 303A(2)(b).

<sup>55</sup> See NYSE Amendment No. 2, *supra* note 6.

is the first anniversary of Commission approval of the proposed rule change.<sup>56</sup>

### 3. Separate Meetings for Board Members

NYSE proposes to require the non-management directors of each NYSE-listed company to meet at regularly scheduled executive sessions without management.<sup>57</sup>

In addition, NYSE proposes to require listed companies to disclose a method for interested parties to communicate directly with the presiding director of such executive sessions, or with the non-management directors as a group.<sup>58</sup> Companies may utilize the same procedures they have established to comply with Rule 10A-3(b)(3).<sup>59</sup>

### 4. Nominating/Corporate Governance Committee

NYSE proposes to require each listed company to have a nominating/corporate governance committee composed entirely of independent directors.<sup>60</sup> The NYSE also proposes to require such committee to have a written charter that addresses, among other items, the committee's purpose and responsibilities, and an annual performance evaluation of the nominating/corporate governance committee ("NYSE Nominating/Corporate Governance Committee Provision").<sup>61</sup> The NYSE further proposes to clarify that the committee would be required to identify individuals qualified to become board members, consistent with the criteria approved by the board.<sup>62</sup>

### 5. Compensation Committee

NYSE proposes to require each listed company to have a compensation committee composed entirely of independent directors.<sup>63</sup> The NYSE also proposes to require the compensation committee to have a written charter that addresses, among other items, the committee's purpose and responsibilities, and an annual

performance evaluation of the compensation committee ("NYSE Compensation Committee Provision").<sup>64</sup> The Compensation Committee also would be required to produce a compensation committee report on executive compensation, as required by Commission rules to be included in the company's annual proxy statement or annual report on Form 10-K filed with the Commission.<sup>65</sup> Further, the NYSE proposes to (1) delete the previously proposed statement that the compensation committee has the sole authority to determine the compensation of the chief executive officer ("CEO"),<sup>66</sup> and provide that either as a committee or together with the other independent directors (as directed by the board), the committee would determine and approve the CEO's compensation level based on the committee's evaluation of the CEO's performance;<sup>67</sup> and (2) add a provision to the commentary on this section indicating that discussion of CEO compensation with the board generally is not precluded.<sup>68</sup>

### 6. Audit Committee

#### a. Composition

NYSE sections 303A(6) and 303A(7) would require each NYSE-listed company to have a minimum three-person audit committee composed entirely of directors that meet the independence standards of both NYSE section 303A(2) and Rule 10A-3.<sup>69</sup> The NYSE also proposes to delete the previously proposed commentary relating to NYSE section 303A(6) and replace it with the following: "The Exchange will apply the requirements of Rule 10A-3 in a manner consistent with the guidance provided by the Securities and Exchange Commission in SEC Release No. 34-47654 (April 1, 2003). Without limiting the generality of the foregoing, the Exchange will provide companies with the opportunity to cure defects provided in Rule 10A-3(a)(3)."<sup>70</sup>

In addition, the Commentary to NYSE section 303A(7)(a) would require that each member of the audit committee be financially literate, as such qualification is interpreted by the board in its business judgment, or must become financially literate within a reasonable period of time after his or her appointment to the audit committee.<sup>71</sup> In addition, at least one member of the audit committee would be required to have accounting or related financial management expertise, as the company's board interprets such qualification in its business judgment.<sup>72</sup> The NYSE also proposes to clarify that while the Exchange does not require that a listed company's audit committee include a person who satisfies the definition of audit committee financial expert set forth in Item 401(e) of Regulation S-K, a board may presume that such a person has accounting or related financial management experience.<sup>73</sup>

If an audit committee member simultaneously serves on the audit committee of more than three public companies, and the listed company does not limit the number of audit committees on which its audit committee members serve, each board would be required to determine that such simultaneous service would not impair the ability of such member to effectively serve on the listed company's audit committee and to disclose such determination.<sup>74</sup>

#### b. Audit Committee Charter and Responsibilities

NYSE section 303A(7)(c) would require the audit committee of each listed company to have a written audit committee charter that addresses: (i) The committee's purpose; (ii) an annual performance evaluation of the audit committee; and (iii) the duties and responsibilities of the audit committee ("NYSE Audit Committee Charter Provision").

The NYSE Audit Committee Charter Provision provides details as to the duties and responsibilities of the audit committee that must be addressed. These include, at a minimum, those set out in Rule 10A-3(b)(2), (3), (4) and (5),<sup>75</sup> as well as the responsibility to

<sup>56</sup> See NYSE Amendment No. 2, *supra* note 6, and General Commentary to NYSE section 303A(2)(b).

<sup>57</sup> See NYSE section 303A(3).

<sup>58</sup> See Commentary to NYSE section 303A(3). In NYSE Amendment No. 2, *supra* note 6, the NYSE proposes to delete the previously proposed requirement that interested parties be able to communicate confidentially, in addition to directly, with such parties.

<sup>59</sup> See Commentary to NYSE section 303A(3).

<sup>60</sup> See NYSE section 303A(4)(a). See *infra* Section II.B.12. concerning Controlled Companies and other entities that would be exempt from this requirement.

<sup>61</sup> See NYSE section 303A(4)(b).

<sup>62</sup> See NYSE Amendment No. 2, *supra* note 6, and NYSE section 303A(4)(b).

<sup>63</sup> See *infra* Sections II.B.12. concerning Controlled Companies and other entities that would be exempt from this requirement.

<sup>64</sup> See NYSE section 303A(5)(a).

<sup>65</sup> See NYSE Amendment No. 2, *supra* note 6, and NYSE section 303A(5)(b)(i)(C).

<sup>66</sup> See NYSE Amendment No. 2, *supra* note 6, and NYSE section 303A(5)(a).

<sup>67</sup> *Id.*

<sup>68</sup> See NYSE Amendment No. 2, *supra* note 6, and Commentary to NYSE section 303A(5).

<sup>69</sup> See NYSE sections 303A(6) and 303A(7). The Commission notes that new Rule 303A would incorporate various provisions of existing NYSE rules on corporate governance for listed companies, including, for example, requirements that an audit committee have a written charter and that such committee be comprised of at least three independent directors who meet certain financial literacy requirements.

<sup>70</sup> See NYSE Amendment No. 2, *supra* note 6, and Commentary to NYSE section 303A(6).

<sup>71</sup> See Commentary to NYSE section 303A(7)(a).

<sup>72</sup> *Id.*

<sup>73</sup> See NYSE Amendment No. 2, *supra* note 6, and Commentary to NYSE section 303A(7)(a).

<sup>74</sup> *Id.*

<sup>75</sup> See NYSE section 303A(7)(c). In NYSE Amendment No. 2, *supra* note 6, the NYSE proposes to cross-reference the sections of Rule 10A-3 that set forth the required duties and responsibilities of the audit committee, instead of detailing these requirements in NYSE Rule 303A as it had previously proposed.

annually obtain and review a report by the independent auditor; discuss the company's annual audited financial statement and quarterly financial statements with management and the independent auditor; discuss the company's earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies; discuss policies with respect to risk assessment and risk management; meet separately, periodically, with management, with internal auditors (or other personnel responsible for the internal audit function), and with independent auditors; review with the independent auditors any audit problems or difficulties and management's response; set clear hiring policies for employees or former employees of the independent auditors; and report regularly to the board.<sup>76</sup>

#### 7. Internal Audit Function

NYSE section 303A(7)(d) would require each listed company to have an internal audit function.<sup>77</sup>

#### 8. Corporate Governance Guidelines

NYSE section 303A(9) would require each listed company to adopt and disclose corporate governance guidelines. The following topics would be required to be addressed: director qualification standards; director responsibilities; director access to management and, as necessary and appropriate, independent advisors; director compensation; director orientation and continuing education; management succession; and annual performance evaluation of the board.<sup>78</sup> Each company's website would be required to include its corporate governance guidelines and the charters of its most important committees, and the availability of this information on the Web site or in print to shareholders would need to be referenced in the company's annual report on Form 10-K filed with the Commission.<sup>79</sup>

#### 9. Code of Business Conduct and Ethics

NYSE section 303A(10) would require each listed company to adopt and disclose a code of business conduct and ethics for directors, officers and employees, and to promptly disclose any waivers of the code for directors or executive officers.<sup>80</sup> The commentary to this section sets forth the most important topics that should be

addressed, including conflicts of interest; corporate opportunities; confidentiality of information; fair dealing; protection and proper use of company assets; compliance with laws, rules and regulations (including insider trading laws); and encouraging the reporting of any illegal or unethical behavior. Each code would be required to contain compliance standards and procedures to facilitate the effective operation of the code. Each listed company's Web site would be required to include its code of business conduct and ethics, and the availability of the code on the website or in print to shareholders would need to be referenced in the company's annual report on Form 10-K filed with the Commission.<sup>81</sup>

#### 10. CEO Certification

NYSE section 303A(12)(a) would require the CEO of each listed company to certify to the NYSE each year that he or she is not aware of any violation by the company of the NYSE's corporate governance listing standards. This certification would be required to be disclosed in the company's annual report or, if the company does not prepare an annual report to shareholders, in the company's annual report on Form 10-K filed with the Commission.<sup>82</sup>

In addition, NYSE section 303A(12)(b) would require the CEO of each listed company to promptly notify the NYSE in writing after any executive officer of the listed company becomes aware of any material non-compliance with any applicable provisions of the new requirements.<sup>83</sup>

#### 11. Public Reprimand Letter

NYSE section 303A(13) would allow the NYSE to issue a public reprimand letter to any listed company that violates an NYSE listing standard.<sup>84</sup>

#### 12. Exceptions to the NYSE Corporate Governance Proposals

The NYSE proposes to exempt any listed company of which more than 50% of the voting power is held by an individual, a group or another company ("Controlled Company") from the requirements that its board have a

majority of independent directors, and that the company have nominating/corporate governance and compensation committees composed entirely of independent directors. A company that chose to take advantage of any or all of these exemptions would be required to disclose that choice, that it is a Controlled Company, and the basis for the determination in its annual proxy statement or, if the company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the Commission.<sup>85</sup> Limited partnerships and companies in bankruptcy proceedings also would be exempt from requirements that the board have a majority of independent directors and that the issuer have nominating/corporate governance and compensation committees composed entirely of independent directors.<sup>86</sup>

The NYSE considers the requirements of section 303A to be unnecessary for closed-end and open-end management investment companies that are registered under the Investment Company Act of 1940 ("Investment Company Act")<sup>87</sup>, given the pervasive federal regulation applicable to them. However, the NYSE proposes that registered closed-end management investment companies ("closed-end funds") would be required to: (1) Have a minimum three-member audit committee that satisfies the requirements of Rule 10A-3; (2) comply with the requirements of the NYSE Audit Committee Charter Provision; and (3) comply with the certification and notification provisions regarding non-compliance.<sup>88</sup> Closed-end funds also would be excluded from the disclosure requirement relating to an audit committee member's simultaneous service on more than three audit committees, but would be subject to the requirement for the board to determine that such simultaneous service would not impair the ability of such member to effectively serve on the listed company's audit committee.<sup>89</sup>

The NYSE also proposes to require business development companies, which are a type of closed-end management investment company defined in section 2(a)(48) of the

<sup>81</sup> See Commentary to NYSE section 303A(10).

<sup>82</sup> See NYSE section 303A(12)(a).

<sup>83</sup> See NYSE section 303A(12)(b). In NYSE Amendment No. 2, *supra* note, the NYSE proposes to clarify that the notification would be required to be in writing.

<sup>84</sup> See NYSE section 303A(13). In NYSE Amendment No. 2, *supra* note, the NYSE proposes to clarify that this lesser sanction was not intended for use in the case of companies that fail to comply with the requirements of Rule 10A-3. See Commentary to NYSE section 303A(13).

<sup>85</sup> See NYSE section 303A—General Application—Equity Listings—Controlled Companies.

<sup>86</sup> *Id.*

<sup>87</sup> 15 U.S.C. 80a-1 *et seq.*

<sup>88</sup> See NYSE section 303A—General Application—Equity Listings—Closed-End and Open End Funds.

<sup>89</sup> *Id.* See also NYSE Amendment No. 2, *supra* note.

<sup>76</sup> See NYSE section 303A(7)(c)(iii).

<sup>77</sup> See NYSE section 303A(7)(d).

<sup>78</sup> See Commentary to NYSE section 303A(9).

<sup>79</sup> *Id.*

<sup>80</sup> See NYSE section 303A(10).

Investment Company Act<sup>90</sup> that are not registered under the Investment Company Act, to comply with all of the provisions of NYSE section 303A applicable to domestic issuers, except that the directors of such companies, including audit committee members, would not be required to satisfy the independence requirements set forth in NYSE section 303A(2) and 303A(7)(b).<sup>91</sup> For purposes of NYSE sections 303A(1), (3), (4), (5), and (9), a director of a business development company would be considered to be independent if he or she is not an "interested person" of the company, as defined in section 2(a)(19) of the Investment Company Act.<sup>92</sup>

Open-end management investment companies ("open-end funds"), which can be listed as Investment Company Units, and are more commonly known as Exchange Traded Funds or ETFs, would be required to: (1) Have an audit committee that satisfies the requirements of Rule 10A-3, and (2) notify the Exchange in writing of any material non-compliance.<sup>93</sup>

In addition, the NYSE proposes also to require the audit committees of closed-end and open-end funds to establish procedures for the confidential, anonymous submission by employees of the investment adviser, administrator, principal underwriter, or any other provider of accounting related services for the investment company, as well as employees of the investment company, of concerns regarding questionable accounting or auditing matters.<sup>94</sup> This responsibility would be required to be addressed in the audit committee charter.<sup>95</sup>

NYSE proposes that except as otherwise required by Rule 10A-3, the new requirements also would not apply to passive business organizations in the form of trusts (such as royalty trusts) or to derivatives and special purpose securities (such as those described in NYSE sections 703.16, 703.19, 703.20, and 703.21). To the extent that Rule 10A-3 applies to a passive business organization, listed derivative, or special purpose security, the requirement to have an audit committee that satisfies the requirements of Rule 10A-3, and the requirement to notify

the NYSE in writing of any material non-compliance, also would apply.<sup>96</sup>

The new requirements generally would not apply to companies listing only preferred or debt securities on the NYSE. To the extent required by Rule 10A-3, however, all companies listing only preferred or debt securities on the NYSE would be required to: (1) Have an audit committee that satisfies the requirements of Rule 10A-3, and (2) notify the Exchange in writing of any material non-compliance.<sup>97</sup>

### 13. Application to Foreign Private Issuers

NYSE section 303A would permit NYSE-listed companies that are foreign private issuers, as such term is defined in Rule 3b-4 under the Exchange Act,<sup>98</sup> to follow home country practice in lieu of the new requirements, except that such companies would be required to: (1) Have an audit committee that satisfies the requirements of Rule 10A-3; (2) notify the NYSE in writing after any executive officer becomes aware of any non-compliance with any applicable provision; and (3) provide a brief, general summary of the significant ways in which its governance differs from those followed by domestic companies under NYSE listing standards.<sup>99</sup> Listed foreign private issuers would be permitted to provide this disclosure either on their website (provided it is in the English language and accessible from the United States) and/or in their annual report as distributed to shareholders in the United States in accordance with Sections 103.00 and 203.01 of the NYSE Manual.<sup>100</sup> If the disclosure is made available only on the website, the annual report would be required to state this and provide the web address at which the information may be obtained.<sup>101</sup>

<sup>96</sup> See NYSE section 303A—General Application—Other Entities. In NYSE Amendment No. 2, *supra* note, the NYSE proposes to add language to clarify the application of Rule 10A-3 to passive business organizations.

<sup>97</sup> See NYSE section 303A—General Application—Preferred and Debt Listings. In NYSE Amendment No. 2, *supra* note, the NYSE proposes to add language to clarify the application of Rule 10A-3 to companies listing only preferred or debt securities.

<sup>98</sup> 17 CFR 240.3b-4.

<sup>99</sup> See NYSE section 303A—General Application—Equity Listings—Foreign Private Issuers, and NYSE section 303A(11). In NYSE Amendment No. 2, *supra* note, the NYSE proposes to clarify the application of Rule 10A-3 to foreign private issuers.

<sup>100</sup> See Commentary to NYSE section 303A(11).

<sup>101</sup> *Id.*

### 14. Proposed Implementation of New Requirements

In NYSE Amendment No. 2, the NYSE proposes a revised implementation schedule for the new requirements. Pursuant to the new schedule, listed companies would have until the earlier of their first annual meeting after January 15, 2004, or October 31, 2004, to comply with the new standards. However, if a company with a classified board is required to change a director who would not normally stand for election in such annual meeting, the company would be permitted to continue such director in office until the second annual meeting after such date, but no later than December 31, 2005. Notwithstanding the foregoing, foreign private issuers would have until July 31, 2005, to comply with any Rule 10A-3 audit committee requirements.<sup>102</sup>

Companies listing in conjunction with their initial public offering<sup>103</sup> would be required to have one independent member at the time of listing, a majority of independent members within 90 days of listing, and fully independent committees within one year. They would be required to meet the majority of independent board requirement within 12 months of listing.<sup>104</sup>

Companies listing upon transfer from another market would have 12 months from the date of transfer in which to comply with any requirement to the extent the market on which they were listed did not have the same requirement. To the extent the other market has a substantially similar requirement but also had a transition period from the effective date of that

<sup>102</sup> See NYSE Amendment No. 2, *supra* note, and NYSE section 303A—General Application—Effective Dates/Transition Period.

<sup>103</sup> In NYSE Amendment No. 2, *supra* note, NYSE proposes that for purposes of section 303A, a company would be considered to be listing in conjunction with an initial public offering if, immediately prior to listing, it does not have a class of common stock registered under the Exchange Act. The NYSE also proposes to permit companies that are emerging from bankruptcy or have ceased to be Controlled Companies within the meaning of section 303A to phase in independent nomination and compensation committees and majority independent boards on the same schedule as companies listing in conjunction with an initial public offering. However, for purposes of the requirement that a company have an audit committee that complies with the requirements of Rule 10A-3, and the requirement that a company notify the Exchange in writing of any material non-compliance, a company will be considered to be listing in conjunction with an initial public offering only if it meets the conditions of Rule 10A-3(b)(1)(iv)(A). Investment companies are not subject to this exemption under Rule 10A-3(b)(1)(iv)(A), however. See NYSE section 303A—General Application—Effective Dates/Transition Period.

<sup>104</sup> See NYSE Amendment No. 2, *supra* note, and NYSE section 303A—General Application—Effective Dates/Transition Period.

<sup>90</sup> 15 U.S.C. 80a-2(a)(48).

<sup>91</sup> See NYSE Amendment No. 2, *supra* note and NYSE section 303A—General Application—Equity Listings—Closed-End and Open-End Funds.

<sup>92</sup> 15 U.S.C. 80a-2(a)(19).

<sup>93</sup> See NYSE Amendment No. 2, *supra* note, and NYSE section 303A—General Application—Closed-End and Open-End Funds.

<sup>94</sup> See NYSE Amendment No. 2, *supra* note, and NYSE section 303A—General Application—Equity Listings—Closed-End and Open-End Funds.

<sup>95</sup> See NYSE Amendment No. 3.

market's rule, which period had not yet expired, the company would have the same transition period as would have been available to it on the other market. This transition period for companies transferring from another market would not apply to the audit committee requirements of Rule 10A-3 unless a transition period is available under Rule 10A-3.<sup>105</sup>

### C. Nasdaq Proposals

According to Nasdaq, the purpose of the Nasdaq Independent Director Proposal is to provide greater transparency regarding certain relationships that would preclude a board of directors from finding that an individual can serve as an independent director, and to increase the role of independent directors on board committees.<sup>106</sup> In Nasdaq's view, the proposal is intended to enhance investor confidence in the companies that list on Nasdaq.<sup>107</sup> According to Nasdaq, the purpose of the Nasdaq Going Concern Proposal is to bring notice of a going concern qualification to investors and potential investors;<sup>108</sup> the purpose of the Nasdaq Related Party Transactions Proposal is to improve investor protection;<sup>109</sup> the purpose of the Nasdaq Issuer Applicability Proposal is to alert investors to the exemptions that may be granted to foreign issuers;<sup>110</sup> and the purpose of the Nasdaq Code of Conduct Proposal is to provide further assurance to investors, regulators, and Nasdaq that each of Nasdaq's issuers has in place a system to focus attention throughout the company on the obligation of ethical conduct, encourage reporting of potential violations, and deal fairly and promptly with questionable behavior.<sup>111</sup>

#### 1. Independence of Majority of Board Members

Nasdaq proposes to amend Nasdaq Rule 4200, which sets forth definitions, and Nasdaq Rule 4350, which governs qualitative listing requirements for Nasdaq National Market and Nasdaq SmallCap Market issuers (other than limited partnerships). Under the amendment to NASD Rule 4350(c)(1), a majority of the directors on the board of a Nasdaq-listed company would be required to be independent directors, as defined in NASD Rule 4200. Nasdaq proposes to require each listed company

to disclose in its annual proxy (or, if the issuer does not file a proxy, in its Form 10-K or 20-F) those directors that the board has determined to be independent under NASD Rule 4200.<sup>112</sup>

If an issuer fails to comply with this requirement due to one vacancy, or one director ceases to be independent due to circumstances beyond their reasonable control, Nasdaq proposes to require the issuer to regain compliance with the requirement by the earlier of its next annual shareholders meeting or one year from the occurrence of the event that caused the failure to comply with this requirement.<sup>113</sup> Nasdaq proposes to require any issuer relying on this provision to provide notice to Nasdaq immediately upon learning of the event or circumstance that caused the non-compliance.<sup>114</sup>

Pursuant to current NASD Rule 4200(a)(15), a director would not be independent if the director is 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, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.<sup>115</sup>

The NASD proposes to revise NASD Rule 4200(a)(15)(A) through (E) and add subparagraphs (F) and (G). NASD Rule 4200(a)(15) provides a list of relationships that would preclude a board finding of independence. First, a director who is, or at any time during the past three years was, employed by the company or by any parent or subsidiary of the company, would not be deemed independent ("Nasdaq Employee Provision").<sup>116</sup>

Second, a director who accepts or has a Family Member<sup>117</sup> who accepts any payments from the company, or any parent or subsidiary of the company, in excess of \$60,000 during the current fiscal year or any of the past three fiscal years, other than certain permitted payments,<sup>118</sup> would not be deemed

independent ("Nasdaq Payments Provision").<sup>119</sup>

Nasdaq proposes to state in the interpretive material to its rules ("Interpretive Material") that the Nasdaq Payments Provision is generally intended to capture situations where a payment is made directly to, or for the benefit of, the director or a family member of the director.<sup>120</sup> For example, consulting or personal service contracts with a director or family member of the director or political contributions to the campaign of a director or a family member of the director would be considered under the Nasdaq Payments Provision.<sup>121</sup>

Third, a director who is a Family Member of an individual who is, or at any time during the past three years was, employed by the company or by any parent or subsidiary of the company as an executive officer, would not be deemed independent ("Nasdaq Family of Executive Officer Provision").<sup>122</sup>

Fourth, a director who is, or has a Family Member who is, a partner in, or a controlling shareholder or an executive officer of, any organization to which the company made, or from which the company received, payments for property or services in the current or any of the past three fiscal years that exceed 5% of the recipient's consolidated gross revenues for that year, or \$200,000, whichever is more, other than certain permitted payments,<sup>123</sup> would not be deemed independent ("Nasdaq Business Relationship Provision").<sup>124</sup> In

plan, or non-discretionary compensation; and loans permitted under section 13(k) of the Exchange Act. 78 U.S.C. 78m(k). See NASD Rule 4200(a)(15)(B). In Amendment No. 3 to the Independent Director Proposal, *supra* note, Nasdaq proposes to add compensation for board committee service and loans permitted under section 13(k) of the Exchange Act to permitted payments. See *also infra* note 122.

<sup>119</sup> See NASD Rule 4200(a)(15)(B).

<sup>120</sup> See Amendment No. 3 to the Independent Director Proposal, *supra* note 12.

<sup>121</sup> See NASD IM-4200—Definition of Independence—Rule 4200(a)(15).

<sup>122</sup> See NASD Rule 4200(a)(15)(C). In Amendment No. 3 to the Independent Director Proposal, *supra* note, Nasdaq proposes a conforming change in subparagraph (B) of NASD Rule 4200 to indicate that employment compensation to a Family Member of an Independent Director as permitted in that subparagraph applies only when the Family Member is not an executive of the company.

<sup>123</sup> Permitted payments would include payments arising solely from investments in the company's securities, and payments under non-discretionary charitable contribution matching programs. See NASD Rule 4200(a)(15)(D). In Amendment No. 3 to the Independent Director Proposal, *supra* note, Nasdaq proposes to include payments under non-discretionary charitable contribution matching programs as permitted payments.

<sup>124</sup> See NASD Rule 4200(a)(15)(D). In Amendment No. 3 to the Independent Director Proposal, *supra* note, Nasdaq proposes to expand this proposal to

Continued

<sup>105</sup> *Id.*

<sup>106</sup> See Nasdaq Independent Director Proposal.

<sup>107</sup> *Id.*

<sup>108</sup> See Nasdaq Going Concern Proposal.

<sup>109</sup> See Nasdaq Related Party Transactions Proposal

<sup>110</sup> See Nasdaq Issuer Applicability Proposal.

<sup>111</sup> See Nasdaq Code of Conduct Proposal.

<sup>112</sup> See Amendment No. 3 to the Nasdaq Independent Director Proposal, *supra* note, and NASD Rule 4350(c)(1).

<sup>113</sup> *Id.*

<sup>114</sup> *Id.*

<sup>115</sup> See NASD Rule 4200(a)(15).

<sup>116</sup> See NASD Rule 4200(a)(15)(A).

<sup>117</sup> In Amendment No. 3 to the Independent Director Proposal, *supra* note, Nasdaq proposes to define "Family Member" as "a person's spouse, parents, children and siblings, whether by blood, marriage or adoption, or anyone residing in such person's home." See NASD Rule 4200(a)(14).

<sup>118</sup> Permitted payments would include compensation for board or board committee service; payments arising solely from investments in the company's securities; compensation paid to a Family Member who is a non-executive employee of the company or a parent or subsidiary of the company; benefits under a tax-qualified retirement

Amendment No. 3 to the Nasdaq Independent Director Proposal, Nasdaq proposes to add Interpretive Material clarifying the application of the Nasdaq Business Relationship Provision. The Interpretive Material states that this proposal is generally intended to capture payments to an entity with which the director or Family Member of the director is affiliated by serving as a partner (other than a limited partner), controlling shareholder or executive officer of such entity.<sup>125</sup> The Interpretive Material states that under exceptional circumstances, such as where a director has direct, significant business holdings, it may be appropriate to apply the corporate measurements in the Nasdaq Business Relationship Provision, rather than the individual measurements of the Nasdaq Payments Provision, and that issuers should contact Nasdaq if they wish to apply the rule in this manner.<sup>126</sup> The Interpretive Material further notes that the independence requirements of the Nasdaq Business Relationship Provision are broader than the rules for audit committee member independence set forth in Rule 10A-3(e)(8) under the Exchange Act.<sup>127</sup>

Moreover, the Interpretive Material states that under the Nasdaq Business Relationship Provision, a director who is, or who has a Family Member who is, an executive officer of a charitable organization may not be considered independent if the company makes payments to the charity in excess of the greater of the greater of 5% of the charity's revenues or \$200,000.<sup>128</sup> The Interpretive Material also discusses the treatment of payments from the issuer to a law firm in determining whether a director who is a lawyer may be considered independent.<sup>129</sup> The Interpretive Material notes that any partner in a law firm that receives payments from the issuer is ineligible to serve on that issuer's audit committee.<sup>130</sup>

Fifth, a director of the listed company who is, or has a Family Member who is, employed as an executive officer of another entity at any time during the past three years where any of the executive officers of the listed company

include Family Members, and to clarify that disqualifying payments are payments for "property or services."

<sup>125</sup> See Amendment No. 3 to the Independent Director Proposal, *supra* note, and NASD-IM-4200—Definition of Independence—Rule 4200(a)(15).

<sup>126</sup> *Id.*

<sup>127</sup> *Id.*

<sup>128</sup> *Id.*

<sup>129</sup> *Id.*

<sup>130</sup> *Id.*

serves on the compensation committee of such other entity, would not be deemed independent ("Nasdaq Interlocking Directorate Provision").<sup>131</sup>

Sixth, a director who is, or has a Family Member who is, a current partner of the company's outside auditor, or was a partner or employee of the company's outside auditor, and worked on the company's audit, at any time, during the past three years, would not be deemed independent ("Nasdaq Auditor Relationship Provision").<sup>132</sup>

Seventh, Nasdaq proposes that, in the case of an investment company, a director would not be considered independent if the director is an "interested person" of the company as defined in section 2(a)(19) of the Investment Company Act, other than in his or her capacity as a member of the board of directors or any board committee.<sup>133</sup> This provision would be in lieu of the other tests for independence specified in the rule.

With respect to the look-back periods referenced in the Nasdaq Employee Provision, the Nasdaq Family of Executive Officer Provision, the Nasdaq Interlocking Directorate Provision, and the Nasdaq Auditor Relationship Provision, Nasdaq proposes to clarify that "any time" during any of the past three years should be considered,<sup>134</sup> and to add Interpretive Material stating that these three year look-back periods commence on the date the relationship ceases. As an example, the Interpretive Material states that a director employed by the company would not be independent until three years after such employment terminates.<sup>135</sup> Nasdaq also proposes to add Interpretive Material stating that the reference to a "parent or subsidiary" in the definition of independence is intended to cover entities the issuer controls and consolidates with the issuer's financial statements as filed with the Commission (but not if the issuer reflects such entity solely as an investment in its financial

<sup>131</sup> See NASD Rule 4200(a)(15)(E). In Amendment No. 3 to the Independent Director Proposal, *supra* note, Nasdaq proposes to expand this proposal to include Family Members.

<sup>132</sup> See NASD Rule 4200(a)(15)(F). In Amendment No. 3 to the Independent Director Proposal, *supra* note, Nasdaq proposes to expand this proposal to include a director who is, or has a Family Member who is, a current partner of the company's outside auditor, regardless of whether such partner worked on the company's audit.

<sup>133</sup> See NASD Rule 4200(a)(15)(G) and Amendment No. 3 to the Nasdaq Independent Director Proposal, *supra* note.

<sup>134</sup> See Amendment No. 3 to the Independent Director Proposal, *supra* note, and NASD Rules 4200(a)(15)(A), (C), (E), and (F).

<sup>135</sup> See Amendment No. 3 to the Independent Director Proposal, *supra* note and NASD IM-4200 "Definition of Independence" Rule 4200(a)(15).

statements). The Interpretive Material also adds that the reference to "executive officer" has the same meaning as the definition in Rule 16a-1(f) under the Exchange Act.<sup>136</sup>

## 2. Separate Meetings for Board Members

Nasdaq proposes to require independent directors to have regularly scheduled meetings at which only independent directors would be present.<sup>137</sup>

## 3. Compensation of Officers

Nasdaq proposes to require the compensation of the CEO of a listed company to be determined or recommended to the board for determination either by a majority of the independent directors, or by a compensation committee comprised solely of independent directors ("Nasdaq Compensation of Executives Provision").<sup>138</sup> In addition, the compensation of all other officers would have to be determined or recommended to the board for determination either by a majority of the independent directors, or a compensation committee comprised solely of independent directors.<sup>139</sup>

Under the Nasdaq proposal, if the compensation committee was comprised of at least three members, one director, who is not independent (as defined in NASD Rule 4200) and is not a current officer or employee or a Family Member of such person, would be permitted to be appointed to the committee if the board, under exceptional and limited circumstances, determines that such individual's membership on the committee is required by the best interests of the company and its shareholders, and the board discloses, in the next annual meeting proxy statement subsequent to such determination (or, if the issuer does not file a proxy, in its Form 10-K or 20-F), the nature of the relationship and the reasons for the determination.<sup>140</sup> A member appointed under such exception would not be permitted to serve longer than two years.

<sup>136</sup> *Id.* 17 CFR 240.16a-1(f).

<sup>137</sup> See NASD Rule 4350(c)(2).

<sup>138</sup> See NASD Rule 4350(c)(3)(A). In Amendment No. 3 to the Independent Director Proposal, *supra* note 12, Nasdaq proposes to delete the requirement that the independent directors meet in executive session to determine CEO compensation, and add the requirement that the CEO may not be present during voting or deliberations.

<sup>139</sup> See NASD Rule 4350(c)(3)(B). In Amendment No. 3 to the Independent Director Proposal, *supra* note 12, Nasdaq proposes to add the option that the compensation of the CEO and other officers could be recommended to the board for its determination rather than determined by the committee.

<sup>140</sup> See NASD Rule 4350(c)(3)(C).

#### 4. Nomination of Directors

Nasdaq proposes to amend NASD Rule 4350(c) to require director nominees to either be selected or recommended for the board's selection either by a majority of independent directors, or by a nominations committee comprised solely of independent directors ("Nasdaq Director Nomination Provision").<sup>141</sup>

If the nominations committee is comprised of at least three members, one director, who is not independent (as defined in NASD Rule 4200) and is not a current officer or employee or a Family Member of such person, would be permitted to be appointed to the committee if the board, under exceptional and limited circumstances, determines that such individual's membership on the committee is required by the best interests of the company and its shareholders, and the board discloses, in the next annual meeting proxy statement subsequent to such determination (of, if the issuer does not file a proxy, in its Form 10-K or 20-F), the nature of the relationship and the reasons for the determination.<sup>142</sup> A member appointed under such exception would not be permitted to serve longer than two years.

Further, Nasdaq proposes to require each issuer to certify that it has adopted a formal written charter or board resolution, as applicable, addressing the nominations process and such related matters as may be required under the federal securities laws.<sup>143</sup> Nasdaq also proposes that the Nasdaq Director Nomination Provision would not apply in cases where either the right to nominate a director legally belongs to a third party,<sup>144</sup> or the company is subject to a binding obligation that requires a director nomination structure inconsistent with this provision and

<sup>141</sup> See NASD Rule 4350(c)(4)(A). In Amendment No. 3 to the Independent Director Proposal, *supra* note 12, Nasdaq proposes to add the option that director nominees could be recommended for the board's selection.

<sup>142</sup> See NASD Rule 4350(c)(4)(C). In Amendment No. 3 to the Independent Director Proposal, *supra* note 12, Nasdaq proposes to delete another exception that it had previously proposed, which would have permitted an appointment to the nominating committee, under specified circumstances, of a non-independent director who owns 20% or more of a company's voting stock.

<sup>143</sup> See NASD Rule 4350(c)(4)(B) and Amendment No. 3 to the Independent Director Proposal.

<sup>144</sup> Nasdaq proposes to add a sentence to explain that this provision does not relieve a company's obligation to comply with the committee composition requirements under Rule 4350(c) and (d). See Amendment No. 3 to the Independent Director Proposal, *supra* note 12, and NASD Rule 4350(c)(4)(D).

such obligation pre-dates the date the provision is approved.<sup>145</sup>

#### 5. Controlled Companies Exempt

Nasdaq proposes generally to exempt any Controlled Company from the requirement to have a majority of independent directors and from the compensation and nomination committee requirements discussed above. However, the independent directors would still be required to have regularly scheduled meetings at which only independent directors are present.<sup>146</sup> A Controlled Company would be defined as a company of which more than 50% of the voting power is held by an individual, a group, or another company. A company relying upon the exemption would be required to disclose in its annual proxy statement (or, if the issuer does not file a proxy, in its Form 10-K or 20-F) that it is a Controlled Company and the basis for that determination. To determine whether a group exists for purposes of this exception, the shareholders must have publicly filed a notice that they are acting as a group (*e.g.*, a Schedule 13D).<sup>147</sup>

#### 6. Audit Committee Charter and Responsibilities

NASD Rule 4350(d) would retain the requirement that each issuer adopt a formal written audit committee charter, and the proposed amendment to the rule would require the charter to specify the committee's purpose of overseeing the accounting and financial reporting processes and the audits of the financial statements of the issuer.<sup>148</sup> The written charter also would be required to include specific audit committee responsibilities and authority, as set forth in the proposed amendment to Rule 4350(d)(3).<sup>149</sup> Nasdaq also

<sup>145</sup> See Amendment No. 3 to the Independent Director Proposal, *supra* note 12 and NASD Rule 4350(c)(4)(E).

<sup>146</sup> See NASD Rule 4350(c)(5). In Amendment No. 3 to the Independent Director Proposal, *supra* note 12, Nasdaq proposes to clarify that the exemption does not apply to executive sessions of independent directors.

<sup>147</sup> See IM-4350-4—Controlled Company Exception.

<sup>148</sup> See NASD Rule 4350(d)(1). NASD Rule 4350(d) would retain various provisions of the current rule, including, for example, the requirements that an audit committee have a written charter and that it be comprised of at least three independent directors who meet certain financial literacy requirements.

<sup>149</sup> NASD Rule 4350(d)(3) would require the audit committee to have the specific audit committee responsibilities and authority necessary to comply with Rule 10A-3(b)(2), (3), (4) and (5) (subject to the exemptions provided in Rule 10A-3(c)), concerning responsibilities relating to: (i) Registered public accounting firms, (ii) complaints relating to accounting, internal accounting controls or auditing

proposes to state in Interpretive Material to Rule 4350(d) that the written charter set forth the scope of the audit committee's responsibilities and the means by which the committee carries out those responsibilities; the outside auditor's accountability to the committee; and the committee's responsibility to ensure the independence of the outside auditors.<sup>150</sup>

#### 7. Audit Committee Composition

NASD Rule 4350(d) would retain the requirement that each listed issuer have an audit committee composed of at least three members.<sup>151</sup> However, under the proposed requirements, each audit committee member would be required to: (1) Be independent, as defined under NASD Rule 4200; (2) meet the criteria for independence set forth in Rule 10A-3 (subject to the exceptions provided in Rule 10A-3(c)); and (3) not have participated in the preparation of the financial statements of the company or any current subsidiary of the company at any time during the past three years, in addition to satisfying the current requirement that the member be able to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement ("Nasdaq Audit Committee Provision").<sup>152</sup>

One director who is not independent as defined in NASD Rule 4200 and meets the criteria set forth in section 10A(m)(3) of the Exchange Act<sup>153</sup> and the rules thereunder, and is not a current officer or employee of the company or a Family Member of such person, 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 company and

matters, (iii) authority to engage advisors, and (iv) funding as determined by the audit committee. In Amendment No. 3 to the Independent Director Proposal, *supra* note 12, Nasdaq proposes to clarify that audit committees for investment companies must also establish procedures for the confidential, anonymous submission of concerns regarding questionable accounting or auditing matters by employees of the investment adviser, administrator, principal underwriter, or any other provider of accounting related services for the investment company, as well as employees of the investment company.

<sup>150</sup> See IM-4350-4—Board Independence and Independent Committees—Audit Committees—Rule 4350(d)—Audit Committee Charter.

<sup>151</sup> See NASD Rule 4350(d)(2). See also *supra* note.

<sup>152</sup> See NASD Rule 4350(d)(2)(A)(i)-(iv). In Amendment No. 3 to the Independent Director Proposal, *supra* note 12, Nasdaq proposes to: (1) Add a cross-reference to Rule 10A-3; and (2) add the third requirement noted above.

<sup>153</sup> 15 U.S.C. 78j-1(m).

its shareholders, and the board discloses, in the next annual proxy statement subsequent to such determination (or, if the issuer does not file a proxy, in its Form 10-K or 20-F), the nature of the relationship and the reasons for that determination. A member appointed under this exception would not be permitted to serve longer than two years and would not be permitted to chair the audit committee.<sup>154</sup> Nasdaq proposes to add to Interpretive Material the recommendation that an issuer disclose in its annual proxy (or, if the issuer does not file a proxy, in its Form 10-K or 20-F) if any director is deemed independent but falls outside the safe harbor provisions of Rule 10A-3(e)(1)(ii).<sup>155</sup>

In addition, Nasdaq will retain the requirement that at least one member of the audit committee 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.<sup>156</sup>

Nasdaq proposes to delete from the Interpretive Material the discussion relating to determining whether a

<sup>154</sup> See NASD Rule 4350(d)(2)(B). In Amendment No. 3 to the Independent Director Proposal, *supra* note 12, Nasdaq proposes to delete a previously proposed provision that would have permitted membership on the audit committee, under certain circumstances, of a director who owns or controls a specified percentage of the issuer's voting securities.

<sup>155</sup> See Amendment No. 3 to the Independent Director Proposal, *supra* note 12. Among other criteria, section 10A(m) of the Exchange Act and Rule 10A-3 thereunder provide that a member of an audit committee of an issuer is not considered "independent" if the member is an "affiliated person" of the issuer or a subsidiary. An "affiliated person" includes, among other things, a person who "controls" the issuer. The safe harbor of Rule 10A-3(e)(1)(ii) provides that a person who is not an executive officer of the issuer and is not the beneficial owner, directly or indirectly, of 10% or more of any class of voting equity securities of the issuer is deemed not to control the issuer for purposes of determining affiliation. However, a person who exceeds the 10% beneficial ownership is not presumptively deemed to control the issuer, and thus could still be deemed independent under the particular facts and circumstances. See Rule 10A-3(e)(1)(ii)(B).

<sup>156</sup> See NASD Rule 4350(d)(2)(A). In Amendment No. 3 to the Independent Director Proposal, *supra* note 12, Nasdaq proposes to clarify in Interpretive Material that a director who qualifies as an audit committee financial expert under Item 401(h) of Regulation S-K or Item 401(e) of Regulation S-B is presumed to qualify as a financially sophisticated audit committee member.

person is an affiliate solely by virtue of stock ownership.<sup>157</sup>

#### 8. Cure Periods

Nasdaq proposes to add a cure period provision, as follows: (1) If a listed issuer fails to comply with the audit committee composition requirements under Rule 10A-3 and NASD Rule 4350(d)(2), because an audit committee member ceases to be independent for reasons outside the member's reasonable control, the audit committee member could remain on the committee until the earlier of the issuer's next annual shareholders meeting or one year from the occurrence of the event that caused the failure to comply with the requirements; and (2) if an issuer fails to comply with the audit committee composition requirements due to one vacancy on the audit committee, and the aforementioned cure period is not otherwise being relied upon for another audit committee member, the issuer would have until the earlier of the next annual shareholders meeting or one year from the occurrence of the event that caused the failure to comply with this requirement.<sup>158</sup> An issuer relying on either of these provisions would be required to provide notice to Nasdaq immediately upon learning of the event or circumstance that caused the non-compliance.

#### 9. Notification of Noncompliance

Nasdaq proposes to require that an issuer provide Nasdaq with prompt notification after an executive officer of the issuer becomes aware of any material noncompliance by the issuer with the requirements of NASD Rule 4350.<sup>159</sup>

#### 10. Code of Business Conduct and Ethics

In the Nasdaq Code of Conduct Proposal, as amended,<sup>160</sup> Nasdaq proposes NASD Rule 4350(n) and related Interpretive Material, which would require each listed company to adopt a code of conduct applicable to all directors, officers and employees, and to make such code publicly available. The code of conduct would be required to comply with the definition of a "code of ethics" set forth in Section 406(c) of the Sarbanes-Oxley Act and any regulations thereunder. In addition, the code must provide for an enforcement mechanism

<sup>157</sup> See Amendment No. 3 to the Independent Director Proposal, *supra* note 12.

<sup>158</sup> See NASD Rule 4350(d)(4)(A) and (B).

<sup>159</sup> See NASD Rule 4350(m), which was added by Amendment No. 3 to the Independent Director Proposal, *supra* note 12.

<sup>160</sup> See the Nasdaq Code of Conduct Proposal, as amended, *supra* notes 25 and 28.

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. Moreover, any waivers of the code for directors or executive officers must be approved by the board and disclosed in a Form 8-K within five days.

In the Interpretive Material, Nasdaq proposes that the requirement of a publicly available code of conduct applicable to all directors, officer 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. Nasdaq states that, 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.

#### 11. Public Announcement of Audit Opinions With Going Concern Qualifications

In the Nasdaq Going Concern Proposal,<sup>161</sup> Nasdaq proposes to amend NASD Rule 4350(b) to require each Nasdaq-listed company that receives an audit opinion that contains a going concern qualification to make a public announcement through the news media disclosing the receipt of such qualification. Under the proposal, the issuer, prior to the release of the public announcement, would be required to provide the text of the public announcement to the StockWatch section of Nasdaq's MarketWatch Department. The public announcement must be provided to Nasdaq StockWatch and released to the media not later than seven calendar days following the filing of the audit opinion in a public filing with the Commission.<sup>162</sup>

#### 12. Related Party Transactions

In the Nasdaq Related Party Transactions Proposal, as amended,<sup>163</sup> Nasdaq proposes to amend NASD Rule 4350(h) to specify that each issuer shall conduct an appropriate review of all related party transactions for potential conflict of interest situations on an ongoing basis and all such transactions would have to be approved by the listed

<sup>161</sup> See the Nasdaq Going Concern Proposal.

<sup>162</sup> See NASD Rule 4350(b)(1)(B).

<sup>163</sup> See the Nasdaq Related Party Transactions Proposal, as amended, *supra* notes 16, 18, and 19.

company's audit committee or another independent body of the board of directors. For purposes of the rule, "related party transactions" would refer to transactions required to be disclosed pursuant to Commission Regulation S-K, Item 404.<sup>164</sup> Nasdaq proposes that the Related Party Transactions Proposal become operative on January 15, 2004.<sup>165</sup>

### 13. Application to Foreign Issuers and Certain Other Issuers

NASD Rule 4350 currently provides that foreign issuers are not required 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. Currently, Nasdaq may provide exemptions from the requirements of NASD Rule 4350 as may be necessary or appropriate to carry out this intent. In the Nasdaq Issuer Applicability Proposal, as amended,<sup>166</sup> Nasdaq proposes to amend this rule and add Interpretive Material to clarify that the authority to grant exemptions from the corporate governance standards applies only to foreign private issuers and does not apply to the extent that such exemption would be contrary to the federal securities laws, including, without limitation, section 10A(m) of the Exchange Act and Rule 10A-3 thereunder. Nasdaq also proposes to provide that a foreign issuer that receives an exemption from NASD Rule 4350 would be required to disclose in its annual reports filed with the Commission each requirement from which it is exempted and describe the home country practice, if any, followed by the issuer in lieu of these requirements. In addition, a foreign issuer making its initial public offering or first U.S. listing on Nasdaq would be required to disclose any such exemptions in their registration statement.

In addition, Nasdaq proposes that management investment companies (including business development companies) would be subject to all of the requirements of NASD Rule 4350, except that management investment companies registered under the Investment Company Act would be exempt from the requirements of NASD Rule 4350(c) and (n), which pertain to board and key committee independence requirements and codes of conduct.<sup>167</sup>

Nasdaq proposed these exemptions in light of the fact that registered management investment companies are already subject to a pervasive system of federal regulation.

Finally, Nasdaq proposes that cooperative entities, such as agricultural cooperatives that are structured to comply with relevant state law and federal tax law and that do not have a publicly traded class of common stock would be exempt from NASD Rule 4350(c); however, such entities would be required to comply with all federal securities laws, including, without limitation, section 10A(m) of the Exchange Act and Rule 10A-3 thereunder.<sup>168</sup>

Nasdaq proposes that asset-backed issuers and other passive issuers,<sup>169</sup> such as unit investment trusts, would be exempt from NASD Rule 4350(c) and (n), which pertain to board and key committee independence requirements and codes of conduct, and the audit committee requirements of NASD Rule 4350(d).<sup>170</sup> Nasdaq noted that these revisions are commensurate with provisions contained in Rule 10A-3.

### 14. Proposed Implementation of New Requirements

In Amendment No. 3 to the Nasdaq Issuer Applicability Proposal,<sup>171</sup> Nasdaq proposed to set out in NASD Rule 4350(a)(5) the proposed dates by which listed companies would be required to comply with the rule changes to NASD Rules 4200 and 4350 that are the subject of this Order. In order to allow companies to make necessary adjustments in the course of their regular annual meeting schedule, and consistent with Exchange Act Rule 10A-3, the rule would establish the deadlines for compliance listed below. During the transition period between the date of approval of the rule filing by the Commission and the deadline indicated for each rule change, companies that have not brought themselves into compliance with the new rules would be required to comply with the previously existing rules, as applicable.<sup>172</sup>

<sup>168</sup> *Id.*

<sup>169</sup> These are issuers that are organized as trusts or other unincorporated associations that do not have a board of directors or persons acting in a similar capacity and whose activities are limited to passively owning or holding (as well as administering and distributing amounts in respect of) securities, rights, collateral or other assets on behalf of or for the benefit of the holders of the listed securities.

<sup>170</sup> See Amendment Nos. 2 and 3 to the Nasdaq Issuer Applicability Proposal.

<sup>171</sup> See *supra* note 24.

<sup>172</sup> To make the application of the rules easier to understand, Nasdaq also proposed in Amendment

Companies would be required to be in compliance with the new rules by the following dates:

The provisions of Rule 4200(a) and Rule 4350(c), (d) and (m) regarding director independence, independent committees, and notification of noncompliance would be required to be implemented by:

- July 31, 2005 for foreign private issuers<sup>173</sup> and small business issuers (as defined in Rule 12b-2<sup>174</sup>); and
- For all other listed issuers, by the earlier of: (1) The listed issuer's first annual shareholders meeting after January 15, 2004; or (2) October 31, 2004.

In the case of an issuer with a staggered board, with the exception of the audit committee requirements, the issuer would have until its second annual meeting after January 15, 2004, but not later than December 31, 2005, to implement all new requirements relating to board composition, if the issuer would be required to change a director who would not normally stand for election at an earlier annual meeting. Such issuers would be required to comply with the audit committee requirements pursuant to the implementation schedule noted above.

Issuers that have listed or will be listed in conjunction with their initial public offering would be afforded exemptions from all board composition requirements consistent with the exemptions afforded in Rule 10A-3(b)(1)(iv)(A). That is, for each committee that the company adopts, the company would be required to have one independent member at the time of listing, a majority of independent members within 90 days of listing, and all independent members within one year. The rule would note, however, that investment companies are not afforded the exemptions in Rule 10A-3(b)(1)(iv)(A). Issuers could choose not to adopt a compensation or nomination committee and could instead rely upon a majority of the independent directors to discharge responsibilities under the rules. These issuers would be required to meet the majority independent board requirement within one year of listing.

Companies transferring from other markets with a substantially similar requirement would be afforded the

No. 3 to the Nasdaq Issuer Applicability Proposal to adopt Rules 4200A and 4350A, which would set forth the sections of existing Rules 4200 and 4350 that will continue to be applicable until the deadlines for compliance with the proposed changes.

<sup>173</sup> See Section II.C.13., *supra* for a discussion of the treatment of foreign private issuers under the Nasdaq proposals.

<sup>174</sup> 17 CFR 240.12b-2.

<sup>164</sup> See NASD Rule 4350(h).

<sup>165</sup> See Amendment No. 3 to the Nasdaq Related Party Transactions Proposal, *supra* note 19.

<sup>166</sup> See *supra* notes 22 to 24.

<sup>167</sup> *Id.*

balance of any grace period afforded by the other market. Companies transferring from other listed markets that do not have a substantially similar requirement would be afforded one year from the date of listing on Nasdaq. The rule would stipulate that this transition period is not intended to supplant any applicable requirements of Rule 10A-3 under the Exchange Act.

Compliance with the limitations on corporate governance exemptions to foreign private issuers would be required by July 31, 2005. However, the requirement that a foreign issuer disclose the receipt of a corporate governance exemption from Nasdaq would apply to new listings and filings made after January 1, 2004.

Compliance with proposed Rule 4350(n), requiring issuers to adopt a code of conduct,<sup>175</sup> would be required six months after approval by the Commission. Proposed Rule 4350(h), requiring audit committee approval of related party transactions, would be operative January 15, 2004. The remainder of Proposed Rules 4350(a) and 4350(b) would be effective upon approval by the Commission.

### III. Summary of Comments on NYSE and Nasdaq Proposals

The Commission received a total of 90 comment letters on the NYSE and Nasdaq proposals.<sup>176</sup> Many of the commenters expressed their support for the goals of the proposals.<sup>177</sup> While some commenters praised specific

<sup>175</sup> See Section III.C.10. *supra* for a discussion of the Code of Conduct Proposal.

<sup>176</sup> Of the comment letters received, 63 related to the NYSE Corporate Governance Proposal, 19 related to the Nasdaq Independent Director Proposal, five related to both the NYSE Corporate Governance Proposal and the Nasdaq Independent Director Proposal, two related to the Nasdaq Code of Conduct Proposal, and one related to the Nasdaq Issuer Applicability Proposal. The public files for the NYSE and Nasdaq proposals are located at the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549-0102. The public files for the rule proposals contain all comment letters on the proposals. A list of commenters on the NYSE and Nasdaq proposals (along with the citations to the letters referenced in this order), is included as Exhibit A to this order. The summary of comments contained in this section and the list of commenters contained in Exhibit A to this Order reflect comments received as of October 13, 2003.

<sup>177</sup> See Independent Community Bankers NYSE Letter, TIAA-CREF NYSE Letter, Herman E-mail, American Bankers Association NYSE Letter, Walden NYSE Letter, Railways Pension NYSE Letter, Social Investment NYSE Letter, Ethical Funds NYSE Letter, Ursuline Sisters NYSE Letter, Barclays NYSE Letter, SIO NYSE Letter, Council on Foundations NYSE Letter, Committee on Securities Regulation NYSE Letter, Intel Nasdaq Letter, Committee on Securities Regulation Nasdaq Letter, Paul Weiss Nasdaq Letter, National Venture Nasdaq Letter, and Qualcomm Nasdaq Letter.

provisions of the proposals,<sup>178</sup> other commenters argued that specific provisions of the proposals were too restrictive or too lenient.<sup>179</sup> Many commenters believed that certain aspects of the proposals needed clarification.<sup>180</sup> The commenters generally addressed issues falling into one or more of the categories discussed below.

#### A. Independence of Majority of Board Members

##### General

Many commenters supported the proposals by NYSE and Nasdaq to require each listed company to have a majority of independent directors on its board,<sup>181</sup> to tighten the definition of

<sup>178</sup> See American Bankers Association NYSE Letter, Walden NYSE Letter, Ursuline Sisters NYSE Letter, Barclays NYSE Letter, SIO NYSE Letter, America's Community Bankers NYSE Letter, America's Community Bankers Nasdaq Letter, Committee on Securities Regulation NYSE Letter, National Venture NYSE Letter, Investment Company Institute NYSE Letter, American Bankers Association Nasdaq Letter, Council on Foundations Nasdaq Letter, Committee on Securities Regulation Nasdaq Letter, National Venture Nasdaq Letter, Investment Company Institute Nasdaq Letter, and TI-USA Nasdaq Letter.

<sup>179</sup> See Council on Foundations NYSE Letter, Independent Community Bankers NYSE Letter, American Bankers Association NYSE Letter, Wachtell NYSE Memo, General Motors NYSE Letter, New York State Bar NYSE Letter, Wells Fargo NYSE Letter, Anadarko NYSE Letter, Winston & Strawn NYSE Letter, CNF NYSE Letter, Aetna NYSE Letter, Dow Lohnes NYSE Letter, Ameren NYSE Letter, Visteon NYSE Letter, Exxon NYSE Letter, Morrison Cohen NYSE Letter, Mirant NYSE Letter, American Society of Corporate Secretaries NYSE Letter, Computer Sciences NYSE Letter, Rockwell NYSE Letter, America's Community Bankers NYSE Letter, National Venture NYSE Letter, Peoples Energy NYSE Letter, Lorsch NYSE Letter, International Paper NYSE Letter, Agilent NYSE Letter, America's Community Bankers Nasdaq Letter, Whitney Nasdaq Letter, People's Energy Nasdaq Letter, America's Community Bankers Nasdaq Letter, Independent Community Bankers Nasdaq Letter, Kreider Nasdaq Letter, Committee on Securities Regulation Nasdaq Letter, Fulton Nasdaq Letter, and National Venture Nasdaq Letter (too restrictive), Herman E-mail, Eisenberg NYSE Letter, Mercer Delta NYSE Letter, TI-USA Nasdaq Letter, and Kolber Nasdaq E-mail (too lenient).

<sup>180</sup> See LeBoeuf NYSE Letter, New York State Bar NYSE Letter, America's Community Bankers NYSE Letter, Aetna NYSE Letter, Exxon NYSE Letter, Agilent NYSE Letter, Perkins Coie NYSE Letter, Mirant NYSE Letter, Computer Sciences NYSE Letter, Winston & Strawn NYSE Letter, General Motors NYSE Letter, Council on Foundations NYSE Letter, Committee on Federal Regulation on Securities Letter, New York City Bar NYSE Letter, Rutledge NYSE Letter, Intel Nasdaq Letter, America's Community Bankers Nasdaq Letter, Cenex Harvest Nasdaq Letter, People's Energy Nasdaq Letter, Paul Weiss Nasdaq Letter, and Committee on Securities Regulation Nasdaq Letter.

<sup>181</sup> See Independent Community Bankers NYSE Letter, Hermann E-mail, American Bankers Association NYSE Letter, Walden NYSE Letter, Railways Pension NYSE Letter, Social Investment NYSE Letter, Ethical Funds NYSE Letter, Ursuline Sisters NYSE Letter, Barclays NYSE Letter, SIO

independent director,<sup>182</sup> and to require the board to affirmatively determine that directors are independent.<sup>183</sup> There were some who disagreed, however. One commenter argued, in general, that boards should not be required to have a majority of independent directors.<sup>184</sup> With respect to NYSE's proposal to tighten the definition of independent director, one commenter expressed disapproval for what it described as an "expanding list of defined relationships."<sup>185</sup> With respect to Nasdaq's proposal to tighten the definition of independent director, another commenter stated its concern that the proposed standards would lead to smaller boards or to boards composed of individuals that might not have the best or most valuable experience.<sup>186</sup>

With respect to the NYSE proposal regarding the manner in which boards may disclose determinations of independence, one commenter stated its belief that permitting boards to adopt categorical standards of independence and to disclose generally that directors meet these standards would ensure that privacy is maintained concerning the specifics of private financial matters.<sup>187</sup> Another commenter requested that, with respect to the barrier to independence of individuals having specified affiliations with "organizations" having a material relationship with the company, the NYSE clarify what "organization" means.<sup>188</sup> With respect to Nasdaq's proposed definition of independence, one commenter requested that Nasdaq clarify that "employee" does not include independent contractors and employees of other goods and service providers.

#### Proposals Regarding Prohibited Compensation for Independent Directors

With respect to the kinds of compensation received by a director or family member that would preclude a finding of independence, one commenter described the NYSE Direct Compensation Provision as a

NYSE Letter, TIAA-CREF NYSE Letter, American Bankers Association Nasdaq Letter, and Independent Community Bankers Nasdaq Letter.

<sup>182</sup> See TIAA-CREF NYSE Letter, Railways Pension NYSE Letter, Barclays NYSE Letter, and SIO NYSE Letter.

<sup>183</sup> See American Bankers Association NYSE Letter, TIAA-CREF NYSE Letter, and American Bankers Association Nasdaq Letter.

<sup>184</sup> See Johnsson E-Mail.

<sup>185</sup> See KPMG NYSE Letter.

<sup>186</sup> See America's Community Bankers Nasdaq Letter.

<sup>187</sup> See American Bankers Association NYSE Letter.

<sup>188</sup> See New York State Bar NYSE Letter.

“reasonable approach,”<sup>189</sup> while another commenter thought the proposal was too rigid because it would disqualify employees who were paid more than \$100,000 and did not have significant decision-making authority.<sup>190</sup> Some commenters requested clarification of this proposal. For example, one of these commenters asked whether “compensation” had a similar meaning to that given by the Commission in Rule 10A-3,<sup>191</sup> and whether any of the following could be excluded: gains from investments in securities and dividends,<sup>192</sup> restricted stock received by directors as part of their compensation for service as directors,<sup>193</sup> payments from banking transactions in the ordinary course of business,<sup>194</sup> and deferred compensation.<sup>195</sup> One commenter expressed its preference for the NYSE Direct Compensation Provision over the Nasdaq Payments Provision because the Nasdaq Payments Provision excluded individuals who received “payments,” which the commenter believed was too broad.<sup>196</sup> One commenter argued that either the \$100,000 threshold of the NYSE Direct Compensation Provision should be increased for larger companies, or the board should have the discretion to establish the appropriate threshold.<sup>197</sup> With respect to the Nasdaq Payments Provision, one commenter argued that an indication of non-independence based on the threshold amounts of payments received should be a rebuttable presumption as in the NYSE Direct Compensation Provision, rather than a bright line test.<sup>198</sup> Commenters advocated that the following should be excluded from these amounts: indirect payments, such as payments to related organizations,<sup>199</sup> payments from banking or brokerage transactions in the ordinary course of business,<sup>200</sup> other items excluded from disclosure per Commission rules such as Item 404 of Form S-K,<sup>201</sup> and compensation for

service on board committees.<sup>202</sup> In contrast, one commenter stated that director’s fees should be the only compensation an independent director could receive from the company.<sup>203</sup> In addition, one commenter stated its belief that the three-year look back should not apply to the Nasdaq Payments Provision because the board would already be required to consider previous employment in making an affirmative determination of director independence.<sup>204</sup> One commenter expressed its strong support for the exception in the NYSE Direct Compensation Provision for compensation received by a director for former service as an interim Chairman or CEO, and recommended that Nasdaq include this exception in its proposal.<sup>205</sup>

**Business Relationship Provisions**  
One commenter supported the NYSE Business Relationship Provision and represented that members of its corporate governance task force (which consists of representatives from both large and small, public and non-public banking organizations) were confident that the majority of directors sitting on the boards of banking organizations impacted by these listing standards would be able to satisfy this requirement.<sup>206</sup> Other commenters argued that the NYSE Business Relationship Provision would be difficult to implement and would not, in many cases, be the most accurate measure of the materiality of a business relationship.<sup>207</sup> Likewise, commenters argued that NYSE’s threshold of 2% was too low,<sup>208</sup> the proposal was not appropriate for smaller companies,<sup>209</sup> the proposal was ambiguous,<sup>210</sup> and that the existence of a commercial relationship should give rise only to a rebuttable presumption of lack of independence.<sup>211</sup> Commenters were also concerned about the application of the proposal to family members.<sup>212</sup> In addition, commenters argued that the

proposal should not apply to the following: Executive officers or employees of a company making the payments who seek to be independent directors of the company that is on the receiving end of the payments,<sup>213</sup> certain loans,<sup>214</sup> non-executive employees,<sup>215</sup> disqualification due to consolidation accounting principles,<sup>216</sup> and gross revenues received in certain competitively bid and public utility transactions.<sup>217</sup>

With respect to the Nasdaq Business Relationship Provision, one commenter recommended defining “controlling shareholder.”<sup>218</sup>

#### Interlocking Directorate Provisions

Two commenters supported the NYSE and Nasdaq Interlocking Directorate Provisions.<sup>219</sup> One commenter does not believe that the look-back provisions of the NYSE and Nasdaq Interlocking Directorate Provisions should apply because independence would seem to be compromised only if the listed company’s executives had the current ability to participate in determining the director’s compensation as an executive officer of the other entity.<sup>220</sup> The commenter suggests that if the NYSE and Nasdaq look-back provisions are applied, then the service of the listed company’s executive, and the employment of the listed company’s director, at the other company should be required to have occurred at the same time during that five-year period.<sup>221</sup>

#### Relationships of a Director with the Company’s Auditors

With respect to the NYSE’s proposal concerning relationships with an auditor, one commenter did not believe that the NYSE had sufficiently explained why a director’s affiliation with a company’s auditor would compromise the director’s independence.<sup>222</sup> In addition, several commenters argued that applying the proposals to family members would be too burdensome, given the small number of accounting firms that provide audit services to large publicly traded companies, and would be difficult to monitor. These commenters suggested

<sup>189</sup> See America’s Community Bankers NYSE Letter.

<sup>190</sup> See GM NYSE Letter.

<sup>191</sup> See America’s Community Bankers NYSE Letter.

<sup>192</sup> See Aetna NYSE Letter.

<sup>193</sup> See Exxon NYSE Letter.

<sup>194</sup> See America’s Community Bankers NYSE Letter.

<sup>195</sup> See New York State Bar NYSE Letter.

<sup>196</sup> See American Bankers Association NYSE Letter.

<sup>197</sup> See Wells Fargo NYSE Letter.

<sup>198</sup> See Committee on Securities Regulation Nasdaq Letter.

<sup>199</sup> See ABC Nasdaq Letter.

<sup>200</sup> See America’s Community Bankers Nasdaq Letter, American Bankers Association Nasdaq Letter, Whitney Nasdaq Letter, and People’s Bank Nasdaq Letter.

<sup>201</sup> See Whitney Nasdaq Letter.

<sup>202</sup> See People’s Bank Nasdaq Letter.

<sup>203</sup> See TI-USA Nasdaq Letter.

<sup>204</sup> See America’s Community Bankers Nasdaq Letter.

<sup>205</sup> See Arrow Electronics Letter.

<sup>206</sup> See American Bankers Association NYSE Letter.

<sup>207</sup> See Mirant NYSE Letter, Winston and Strawn NYSE Letter, CNF NYSE Letter, America’s Community Bankers NYSE Letter, and New York State Bar NYSE Letter.

<sup>208</sup> See Anadarko NYSE Letter.

<sup>209</sup> See Agilent NYSE Letter.

<sup>210</sup> See Perkins Coie NYSE Letter and Winston & Strawn NYSE Letter.

<sup>211</sup> See Anadarko NYSE Letter, Aetna NYSE Letter, and Ameren NYSE Letter.

<sup>212</sup> See Aetna NYSE Letter, Visteon NYSE Letter, and Mirant NYSE Letter.

<sup>213</sup> See CNF NYSE Letter.

<sup>214</sup> See Aetna NYSE Letter.

<sup>215</sup> *Id.*

<sup>216</sup> See Dow, Lohnes NYSE Letter.

<sup>217</sup> See Ameren NYSE Letter.

<sup>218</sup> See America’s Community Bankers Nasdaq Letter.

<sup>219</sup> See Council on Foundations Nasdaq Letter and American Bankers Association NYSE Letter.

<sup>220</sup> See America’s Community Bankers Nasdaq Letter and America’s Community Bankers NYSE Letter.

<sup>221</sup> *Id.*

<sup>222</sup> See Computer Sciences NYSE Letter.

limiting the scope of the proposal.<sup>223</sup> Furthermore, commenters requested clarification of the terms “external auditors,”<sup>224</sup> “internal auditors,”<sup>225</sup> “affiliated with,”<sup>226</sup> and “executives.”<sup>227</sup> One commenter supported this proposal.<sup>228</sup>

With respect to the Nasdaq proposal on the same topic, one commenter suggested limiting the scope of the proposal by excluding from its prohibition partners or employees that provide only a minimal amount of work on the company’s audit or who are brought in to assist on technical or industry-specific issues.<sup>229</sup>

#### Definition of Family Member

In general, many commenters criticized the proposed NYSE and Nasdaq definitions of family members for being too broad and impractical to apply.<sup>230</sup> One commenter expressed its preference for NYSE’s proposed definition,<sup>231</sup> and another commenter stated that NYSE’s proposed definition is reasonable.<sup>232</sup>

#### Look-Back Periods and Their Phase-In

With respect to the look-back periods proposed by the NYSE and Nasdaq to disqualify former employees, auditor personnel, interlocking directors and their families, as applicable, for a specified time, two commenters argued that no look-back periods were necessary.<sup>233</sup> One of these commenters recommended that Nasdaq clarify that the look-back would apply to any time within the three-year period, not the

<sup>223</sup> See Aetna NYSE Letter, Exxon NYSE Letter, Wells Fargo NYSE Letter, Morrison Cohen NYSE Letter, and New York State Bar NYSE Letter.

<sup>224</sup> See Mirant NYSE Letter, America’s Community Bankers NYSE Letter, and Computer Sciences NYSE Letter.

<sup>225</sup> See America’s Community Bankers NYSE Letter.

<sup>226</sup> *Id.*

<sup>227</sup> See Aetna NYSE Letter.

<sup>228</sup> See American Bankers Association NYSE Letter.

<sup>229</sup> See America’s Community Bankers Nasdaq Letter.

<sup>230</sup> See Intel Nasdaq Letter, People’s Bank Nasdaq Letter, America’s Community Bankers Nasdaq Letter, American Bankers Association Nasdaq Letter, Independent Community Bankers Nasdaq Letter, Kreider Nasdaq Letter, Mirant NYSE Letter, American Society of Corporate Secretaries NYSE Letter, America’s Community Bankers NYSE Letter, Winston & Strawn NYSE Letter, Computer Sciences NYSE Letter, Aetna NYSE Letter, Exxon NYSE Letter, Wells Fargo NYSE Letter, New York State Bar NYSE Letter, and Rockwell NYSE Letter.

<sup>231</sup> See American Bankers Association Nasdaq Letter.

<sup>232</sup> See America’s Community Bankers NYSE Letter.

<sup>233</sup> See America’s Community Bankers Nasdaq Letter and Independent Community Bankers Nasdaq Letter.

entire three-year period.<sup>234</sup> Two commenters<sup>235</sup> approved of NYSE’s proposal to phase-in the look-back periods but, along with other commenters,<sup>236</sup> argued that a five-year look-back period would be too long. Some commenters argued that Nasdaq’s look-back provisions should be phased-in as in the NYSE’s proposal.<sup>237</sup>

#### Affiliates

With respect to how NYSE proposes to define independent directors, two commenters asked, absent other disqualifying factors, if a director that sits on the board of a company’s affiliate could be an independent director with respect to that company.<sup>238</sup>

#### Application to Investment Companies

With respect to how Nasdaq proposes to define independent director, one commenter stated that whether a director of an investment company is independent should be determined exclusively under the provisions of section 2(a)(19) of the Investment Company Act.<sup>239</sup>

#### Banks and Banking Transactions

Several commenters stated their concern about the impact of both the NYSE and Nasdaq proposals on small community banks and the disqualification of otherwise independent directors due to ordinary course of business banking transactions.<sup>240</sup> These commenters recommended that Nasdaq and NYSE amend their proposals accordingly. However, one of these commenters expressed its support for the NYSE proposal and represented that members of its corporate governance task force (which consists of representatives from both large and small, public and non-public banking organizations) were confident that the majority of directors sitting on the boards of banking organizations impacted by these listing

<sup>234</sup> See America’s Community Bankers Nasdaq Letter.

<sup>235</sup> See America’s Community Bankers NYSE Letter and American Bankers Association NYSE Letter.

<sup>236</sup> See National Venture NYSE Letter and Independent Community Bankers NYSE Letter.

<sup>237</sup> See American Bankers Association Nasdaq Letter, Committee on Securities Regulation Nasdaq Letter, Whitney Nasdaq Letter, and Independent Community Bankers Nasdaq Letter.

<sup>238</sup> See Cleary NYSE Letter and LeBoeuf NYSE Letter.

<sup>239</sup> See Investment Company Institute Nasdaq Letter.

<sup>240</sup> See Independent Community Bankers NYSE Letter, American Bankers Association NYSE Letter, Wachtell NYSE Letter, America’s Community Bankers NYSE Letter, Whitney Nasdaq Letter, American Bankers Association Nasdaq Letter, America’s Community Bankers Nasdaq Letter, and Independent Community Bankers Nasdaq Letter.

standards would be able to satisfy the proposed requirements.<sup>241</sup>

#### Charities

One commenter argued that both companies and the charities they support would benefit from a bright line uniform rule that would apply to all charitable contributions without regard to the market on which a company is traded. The commenter stated its belief that Nasdaq’s Business Relationship Provision would be a reasonable standard for assessing the effect of charitable contributions on a director’s independence, and expressed its concern that NYSE-listed companies would be more likely to discontinue giving to charities than to expend the time and effort necessary to craft the categorical standards that would be needed under the NYSE proposal.<sup>242</sup>

#### Other Comments on Independence Proposals

Some commenters recommended strengthening the independence standards. For example, two commenters recommended that a former CEO should never be eligible to serve as an independent director.<sup>243</sup> One of these commenters argued that the board should be required to take into account a director’s relationship with senior management and other directors in making a determination of independence.<sup>244</sup> Another commenter recommended barring investment institutions from having board seats in companies they have investments in.<sup>245</sup> Three commenters recommended adding considerations such as ethnic and gender diversity of the board to the discussion of independence.<sup>246</sup>

With respect to the Nasdaq proposal, one commenter suggested defining “executive officer”—which appear in the Nasdaq Payments Provision, the Nasdaq Family of Executive Officer Provision, and the Nasdaq Business Relationship Provision—as defined in Rule 16a-1(f) of the Exchange Act, to prevent these proposals from disqualifying employees who have no policy-making role at the corporate level.<sup>247</sup> The same commenter also recommended clarifying the maning of

<sup>241</sup> See American Bankers Association NYSE Letter.

<sup>242</sup> See Council on Foundations Nasdaq Letter and Council on Foundations NYSE Letter.

<sup>243</sup> See TIAA-CREF NYSE Letter and Coleman NYSE Letter.

<sup>244</sup> See TIAA-CREF NYSE Letter.

<sup>245</sup> See Hermann E-mail, Social Investment NYSE Letter, Ethical Funds NYSE Letter, and Calvert NYSE Letter.

<sup>246</sup> See Social Investment NYSE Letter, Ethical Funds NYSE Letter, and Calvert NYSE Letter.

<sup>247</sup> See Intel Nasdaq Letter.

“subsidiary,” which appears in the Nasdaq Employee Provision, the Nasdaq Payments Provision, and the Nasdaq Family of Executive Officer Provision.

One commenter expressed its strong support for the position taken by both the NYSE and Nasdaq not to disqualify independent directors for ownership of even a significant amount of stock.<sup>248</sup>

Two commenters recommended that NYSE and Nasdaq apply a more lenient independence standard to smaller companies.<sup>249</sup>

With respect to the NYSE proposal, one commenter recommended that NYSE adopt the provision permitted by Rule 10A-3 that would allow a listed issuer to have one audit committee member that ceases to be independent for reasons outside the member's reasonable control for a limited amount of time, and to extend such provision to all independent directors and the other non-Rule 10A-3 independence requirements.<sup>250</sup> Another commenter recommended adding a provision relating to appropriate procedures for a company to cure any defects in its compliance with the proposed new independence standards.<sup>251</sup>

#### B. Separate Meetings for Independent Directors

Several commenters were in favor of the NYSE proposal to require separate executive sessions for non-management directors.<sup>252</sup> One commenter stated that it regarded this requirement as among the most important in improving the independence of the board.<sup>253</sup> Another commenter criticized the proposal because it believes that it could lead to decisions being made without critical information available to management, and could raise liability issues for the non-management directors under state law if their decisions are determined to be harmful to the company or not in its best interest.<sup>254</sup> The commenter suggested that the NYSE encourage these meetings, but not make them mandatory, so that each company could determine if the sessions would be productive. A third commenter stated its belief that requiring executive

sessions would have a divisive effect within boards of listed companies and would deprive directors of guidance by management.<sup>255</sup> Another commenter argued that independent directors, not non-management directors, should be required to attend executive sessions, and that an independent director should be required to preside over the executive sessions.<sup>256</sup>

With respect to the Nasdaq proposal to require separate sessions for independent directors, one commenter stated its view that such a requirement could be burdensome, and recommended requiring regular meetings of non-management directors.<sup>257</sup> Another commenter recommended that Nasdaq clarify what would be expected to occur at these meetings.<sup>258</sup>

#### C. Communications with Independent Directors

Commenters recommended that NYSE clarify its proposal that interested parties should have the ability to freely communicate with a company's non-management directors with respect to the identity of “interested parties;”<sup>259</sup> how they should communicate with independent directors;<sup>260</sup> what topics would be appropriate to direct to independent directors, instead of the entire board;<sup>261</sup> and whether management could be involved in screening communications and in reviewing and responding to concerns.<sup>262</sup> Another commenter recommended limiting the proposal to employees.<sup>263</sup> With respect to the Nasdaq proposal, one commenter advocated that companies ensure that employees know that they would not be retaliated against for reports made in good faith.<sup>264</sup>

#### D. Compensation of Officers

Many commenters disapproved of the NYSE Compensation Committee Provision because the compensation committee would be given the sole

authority to determine CEO compensation.<sup>265</sup> Commenters argued that the full board should have a role in making CEO compensation decisions,<sup>266</sup> or that all independent directors should have a role in making CEO compensation decisions, perhaps even by deciding how CEO compensation decisions would be made.<sup>267</sup> One commenter stated that the board should be permitted to allocate this responsibility to other committees or other groups of directors, as long as all members are independent, and that the compensation committee should be permitted to make a recommendation to be approved by all of the independent directors.<sup>268</sup> Another commenter recommended that the NYSE make clear that the compensation committee could be given the discretion to make other decisions.<sup>269</sup> Other commenters supported the proposal.<sup>270</sup> One commenter provided recommendations for how the compensation committee should evaluate CEO performance.<sup>271</sup>

With respect to the Nasdaq Compensation of Executives Provision, one commenter argued that it would not be necessary or appropriate to apply this proposal to investment companies.<sup>272</sup> With respect to both the NYSE Compensation Committee Provision and the Nasdaq Compensation of Executives Provision, two commenters asked how other compensation would be determined.<sup>273</sup>

#### E. Nomination of Directors

Several commenters supported the NYSE Nominating/Corporate Governance Committee Provision,<sup>274</sup> and one commenter supported the exception that provides that nominating committee approval is not required where the right to nominate a director

<sup>265</sup> See Business Roundtable NYSE Letter, American Society of Corporate Secretaries NYSE Letter, International Paper NYSE Letter, Lorsch NYSE Letter, Computer Sciences NYSE Letter, Peoples Energy NYSE Letter, and Pfizer NYSE Letter.

<sup>266</sup> See Computer Sciences NYSE Letter, Pfizer NYSE Letter, and International Paper NYSE Letter.

<sup>267</sup> See Business Roundtable NYSE Letter, Lorsch NYSE Letter, and Peoples Energy NYSE Letter.

<sup>268</sup> See Business Roundtable NYSE Letter.

<sup>269</sup> See Wells Fargo NYSE Letter.

<sup>270</sup> See TIAA-CREF NYSE Letter, Walden NYSE Letter, Social Investment NYSE Letter, and Ethical Funds NYSE Letter.

<sup>271</sup> See MVC Associates NYSE E-mail.

<sup>272</sup> See Investment Company Institute Nasdaq Letter.

<sup>273</sup> See KPMG NYSE Letter and America's Community Bankers Nasdaq Letter.

<sup>274</sup> See TIAA-CREF NYSE Letter, Walden NYSE Letter, Social Investment NYSE Letter, Ethical Funds NYSE Letter, and Ursuline Sisters NYSE Letter.

<sup>248</sup> See National Venture Nasdaq Letter and National Venture NYSE Letter.

<sup>249</sup> See Independent Community Bankers NYSE Letter, Independent Community Bankers Nasdaq Letter, and America's Community Bankers Nasdaq Letter.

<sup>250</sup> See Cleary NYSE Letter.

<sup>251</sup> See Financial Services Agency NYSE Letter.

<sup>252</sup> See TIAA-CREF NYSE Letter, Walden NYSE Letter, Social Investment NYSE Letter, Ethical Funds NYSE Letter, Barclays NYSE Letter, and SIO NYSE Letter.

<sup>253</sup> See TIAA-CREF NYSE Letter.

<sup>254</sup> See America's Community Bankers NYSE Letter.

<sup>255</sup> See Independent Community Bankers NYSE Letter.

<sup>256</sup> See Eisenberg NYSE Letter.

<sup>257</sup> See People's Bank Nasdaq Letter.

<sup>258</sup> See America's Community Bankers Nasdaq Letter.

<sup>259</sup> See Committee on Securities Regulation NYSE Letter.

<sup>260</sup> See America's Community Bankers NYSE Letter, Winston & Strawn NYSE Letter, Kerr-McGee NYSE Letter, Agilent NYSE Letter, and Committee on Securities Regulation NYSE Letter.

<sup>261</sup> See Winston & Strawn NYSE Letter.

<sup>262</sup> See Kerr-McGee NYSE Letter, Agilent NYSE Letter, and JP Financial NYSE Letter.

<sup>263</sup> See Agilent NYSE Letter.

<sup>264</sup> See America's Community Bankers Nasdaq Letter.

legally belongs to a third party.<sup>275</sup> However, one commenter argued that the NYSE should permit director nomination responsibilities to be allocated to other committees or other groups of directors so long as all members are independent.<sup>276</sup>

With respect to the role of board committees generally, one commenter recommended that the proposed listing standards explicitly recognize the oversight role and the responsibilities of the board of directors as a whole.<sup>277</sup>

While one commenter supported the Nasdaq Director Nomination Provision,<sup>278</sup> another commenter believed that the full board should be involved in the director nomination process, because otherwise all the independent directors may be friends and may not be independent in thought from one another.<sup>279</sup> One commenter recommended clarifying that the proposal's exception for cases where the right to nominate a director legally belongs to a third party includes arrangements other than contractual arrangements.<sup>280</sup> Another commenter recommended changing the 20% shareholder exception that had been included in Nasdaq's original proposal by deleting the phrase, "and is not independent as defined in Rule 4200 because that director is also an officer."<sup>281</sup> In addition, another commenter argued that the proposal should not apply to investment companies whose independent directors are nominated by independent directors.<sup>282</sup>

#### F. Controlled Company Exemption

While one commenter supported both the NYSE and Nasdaq proposals to exempt controlled companies from some of the independent director requirements,<sup>283</sup> two commenters did not support the NYSE proposal.<sup>284</sup> One of these commenters argued that it would disenfranchise minority shareholders,<sup>285</sup> and the other commenter argued that the exemption should apply only where the measure of "control" is both voting and economic

control, because corporations with two-tier classes of voting stock, where the minority economic interests exercise voting control because of supermajority voting rights, are particularly subject to the potential for abuse.<sup>286</sup> With respect to the Nasdaq proposal, one commenter recommended adding language to make clear that controlled companies choosing not to rely on the exemption need not include any special disclosures about their controlled status.<sup>287</sup>

#### G. Audit Committee Charter

In general, several commenters supported increasing the authority and responsibility of the audit committee.<sup>288</sup> However, one commenter argued that final authority over audit committee issues should rest with all the independent directors.<sup>289</sup> With respect to the NYSE Audit Committee Charter Provision, several commenters were concerned with the extent of the audit committee's proposed new responsibilities.<sup>290</sup> For example, one of these commenters argued that the audit committee should be permitted to delegate non-financial risk management activities to other committees so long as such committee reports to the audit committee.<sup>291</sup> Another commenter argued that the audit committee should not be responsible for legal and regulatory compliance, and that investing a single committee with an overload of functions may dilute resources of the committee that should be available to its accounting and financial oversight role.<sup>292</sup> A third commenter argued that there were too many items for the audit committee to discuss and that the audit committee needs the flexibility to set its agenda to focus on the company's most significant financial reporting and corporate governance issues.<sup>293</sup> One of the commenters also argued that financial statements are the representations and responsibility of management, not the audit committee.<sup>294</sup>

Further, one commenter requested clarification of whether advance discussion of quarterly financial statements would be required and, if so,

argued that the audit committee should be permitted to decide whether this requirement should apply to the earnings release or the quarterly financial statements.<sup>295</sup> Another commenter recommended excluding investment companies from the proposed requirement that audit committee members discuss earnings press releases as well as financial information and earnings guidance provided to analysts and rating agencies.<sup>296</sup>

With respect to the Nasdaq Audit Committee Charter Provision, the same commenter supported the proposed requirements regarding complaints, particularly their flexibility; and favored the proposal to grant the audit committee the authority to engage and fund outside advisors.<sup>297</sup> However, the commenter also argued that the Nasdaq proposal should be revised to make clear that each Nasdaq-listed company would be required to provide appropriate funding to the audit committee.<sup>298</sup> Another commenter argued that the Nasdaq proposal should be revised to require audit committee charters to state that one of the audit committee's purposes must be to assist the board in oversight of the company's compliance with laws and regulations, which would be consistent with the NYSE Audit Committee Charter Provision.<sup>299</sup>

Several commenters, writing before the NYSE and Nasdaq filed amendments to the proposals, pointed out that the NYSE and Nasdaq Audit Committee Charter Provisions should be revised so that the responsibilities required of the audit committee would comply with the requirements of Rule 10A-3.<sup>300</sup>

#### H. Audit Committee Independence

With respect to the NYSE proposal on audit committee independence, two commenters supported the proposal to require an independent audit committee.<sup>301</sup> However, several commenters were concerned about the interplay between the proposal and the requirements of Rule 10A-3. For example, one commenter argued that the proposal should incorporate the various exceptions and accommodations

<sup>275</sup> See National Venture NYSE Letter.

<sup>276</sup> See American Society of Corporate Secretaries NYSE Letter.

<sup>277</sup> See Securities Committee NYSE Letter.

<sup>278</sup> See National Venture Nasdaq Letter.

<sup>279</sup> See Kolber Nasdaq Letter.

<sup>280</sup> See Cenex Harvest Nasdaq Letter.

<sup>281</sup> See Kreider Nasdaq Letter.

<sup>282</sup> See Investment Company Institute Nasdaq Letter.

<sup>283</sup> See National Venture NYSE Letter and National Venture Nasdaq Letter.

<sup>284</sup> See International Corporate Governance NYSE Letter and Cascade NYSE Letter.

<sup>285</sup> See International Corporate Governance NYSE Letter.

<sup>286</sup> See Cascade NYSE Letter.

<sup>287</sup> See People's Bank Nasdaq Letter.

<sup>288</sup> See TIAA-CREF NYSE Letter, National Association of State Treasurers NYSE Letter, Railways Pension NYSE Letter, Barclays NYSE Letter, and SIO NYSE Letter.

<sup>289</sup> See Computer Sciences NYSE Letter.

<sup>290</sup> See American Society of Corporate Secretaries NYSE Letter, KPMG NYSE Letter, and Computer Sciences NYSE Letter.

<sup>291</sup> See American Society of Corporate Secretaries NYSE Letter.

<sup>292</sup> See KPMG NYSE Letter.

<sup>293</sup> See Computer Sciences NYSE Letter.

<sup>294</sup> See KPMG NYSE Letter.

<sup>295</sup> See Wells Fargo NYSE Letter.

<sup>296</sup> See Investment Company Institute NYSE Letter.

<sup>297</sup> See Investment Company Institute Nasdaq Letter.

<sup>298</sup> *Id.*

<sup>299</sup> See TI-USA Nasdaq Letter.

<sup>300</sup> See Committee on Securities Regulation NYSE Letter, New York State Bar NYSE Letter, Financial Services Agency NYSE Letter, and Investment Company Institute Nasdaq Letter.

<sup>301</sup> See Social Investment NYSE Letter and Ethical Funds NYSE Letter.

codified in Rule 10A-3.<sup>302</sup> Another commenter recommended clarifying whether the Commission's Rule 10A-3 definition of impermissible compensation should be applied.<sup>303</sup> A third commenter asked: (1) Which definition of "immediate family member" should be used; (2) whether NYSE intends to apply a five-year look-back; (3) whether NYSE intends to consider payments made in any period prior to board service; and (4) whether NYSE intends to consider whether payments are made to a family member or to a firm providing advisory or professional services to the listed company with which a director is or was associated in the capacities referred to in Rule 10A-3(e)(8).<sup>304</sup>

Another commenter requested that NYSE determine that banking transactions in the ordinary course of business between banks and their directors and their affiliated companies would not constitute a material relationship that would impair an audit committee member's independence.<sup>305</sup>

With respect to the Nasdaq proposal on audit committee independence, one commenter disapproved of the application of a three-year look back, and was concerned that this provision would deprive a company of a high-quality audit committee member who has an appreciation for the operational aspect of the business.<sup>306</sup> The commenter argued that no look-back was necessary because directors have a legal duty to act independently of previous allegiances. Although the commenter opposed any look-back, it commented that shortening the look-back to one year would significantly mitigate the adverse effect.

Two commenters approved of the provisions in Nasdaq's original proposal to include a bright line test that would bar directors who own or control 20% or more of a company's stock.<sup>307</sup> One commenter requested further clarification of this provision.<sup>308</sup> Another commenter argued that directors who own more than 20% of a company's stock are the directors who are most independent of management because they have a stake in the firm apart from the compensation they

receive as directors, and often there is no indicia whatsoever of control.<sup>309</sup> The same commenter argued that the proposed standard could be highly disruptive, expensive and counterproductive.<sup>310</sup>

Other commenters requested clarification of who Nasdaq would consider to be an affiliate.<sup>311</sup> For example, one of these commenters requested more guidance as to what factors ought to be considered in determining whether an individual is an affiliate.<sup>312</sup> Another commenter asked whether a director could serve on both the board of a holding company and the board of a subsidiary of the holding company.<sup>313</sup> Two other commenters expressed concern about the effect of banking relationships.<sup>314</sup>

Although one commenter supported Nasdaq's proposal to allow certain leniencies in exceptional and limited circumstances, it argued that a company should not be required to disclose its use of these exceptions in a proxy because that would discourage use of the exceptions. The commenter stated that, instead, a company should be required to disclose its use of these exceptions in a report to Nasdaq.<sup>315</sup> Another commenter stated that it would be helpful for Nasdaq to clarify the relationship between the Nasdaq proposal and the requirements of Rule 10A-3, such as whether the same definition of family member and application of a look-back applies to both.<sup>316</sup>

One commenter requested clarification of the relationship between current Nasdaq rules addressing audit committees and the Nasdaq Audit Committee Provision.<sup>317</sup>

#### *I. Financial Background of Audit Committee Members*

With respect to the NYSE and Nasdaq proposals on the requisite background of audit committee members, two commenters recommended harmonizing the two proposals.<sup>318</sup> One of these

commenters recommended modifying the NYSE proposal to require audit committee members to be financially literate at the time they join the audit committee.<sup>319</sup> The other commenter recommended modifying the Nasdaq proposal to provide that an individual who satisfies the Commission's definition of an audit committee financial expert would be qualified to be an audit committee member.<sup>320</sup>

With respect to the NYSE and Nasdaq proposals to require at least one member of the audit committee to have accounting or related financial management expertise, one commenter requested confirmation that past and current employment as a venture capitalist would allow a director to meet this requirement on a per se basis.<sup>321</sup> The commenter also recommended that the NYSE make clear that "accounting or related financial management experience" does not require any particular background, certification or education.<sup>322</sup>

#### *J. NYSE Audit Committee Member Simultaneous Service Provision*

With respect to the NYSE proposal limiting the permissibility of simultaneous service on more than three audit committees, one commenter recommended moving this proposal to a different section of the NYSE proposal because it does not relate to independence.<sup>323</sup> Another commenter questioned whether the proposed requirement would be mandatory because it appears in the commentary, and argued that because it is difficult to generalize about which directors are likely to have adequate time to carry out the duties of the committee, it should apply only to directors who are currently functioning in active senior executive roles of listed companies.<sup>324</sup> A third commenter strongly recommended that in application of the proposed requirement to investment companies, a "fund complex" should be treated as one company because: (1) It is common practice in the investment company industry for the same directors to serve on the audit committee of one or more funds in a complex; (2) an investment company's financial

and Committee on Securities Regulation Nasdaq Letter.

<sup>319</sup> See Investment Company Institute NYSE Letter.

<sup>320</sup> See Committee on Securities Regulation Nasdaq Letter.

<sup>321</sup> See National Venture NYSE and Nasdaq Letters.

<sup>322</sup> See National Venture NYSE Letter.

<sup>323</sup> See American Society of Corporate Secretaries NYSE Letter.

<sup>324</sup> See GM NYSE Letter.

<sup>309</sup> See Wachtel Nasdaq Letter.

<sup>310</sup> *Id.*

<sup>311</sup> See Paul Weiss Nasdaq Letter, America's Community Bankers Nasdaq Letter, American Bankers Association Nasdaq Letter, and Investment Company Institute Nasdaq Letter.

<sup>312</sup> See Paul Weiss Nasdaq Letter.

<sup>313</sup> See America's Community Bankers Nasdaq Letter.

<sup>314</sup> See American Bankers Association Nasdaq Letter and Independent Community Bankers Nasdaq Letter.

<sup>315</sup> See Paul Weiss Nasdaq Letter.

<sup>316</sup> See Committee on Securities Regulation Nasdaq Letter.

<sup>317</sup> See America's Community Bankers NYSE Letter.

<sup>318</sup> See Investment Company Institute NYSE Letter, Investment Company Institute Nasdaq Letter,

<sup>302</sup> See Cleary NYSE Letter.

<sup>303</sup> See America's Community Bankers NYSE Letter.

<sup>304</sup> See Committee on Federal Regulation of Securities Letter.

<sup>305</sup> See Independent Community Bankers NYSE Letter.

<sup>306</sup> See National Venture Nasdaq Letter.

<sup>307</sup> See National Venture Nasdaq Letter and Paul Weiss Nasdaq Letter.

<sup>308</sup> See America's Community Bankers Nasdaq Letter.

statements are less complicated and therefore audit committee oversight requires less time; and (3) all funds in a fund complex typically rely on the same accounting system and are subject to the same internal controls and policies.<sup>325</sup>

#### K. Internal Audit Function

With respect to the NYSE proposal to require an internal audit function at all listed companies, one commenter recommended evaluating whether this requirement would be identical to the requirements of Rule 10A-3.<sup>326</sup> If the rules were not identical, the commenter recommended delaying the imposition of additional requirements until those required by federal law have been adopted and implemented, and their efficacy evaluated after a reasonable amount of time.<sup>327</sup> Two commenters argued that investment companies should be excluded from the internal audit requirement.<sup>328</sup> A third commenter strongly recommended that Nasdaq implement the same requirement.<sup>329</sup>

#### L. NYSE Corporate Governance Guidelines

With respect to the NYSE proposal relating to corporate governance guidelines, one commenter strongly supported the proposal, particularly the concept of requiring director orientation for new directors and continuing education for all directors.<sup>330</sup> Two other commenters also supported requiring director orientation.<sup>331</sup> Another commenter strongly supported requiring annual evaluations by the board,<sup>332</sup> and one commenter supported requiring board and committee assessments.<sup>333</sup> Two of the commenters also recommended that evidentiary protection be provided in connection with any evaluations or assessments made by the board or its committees.<sup>334</sup>

While two other commenters supported requiring corporate governance guidelines, they argued that such guidelines should promote ethical guidelines for conducting core business, and that director orientation should

include social and environmental risk management, as well as training on corporate social responsibility.<sup>335</sup>

Another commenter stated that the reference to charitable contributions in the proposed commentary to the guideline topic relating to director compensation was too vague.<sup>336</sup> This commenter recommended deleting the reference in its entirety or revising it to cover only the situation in which a director is permitted, as a perk of his or her position, to recommend a corporate gift to a favorite charity.<sup>337</sup>

#### M. Code of Business Conduct and Ethics

With respect to the NYSE proposal regarding codes of business conduct and ethics, one commenter supported the proposal and stated that it will help companies manage conflicts of interest.<sup>338</sup> Five other commenters also supported the proposal,<sup>339</sup> but four of these commenters argued that it should deal with a broader scope of issues including environmental and social practices.<sup>340</sup> Two of these commenters promoted the Global Reporting Initiative, which provides a uniform disclosure policy and extends the reach of corporate social responsibility to economically, environmentally and socially sustainable business practices.<sup>341</sup> In addition, one commenter recommended that the NYSE require that CEOs endorse the codes with their signatures.<sup>342</sup>

One commenter supported the proposal to require companies to disclose waivers.<sup>343</sup> Another commenter argued that the NYSE should require companies to disclose only a waiver of material terms of their codes because requiring disclosure of any waivers would be too burdensome and would discourage companies from adopting comprehensive codes.<sup>344</sup> With respect to the Nasdaq Code of Conduct Proposal, one commenter supported the proposal, but recommended that Nasdaq require its listed companies to publish a summary of the compliance processes

in place to support the code.<sup>345</sup> Another commenter also supported the proposal, but recommended that Nasdaq limit the proposed disclosure requirement to waivers of material terms of the code, because requiring disclosure of any waivers would be too burdensome and would discourage companies from adopting comprehensive codes.<sup>346</sup> The commenter also stated that the proposal should address "implicit waivers," which would occur when a company fails to take action against a violation of the code. The commenter also recommended that Nasdaq permit waivers to be approved either by the board or a committee of the board to give listed companies the flexibility to place the oversight of a company's code of conduct within the jurisdiction of a particular committee if that structure would be more effective and appropriate.

Another commenter recommended that Nasdaq modify its proposal to provide that investment companies that are already subject to code of ethics and other requirements pursuant to rules under the Investment Company Act would be deemed to satisfy any new Nasdaq requirements regarding codes of conduct.<sup>347</sup> The commenter argued that this modification would be consistent with Nasdaq's intentions and the NYSE proposal.

#### N. Noncompliance

One commenter urged the NYSE and Nasdaq to modify their proposals to permit transitional periods of noncompliance, distinct from any similar procedures for other listing standards.<sup>348</sup>

#### O. CEO Certification

Several commenters supported the NYSE proposal to require a company's CEO to certify annually that he or she is not aware of any violation of the Exchange's corporate governance rules.<sup>349</sup> One of these commenters claimed that requiring CEO certification has caused many companies to engage in better due diligence about their financial statements.<sup>350</sup> Other commenters disapproved of the proposal.<sup>351</sup> One of the commenters opposing the proposal argued that

<sup>325</sup> See Investment Company Institute NYSE Letter.

<sup>326</sup> See Committee on Securities Regulation NYSE Letter.

<sup>327</sup> *Id.*

<sup>328</sup> See Investment Company Institute NYSE Letter and Sullivan & Cromwell NYSE Letter.

<sup>329</sup> See TI-USA Nasdaq Letter.

<sup>330</sup> See TIAA-CREF NYSE Letter.

<sup>331</sup> See Walden NYSE Letter and Ursuline Sisters NYSE Letter.

<sup>332</sup> See Mercer Delta NYSE Letter.

<sup>333</sup> See Boardroom Consultants NYSE Letter.

<sup>334</sup> See Mercer Delta NYSE Letter and Boardroom Consultants NYSE Letter.

<sup>335</sup> See Social Investment NYSE Letter and Ethical Funds NYSE Letter.

<sup>336</sup> See Council on Foundations NYSE Letter.

<sup>337</sup> *Id.*

<sup>338</sup> See TIAA-CREF NYSE Letter.

<sup>339</sup> See Barclays NYSE Letter, Walden NYSE Letter, Social Investment NYSE Letter, Ursuline Sisters NYSE Letter, and SIO NYSE Letter.

<sup>340</sup> See Walden NYSE Letter, Social Investment NYSE Letter, Ursuline Sisters NYSE Letter, and SIO NYSE Letter.

<sup>341</sup> See Walden NYSE Letter, and SIO NYSE Letter.

<sup>342</sup> See Social Investment NYSE Letter.

<sup>343</sup> See Railways Pension NYSE Letter.

<sup>344</sup> See America's Community Bankers NYSE Letter.

<sup>345</sup> See TIAA-CREF Nasdaq Letter.

<sup>346</sup> See America's Community Bankers Nasdaq Letter.

<sup>347</sup> See ICI 2002-139 Letter.

<sup>348</sup> See Committee on Federal Regulation of Securities Letter.

<sup>349</sup> See TIAA-CREF NYSE Letter, Walden NYSE Letter, Railways Pension NYSE Letter, Ursuline Sisters NYSE Letter, and Barclays NYSE Letter.

<sup>350</sup> See TIAA-CREF NYSE Letter.

<sup>351</sup> See Computer Sciences NYSE Letter and Agilent NYSE Letter.

requiring CEO certification is too high of a standard given the myriad of rules and standards facing listed companies, and recommended requiring a representation from the CEO, rather than a certification.<sup>352</sup> The other commenter argued that the NYSE proposal should be modified to require notification of material noncompliance with the new standards by the company, and not the CEO in his or her individual capacity, for the following reasons: (1) Certification could still be made if the CEO was unavailable or unwilling to make the certification; (2) the proposal adds an element of personal liability to the CEO that the commenter believes is unduly burdensome and is not contemplated by Rule 10A-3, which only applies to non-compliance with audit-related matters; and (3) the requirement is more onerous and time-consuming than the annual certification requirement.<sup>353</sup> The commenter also recommended that the NYSE make clear that the event that triggers the reporting requirement would not create a private cause of action against the company or the CEO.

One commenter recommended that the proposal be modified to provide that the CEO certify that he or she is not aware of any "material and ongoing" violations, and that the NYSE should clarify what is not material or ongoing.<sup>354</sup>

Another commenter asked whether a company would be required to include a full text of these certifications, or a statement that the certifications have been made in its annual report.<sup>355</sup>

#### P. NYSE Public Reprimand Provision

Two commenters supported the NYSE proposal to permit the Exchange to issue public reprimand letters to non-compliant companies.<sup>356</sup> One commenter recommended that the NYSE specify that any new NYSE corporate governance rules should not create a private right of action for non-compliance.<sup>357</sup> Another commenter recommended that the NYSE research and revise this proposal separately from the remainder of the corporate governance reforms.<sup>358</sup> The commenter also stated that a provision for due process prior to issuance of a reprimand letter would be necessary for fact

checking and an opportunity to remedy the company's non-compliance.<sup>359</sup>

#### Q. Other Exemptions

One commenter strongly concurred with NYSE's exemption for closed-end funds.<sup>360</sup> Another commenter approved of the NYSE exemption for companies in bankruptcy and urged Nasdaq to adopt a similar exemption.<sup>361</sup>

#### R. Application of Rules to Foreign Private Issuers

Several commenters supported the NYSE proposal regarding private foreign issuers.<sup>362</sup> A few commenters recommended that the NYSE modify the proposal to clarify that foreign issuers would be permitted to take advantage of the accommodations for foreign issuers set forth in Rule 10A-3.<sup>363</sup>

With respect to the Nasdaq proposal regarding foreign private issuers, one commenter argued that, consistent with the NYSE proposal, the Nasdaq proposal should be amended to: (1) Automatically exempt foreign private issuers from the proposed corporate governance requirements (except for Rule 10A-3 requirements); (2) synchronize its effective date with Rule 10A-3 requirements; and (3) require disclosure of exemptions and alternative measures in a company's first annual report covering the fiscal year ending on or after July 31, 2005.<sup>364</sup>

#### S. Implementation Schedule

With respect to the NYSE's proposed implementation schedule, one commenter criticized what it viewed as a long delay in implementation of the new requirements.<sup>365</sup> Another commenter recommended coordinating the effective dates and transition periods with Rule 10A-3 requirements.<sup>366</sup>

With respect to Nasdaq's proposed implementation schedule for its Independent Director Proposal, one commenter recommended that Nasdaq adopt transition periods for compliance for newly-listed companies similar to the transition periods outlined in the NYSE proposal.<sup>367</sup> Two commenters

recommended that Nasdaq adopt transition periods for compliance for companies with classified boards similar to the transition periods outlined in the NYSE proposal.<sup>368</sup> Another commenter recommended granting small business issuers additional time to come into compliance.<sup>369</sup>

#### IV. Amendments to NYSE and Nasdaq Proposals

The discussion in Sections II.B. and C. above reflects revisions proposed in the amendments to the NYSE and Nasdaq proposals that were submitted by the NYSE and Nasdaq following publication of the NYSE Notice and the Nasdaq Notice. The discussion below summarizes those revisions.

In Amendment No. 2 to its Corporate Governance Proposal, the NYSE proposed revisions in a number of areas. The proposed revisions in Amendment No. 2 would:

- Conform the compliance dates and transition periods with those mandated for audit committees by Rule 10A-3 under the Exchange Act;
- Provide phase-in periods with respect to certain requirements for companies listing in conjunction with an initial public offering, companies emerging from bankruptcy, and companies that ceased to be Controlled Companies;
  - Revise the "look-back" periods so that the independence tests would have a one year look-back during the first year after Commission approval of the new standards, with the full look-back period becoming applicable after the end of that first year, and would shorten the periods from five years to three years;
  - Clarify that when applying look-back provisions to family members, listed companies need not consider individuals who are no longer family members due to separation or divorce, or individuals who have died or become incapacitated;
    - Indicate that references to "company" would include any parent or subsidiary in a consolidated group with the company;
    - Clarify the NYSE Employee Provision to provide that a director who is an employee, or whose immediate family member is an executive officer, of the company would not be considered independent until three years after the end of such employment relationship;
    - Provide that employment as an interim Chairman or CEO would not

<sup>359</sup> *Id.*

<sup>360</sup> See Investment Company Institute NYSE Letter.

<sup>361</sup> See Committee on Federal Regulation of Securities Letter.

<sup>362</sup> See Committee on Securities Regulation NYSE Letter, TIAA-CREF NYSE Letter, and Walden NYSE Letter.

<sup>363</sup> See Cleary NYSE Letter and Financial Services Agency NYSE Letter.

<sup>364</sup> See S&C 2002-138 Letter.

<sup>365</sup> See Eisenberg NYSE Letter.

<sup>366</sup> See Computer Sciences NYSE Letter.

<sup>367</sup> See Committee on Securities Regulation Nasdaq Letter.

<sup>368</sup> See Committee on Securities Regulation Nasdaq Letter and Whitney Nasdaq Letter.

<sup>369</sup> See National Venture Nasdaq Letter.

<sup>352</sup> See Computer Sciences NYSE Letter.

<sup>353</sup> See Agilent NYSE Letter.

<sup>354</sup> See Committee on Securities Regulation NYSE Letter.

<sup>355</sup> See Ogden Newell NYSE Letter.

<sup>356</sup> See TIAA-CREF NYSE Letter and Barclays NYSE Letter.

<sup>357</sup> See Committee on Securities Regulation NYSE Letter.

<sup>358</sup> See Computer Sciences NYSE Letter.

disqualify a director from being considered independent following that employment;

- Revise the NYSE Direct Compensation Provision to be a bright-line test, rather than a rebuttable presumption and clarify that immediate family member compensation would need only to be considered if the family member is an executive officer of the listed company;

- Revise the NYSE Business Relationship Provision to test all payments (whether to or from the listed company) against the consolidated gross revenues of the director's company, rather than also testing them against the listed company;

- Apply the look-back period in the NYSE Business Relationship Provision only to the financial relationship between the listed company and the current employer of the director, and not require the listed company to consider former employment of the director or family member;

- Clarify in the Commentary to the NYSE Business Relationship Provision that listed companies must disclose contributions to a charity of which a director serves as an executive officer, if the contributions satisfy the proposal's threshold test;

- Recommend that listed companies should hold an executive session limited solely to independent directors at least once a year;

- Revise the NYSE Compensation Committee Provision to clarify that all independent directors may be involved in approving the CEO's compensation and that the board in general is not precluded from discussing CEO compensation;

- Restructure the audit committee provisions to clearly define the audit committee requirements applicable to listed companies pursuant to Rule 10A-3;

- Exclude closed-end funds from specified provisions of section 303A, in recognition of the additional regulation to which closed-end funds are subject under the Investment Company Act;

- Require open-end funds to comply with the requirements of section 303A(6), which implement Rule 10A-3 under the Exchange Act;

- Require business development companies to comply with all of the provisions of section 303A applicable to domestic issuers, but use the "interested person" standard under section 2(a)(19) of the Investment Company Act for purposes of determining director independence; and

- Require the audit committees of open-end and closed-end funds to establish procedures for the

confidential, anonymous submission of concerns regarding questionable accounting or auditing matters by employees of the investment adviser, administrator, principal underwriter, or any other provider of accounting related services for the fund, as well as employees of the fund.

In Amendment No. 3 to its Corporate Governance Proposal, NYSE proposed to require that the audit committee charter of a closed-end or open-end fund address the responsibility of the audit committee to establish procedures for the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters, but not to require the procedures to be set forth in the charter, as would have been required by Amendment No. 2.

In Amendment No. 3 to the Nasdaq Independent Director Proposal, Nasdaq proposed revisions to various aspects of its proposal. The proposed revisions in Amendment No. 3 would:

- Narrow the definition of "Family Member;"

- Expand the relationships that would preclude a finding of independence to apply not only to directors, but also to family members of directors;

- Exclude non-discretionary charity match programs from the definition of payments that would preclude a finding of independence;

- Exclude from the Nasdaq Payments Provision loans permitted under section 13(k) of the Exchange Act;

- Expand the scope of the relationships with the company's outside auditor that preclude a finding of independence;

- Amend the Interpretive Material associated with the definition of independence to provide clarification regarding applicability of the rule, particularly with respect to directors associated with law firms, and with respect to the meaning of the term "executive officer;"

- Retain bright-line tests for determining whether a director is independent;

- Retain the same standards for both large and smaller companies;

- Add a requirement that issuers identify in their proxy those directors that the board has determined to be independent;

- Clarify that independent committees may either take action or recommend that the board take action;

- Clarify that the new requirements relating to nominations committees would not apply in cases where the right to nominate a director legally belongs to a third party, or the company

is already subject to a legally binding obligation that requires a director nomination structure inconsistent with the rule;

- Add a requirement for a nominations committee charter;

- Add a requirement that Controlled Companies be subject to the independent director executive session requirement;

- Remove a provision that would have allowed one director holding 20% or more of the company's stock to serve on the nominations committee although the director would not be independent because that director is also a company officer;

- Conform the proposals relating to audit committees to Rule 10A-3;

- Clarify that directors who have participated in the preparation of the financial statements of the company during the past three years cannot serve on the audit committee;

- Add cure periods with respect to the audit committee and majority independent board requirements that are generally consistent with the cure periods in Rule 10A-3, but extend to board vacancies as well as circumstances where a director ceases to be independent for reasons outside the director's control;

- Provide a different measure of independence for investment companies, consistent with the Investment Company Act;

- Expand NASD Rule 4350(d)(3) and its Interpretive Material to provide that audit committees of investment companies must establish procedures for the confidential, anonymous submission of concerns regarding questionable accounting or auditing matters by employees of the investment adviser, administrator, principal underwriter, or any other provider of accounting related services for the investment company, as well as employees of the investment company;

- Clarify that a director who qualifies as an audit committee financial expert under Item 401(h) of Regulation S-K or Item 401(e) of Regulation S-B is presumed to qualify as a financially sophisticated audit committee member under NASD Rule 4350(d)(2)(A); and
- Add a requirement that issuers must notify Nasdaq of any material non-compliance with NASD Rule 4350.

In amendments to the Nasdaq Issuer Applicability Proposal, Nasdaq proposed revisions in a number of areas, including in response to public comments or suggestions from Commission staff. The proposed revisions would:

- Clarify the applicability of the rules to foreign issuers;

- Clarify that: (1) Investment companies (including business development companies) are subject to all the requirements of NASD Rule 4350, except that registered management investment companies are exempt from the requirements of NASD Rule 4350(c); (2) asset-backed issuers and certain other passive issuers are exempt from the requirements of NASD Rule 4350(c) and (d); and (3) certain cooperative entities are exempt from NASD Rule 4350(c); but that each of these entities must comply with all federal securities laws, including Rule 10A-3;

- Set forth the dates by which issuers would be required to come into compliance with the proposed rule changes that are the subject of this Order;

- Add new Rules 4200A and 4350A to incorporate the sections of Rules 4200 and 4350 that would continue to apply until the proposed rule changes become operative; and

- Exempt registered management investment companies, asset-backed issuers, and unit investment trusts from the requirement of proposed subsection (n) of NASD Rule 4350 regarding codes of conduct.

In addition, Nasdaq amended its Code of Conduct Proposal to clarify that any waivers of a company's code of conduct for directors or executive officers would be required to be disclosed in a Form 8-K within five days.<sup>370</sup>

## V. Discussion

After careful review, the Commission finds that the NYSE Corporate Governance Proposal, as amended, is consistent with the Exchange Act and the rules and regulations promulgated thereunder applicable to a national securities exchange and, in particular, with the requirements of section 6(b) of the Exchange Act.<sup>371</sup> Specifically, the Commission finds that the NYSE Corporate Governance Proposal, as amended, is consistent with section 6(b)(5) of the Exchange Act<sup>372</sup> in that it is designed, among other things, to facilitate transactions in securities; to prevent fraudulent and manipulative acts and practices; to promote just and equitable principles of trade; to remove impediments to and perfect the mechanism of a free and open market and a national market system; and in general, to protect investors and the

public interest, and does not permit unfair discrimination among issuers.

After careful review, the Commission finds that the Nasdaq Independent Director Proposal, as amended; the Nasdaq Going Concern Proposal; the Nasdaq Related Party Transactions Proposal, as amended; the Nasdaq Issuer Applicability Proposal, as amended; and the Nasdaq Code of Conduct Proposal, as amended, are consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to a national securities association.<sup>373</sup> The Commission finds that these Nasdaq proposed rule changes, as amended, are consistent with provisions of section 15A of the Exchange Act,<sup>374</sup> in general, and with section 15A(b)(6) of the Exchange Act,<sup>375</sup> in particular, in that they are designed, among other things, to facilitate transactions in securities; to prevent fraudulent and manipulative acts and practices; to promote just and equitable principles of trade; to remove impediments to and perfect the mechanism of a free and open market and a national market system; and in general, to protect investors and the public interest, and do not permit unfair discrimination among issuers.

Recent corporate scandals have shaken investor confidence in the securities markets because of breaches of trust, failures of responsibility, breakdowns in governance, and lack of candid disclosure. These developments led to the enactment of the Sarbanes-Oxley Act, which, among other things, directed the Commission to undertake rulemaking in a number of areas, including mandatory listing standards to be adopted by self-regulatory organizations ("SROs") concerning the composition and function of listed issuers' audit committees. One of the main goals of the Sarbanes-Oxley Act is to improve investor confidence in the financial integrity of listed issuers, which in turn will promote confidence in the markets for listed issuers' securities.

Through their corporate governance listing standards, the SROs play an important role in assuring that their listed issuers establish good governance practices and maintain effective oversight of the reliability of corporate

financial information. A few years ago, several exchanges and Nasdaq implemented rules to strengthen the effectiveness of their listed companies' audit committees; these rules were adopted in response to the recommendations of the Blue Ribbon Committee.<sup>376</sup> More recently, at the urging of the Commission's Chairman at the time, the exchanges and Nasdaq undertook a review of their corporate governance listing standards with the objective of strengthening their rules. In April of this year, in response to a directive of the Sarbanes-Oxley Act, the Commission adopted Rule 10A-3 under the Exchange Act. Rule 10A-3 requires the rules of the national securities exchanges or national securities associations to prohibit the initial or continued listing of any security of an issuer that is not in compliance with the rule's requirements regarding issuer audit committees. As a result of Commission and Congressional initiatives, the NYSE and Nasdaq proposed rule changes that are intended to assure that a listed issuer's board of directors and key committees are comprised in a manner that is designed to provide an objective oversight role and that directors and management adhere to high standards of conduct. In addition, the proposals are intended to strengthen the independence of audit committees, including by establishing rules designed to assure listed issuers' compliance with the requirements of Rule 10A-3.

In the Commission's view, the NYSE and Nasdaq proposals that are the subject of this Order will foster greater transparency, accountability and objectivity in the oversight by, and decision-making processes of, the boards and key committees of listed issuers. The NYSE and Nasdaq proposals also will promote compliance with high standards of conduct by the issuers' directors and management. In addition, in the Commission's view, the NYSE Corporate Governance Proposal and the Nasdaq Independent Director Proposal satisfy the mandate of Rule 10A-3, which requires that the rules of a national securities exchange or national securities association prohibit the initial or continued listing of any security of an issuer that is not in compliance with the requirements of any portion of paragraph (b) or (c) of Rule 10A-3. In this regard, the NYSE Corporate Governance Proposal and the Nasdaq Independent Director Proposal will promote independent and objective review and oversight of an issuer's financial reporting practices.

<sup>370</sup> See also *supra* notes 14, 18-19, 22-24, 28.

<sup>371</sup> 15 U.S.C. 78f(b). In approving the NYSE Corporate Governance Proposal, the Commission has considered the proposed rules' impact on efficiency, competition and capital formation. 15 U.S.C. 78c(f).

<sup>372</sup> 15 U.S.C. 78f(b)(5).

<sup>373</sup> In approving the Nasdaq Independent Director Proposal, the Nasdaq Going Concern Proposal, the Nasdaq Related Party Transactions Proposal, the Nasdaq Issuer Applicability Proposal, and the Nasdaq Code of Conduct Proposal the Commission has considered the proposed rules' impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>374</sup> 15 U.S.C. 78o-3.

<sup>375</sup> 15 U.S.C. 78o-3(b)(6).

<sup>376</sup> See *supra* note.

The Commission has long encouraged exchanges to adopt and strengthen their corporate governance listing standards in order to, among other things, enhance investor confidence in the securities markets. The Commission believes that, with these proposals, NYSE and Nasdaq have made significant strides in strengthening their corporate governance listing standards. The Commission notes that many commenters generally supported the NYSE's and Nasdaq's initiatives, although some commenters offered suggestions to clarify, improve, or reconcile various provisions of the proposals. Accordingly, NYSE and Nasdaq amended their proposals to respond to specific issues raised by the commenters; and to harmonize their respective rule proposals in certain areas. The Commission discusses below significant aspects of the NYSE and Nasdaq corporate governance proposals.

#### *Definition of "Independent Director" and Composition of Board of Directors*

Both NYSE and Nasdaq propose to require listed issuers to have a majority of independent directors on their boards; require the boards of listed issuers to make an affirmative determination of independence and provide information to investors about their determinations; and identify certain relationships that automatically preclude a board finding of independence.

A number of commenters supported these rule amendments, although a few commenters voiced their objections. The Commission believes that requiring boards to have a majority of independent directors should increase the likelihood that boards will make decisions in the best interests of shareholders. The Commission further believes that requiring boards to make an affirmative determination of independence, and to disclose these determinations, will increase the accountability of boards to shareholders and give shareholders the ability to evaluate the quality of a board's independence and its independence determinations.

The Commission also believes that, by tightening the definition of "independent director," the NYSE and Nasdaq rule revisions appropriately prohibit many relationships that otherwise could impair the independence of directors, such as employment, business, financial, and family relationships. The Commission believes that the listing standards as proposed by the NYSE and Nasdaq provide objective and clear guidance for evaluating a director's independence.

Accordingly, these new listing standards will establish criteria for independence that can be consistently and fairly applied by companies. The Commission also notes that, in addition to incorporating specific factors that preclude a director from being considered independent, the NYSE and Nasdaq provisions require a board to further exercise appropriate discretion to identify any additional material relationship that the director may have with the listed issuer that could interfere with the director's ability to exercise independent judgment.

The Commission also believes that requiring an issuer to disclose in its annual proxy (or annual report on Form 10-K for an issuer that does not file a proxy) its determination regarding those directors it has deemed to be independent will provide greater transparency to the governance process. In addition, the Commission believes it is appropriate for NYSE to require that non-management directors meet at regularly scheduled executive sessions, and for Nasdaq to impose a similar requirement with respect to independent directors meeting in regularly-scheduled executive sessions.

The Commission notes that the NYSE and Nasdaq amended their proposals regarding the independence of directors to respond to concerns or suggestions raised by the commenters or to harmonize more closely various provisions of their proposals to reduce the possibility of differing regulatory treatment. In this regard, the NYSE tightened the definition of "independent director" to state that an employee of the company (or an individual whose immediate family member is an executive officer) is not independent until a specified period after the end of such employment relationship, which is similar to a provision that was proposed by Nasdaq. The NYSE also revised language of the NYSE Business Relationship Proposal by adding language to indicate that the term "company" included parents and subsidiaries. As a result of these changes, the NYSE and Nasdaq provisions are more closely aligned.

In addition, the NYSE revised its provision regarding a director or immediate family member's receipt of \$100,000 in direct compensation from a rebuttable presumption to a bright-line test, which aligns this provision more closely with the test proposed by Nasdaq. The NYSE also amended the length of its look-back periods from five years to three years and revised the phase-in of its look-back proposal so that the full three-year look-back period would be implemented one year after

the Commission's approval of the proposed rule change. As a result of the revisions to the look-back periods, the NYSE narrowed differences in how the NYSE and Nasdaq rules would be applied. Similar to Nasdaq's proposal, the NYSE added a presumption of financial expertise for directors who satisfy the definition of audit committee financial expert set out in Item 401(h) of Regulation S-K.

The Commission notes that Nasdaq also has revised the Nasdaq Independent Director Proposal to take into account the concerns or suggestions of commenters and to bring its proposal into greater harmony with the NYSE Corporate Governance Proposal. In response to commenters' concerns about the clarity of the Nasdaq Independent Director Proposal, Nasdaq set forth more clearly how the terms "subsidiary," and "executive officer" would be defined; indicated that the three-year look-back would apply to relationships that existed at any time within the three-year period; and noted that an independent director who serves on the boards of both a holding company and a subsidiary would not be considered an affiliate of either entity merely as a result of such service. Nasdaq also revised the Nasdaq Independent Director Proposal to provide that loans permitted by section 13(k) of the Exchange Act and compensation for service on board committees were permissible payments. Nasdaq also has extended certain prohibitions to the family members of directors under the amended definition. For example, a director would not be considered independent if a family member of a director is a controlling shareholder or executive officer of any organization to which the company made or from which the company received, payments for property or services in the current or any of the past three fiscal years that exceed 5% of the recipient's consolidated gross revenues for that year or \$200,000, whichever is more. In addition, Nasdaq expanded the scope of relationships with the company's outside auditor that would preclude a finding of independence. A director would not be considered independent if he or she is a partner of the company's outside audit firm or if one of his or her family members is a partner of the outside audit firm. Finally, Nasdaq narrowed the definition of "Family Member" and required the issuer to disclose those directors that it has determined to be independent; both of these changes conform the Nasdaq and NYSE proposals more closely.

### *Nomination of Directors*

The NYSE Corporate Governance Proposal requires each issuer to have a nominating committee that is comprised entirely of independent directors, while the Nasdaq Independent Director Proposal would require the issuer's director nominees to be selected or recommended for the board's selection by a majority of the independent directors or by a nominating committee comprised solely of independent directors. In addition, the NYSE proposal requires that the nominating committee have a written charter that addresses the committee's purpose and responsibilities and an annual performance evaluation of the committee; the Nasdaq proposal requires each issuer to certify that it has adopted a formal written charter or a board resolution addressing the nominations process and such related matters as may be required under the Federal securities laws. With Nasdaq's addition of the written charter requirement, the NYSE and Nasdaq nominating committee proposals are more closely aligned. The commenters who provided their views on independent nominating committees generally supported the NYSE and Nasdaq proposals, although a few of them suggested revisions.

The Commission believes that directors that are independent of management are more likely to support the nomination of qualified, independent directors, and that a written document governing the nominating committee is beneficial in that it would describe the process used to identify board candidates and the criteria for selecting or recommending those candidates. Therefore, the Commission believes that the NYSE and Nasdaq nominating committee provisions are appropriate. In the Commission's view, the NYSE and Nasdaq proposals relating to the definition of "independent director" are a reasonable approach to enable a listed issuer to ascertain whether an individual is truly independent of the issuer. Moreover, the NYSE and Nasdaq proposals requiring a majority of the board to be independent should help to serve shareholders' interests by assuring that key decisions are considered by a board comprised of a majority of individuals without relationships to the issuer that otherwise could impair their judgment.

### *Compensation of Officers*

The NYSE Compensation Committee Provision requires each issuer to have a compensation committee composed

entirely of independent directors that, either as a committee or together with the other independent directors, determines and approves the CEO's compensation, and that makes recommendations to the board with respect to non-CEO compensation. The committee is required to have a written charter addressing the committee's purpose and responsibilities. The Nasdaq Compensation of Executives Provision requires the compensation of the CEO and other executive officers of an issuer to be determined or recommended to the board for determination either by a majority of independent directors or by a compensation committee comprised solely of independent directors. The Nasdaq proposal stipulates that the CEO may not be present during voting or deliberations on the CEO's compensation. In addition, if the committee has at least three members, the Nasdaq proposal permits one director who is not independent and is not a current officer or employee or Family Member of such person to be appointed to the committee for a limited term if the board, under exceptional and limited circumstances, determines that such individual's membership is required and discloses the nature of the relationship and the reasons for the determination.

A number of commenters disapproved of the NYSE's original proposal because it would have given the compensation committee the sole authority to determine CEO compensation. The Commission notes that, in response to these comments, NYSE revised its proposal to state that the committee's responsibility is to determine and approve the CEO's compensation level either as a committee or together with the other independent directors, and made clear that the revised provision does not preclude discussion of CEO compensation with the board generally. Nasdaq also amended its proposal to clarify that an issuer has the flexibility to empower a compensation committee either to take action itself or to recommend that the board take action.

The Commission believes that directors that are independent of management are more likely to evaluate the performance of the CEO and other officers impartially and to award compensation on an objective basis. The Commission believes that the new standards that NYSE and Nasdaq have proposed with respect to how listed companies determine the compensation of their officers are appropriate.

### *Audit Committee and Compliance With Rule 10A-3*

Both NYSE and Nasdaq proposed to strengthen their listing requirements regarding audit committees. Both require listed issuers to comply with the standards set forth in Rule 10A-3, and both elected to adopt the cure period provided in Rule 10A-3(a)(3) for audit committee members who cease to be independent for reasons outside their reasonable control. Both NYSE and Nasdaq retain the requirement that listed issuers have an audit committee that is comprised of at least three directors. Moreover, audit committee members are required to meet the NYSE's or Nasdaq's respective definitions of independence in addition to the independence requirements of Rule 10A-3. The NYSE proposal also requires a special board determination and disclosure in certain instances if an audit committee member simultaneously serves on the audit committee of more than three public companies. The Nasdaq proposal includes a limited exceptional and limited circumstances exception for its non-Rule 10A-3 independence standards and a cure period for certain audit committee vacancies.

Both the NYSE and Nasdaq proposals retain the current provisions that require each member of the audit committee to meet financial literacy requirements and that at least one audit committee member have increased financial sophistication. Regarding the latter requirement, both proposals provide that a director who qualifies as an audit committee financial expert under Commission rules is presumed to qualify for the increased sophistication requirements.

The NYSE and Nasdaq proposals retain the requirement that the audit committee have a written charter that addresses the committee's purpose and responsibilities, and add that the audit committee's responsibilities under Rule 10A-3 must be included. In addition, the NYSE proposal requires that the audit committee charter address an annual performance evaluation of the audit committee.

As with the NYSE and Nasdaq general independence proposals, a number of commenters supported these rule amendments, while a few voiced their concerns. Several commenters, writing before the NYSE and Nasdaq filed amendments to the proposals, requested that the audit committee proposals be reconciled with Rule 10A-3. Others requested clarification of the proposals.

In the Commission's view, an audit committee comprised of independent

directors is better situated to assess objectively the quality of the issuer's financial disclosure and the adequacy of internal controls than a committee that includes members who are affiliated with management. By increasing the independence and competence of audit committees, the amendments are designed to further greater accountability and to improve the quality of financial disclosure and oversight of the financial reporting process. The Commission believes that vigilant and informed oversight by a strong, effective and independent audit committee should help to counterbalance pressures to misreport results and will impose increased discipline on the process of preparing financial information. Improved oversight may help detect fraudulent financial reporting earlier and perhaps thus deter it or minimize its effects. All of these benefits should promote increased market efficiency due to improved information and investor confidence in the reliability of a company's financial disclosure and system of internal controls.

The Commission notes that the NYSE and Nasdaq proposals enhance audit committee independence by implementing the criteria for independence enumerated in Rule 10A-3. In addition, the NYSE and Nasdaq amendments regarding the definition of "independent director" restrict additional relationships not specified in Rule 10A-3 and contain look-back periods to create a comprehensive overall standard for audit committee member independence. As the Commission noted in its release adopting Rule 10A-3,<sup>377</sup> it expected that the definition of independence contained in Rule 10A-3 would build and rely on the enhanced independence definitions that SROs adopt through rulemaking conducted under Commission oversight to significantly improve existing standards of independence for audit committee members and thereby help assure strong, independent audit committees.

In addition, the Commission believes that requiring companies to specify the enhanced audit committee responsibilities in their formal written charters, and to delineate how the committee carries out those responsibilities, will help to assure that 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 NYSE and

Nasdaq proposals explicitly require the audit committee to have the duties and responsibilities specified in Rule 10A-3, including direct responsibility for the appointment, compensation, retention and oversight of the company's outside auditor; the ability to engage outside advisors; the ability to obtain funding for the audit committee and its outside advisors; and the responsibility to establish procedures for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters, including procedures for the confidential, anonymous submission of employee complaints.

The Commission notes that these heightened standards complement existing listing standards adopted by NYSE and Nasdaq as a result of the Blue Ribbon Committee's report and retained under the new proposals. The existing standards include the requirement that each issuer have an audit committee composed of at least three independent directors who are able to read and understand financial statements, thus helping to ensure that the committee as a whole is financially literate. Moreover, one member of the audit committee is required to have additional financial expertise or sophistication, thus further enhancing the effectiveness of the audit committee in carrying out its financial oversight responsibilities.

The Commission notes that the NYSE and Nasdaq amended their proposals regarding audit committees to respond to concerns raised by commenters or to adopt commenters' suggestions. In addition, the NYSE and Nasdaq made a number of revisions to their proposals to conform their original proposals, which were submitted before Commission approval of Rule 10A-3, to the requirements in Rule 10A-3 as adopted by the Commission. Several of the commenters' concerns regarding the original proposals, such as those relating to the prohibition on "affiliate" status for audit committee members, were addressed in the Commission's adoption of Rule 10A-3 and the conforming amendments submitted by NYSE and Nasdaq. In addition, in this regard, Nasdaq removed a provision in its original proposal that would have permitted directors who own or control less than 20% of a company's stock to be audit committee members. The NYSE and Nasdaq also added various clarifications in their rules in response to comment. For example, both proposals state that a person who satisfies the Commission's definition of an audit committee financial expert is presumed to have requisite financial expertise. In addition, the NYSE and

Nasdaq made changes to their proposals to address the rules' application to investment companies.

The Commission believes that the NYSE and Nasdaq proposals regarding audit committees are appropriate and are consistent with section 10A(m)<sup>378</sup> of the Exchange Act and Rule 10A-3 thereunder.<sup>379</sup>

#### *Code of Conduct*

Both the NYSE and Nasdaq proposed to require listed issuers to adopt and make publicly available a code of conduct with enforcement provisions applicable to all directors, officer, and employees, and to require any waivers of the code for directors or executive officers to be disclosed. A number of commenters supported these rule amendments, although a few commenters provided suggestions for improving the proposals. The Commission believes that requiring listed issuers to adopt a code of conduct should help to foster the ethical behavior of directors, officers, and employees because directors, officer and employees will know the standards of conduct expected of them in ethically fulfilling the responsibilities of their positions and will be made fully cognizant that their actions will be monitored. The Commission also believes that requiring the code of conduct and any waivers of the code for directors and executive officers to be disclosed will provide shareholders the opportunity to evaluate the quality of a company's code and the ability to scrutinize significant waivers of its provisions.

#### *Applicability to Registered Management Investment Companies, Certain Other Entities, and Foreign Private Issuers*

Both the NYSE and Nasdaq proposed to exempt management investment companies that are registered under the Investment Company Act from the new requirements relating to board independence and the role of independent directors in nomination and compensation decisions. The Commission believes that this exemption is reasonable, because the Investment Company Act already assigns important duties of investment company governance, such as approval of the investment advisory contract, to independent directors. Further, many of the Commission's exemptive rules under the Investment Company Act require investment companies relying on those rules to have a majority of independent directors, and require

<sup>377</sup> Securities Act Release No. 8220 (April 9, 2003), 68 FR 18788 (April 16, 2003).

<sup>378</sup> 15 U.S.C. 78j-1(m).

<sup>379</sup> 17 CFR 240.10A-3.

those independent directors to select and nominate other independent directors.

The Commission also notes that registered management investment companies will still be required to comply with the new rules relating to audit committees, consistent with Rule 10A-3. In addition, business development companies will be required to comply with all of the new requirements under both proposals, but will be required to use the "interested person" standard under the Investment Company Act for purposes of determining director independence.

Both NYSE and Nasdaq further proposed to exempt asset-backed issuers and other passive issuers from the new requirements relating to board independence and independent director role in nomination and compensation decisions, as well as from the new requirements relating to audit committees. The Commission believes that such an exemption is reasonable, and notes that such entities are exempt from the requirements of Rule 10A-3.

The Commission further believes that other proposed provisions relating to limited partnerships, companies in bankruptcy, and cooperative entities are reasonable, given the specific characteristics of these entities. The Commission notes that these provisions have been designed for consistency with Rule 10A-3.

The NYSE proposal would permit foreign private issuers to follow home country practice in lieu of the provisions of the new rules, except that such issuers would be required to comply with the requirements relating to audit committees and notification of non-compliance mandated by Rule 10A-3. In addition, foreign private issuers would be required to disclose significant ways in which their corporate governance practices differ from the standards that NYSE requires of domestic companies. The Nasdaq Issuer Applicability Proposal clarifies that Nasdaq's existing authority under its rules to provide exemptions from its corporate governance standards as necessary so that a foreign private issuer is not required to do any act that is contrary to home country laws or business practices does not apply to the extent that it would be contrary to the requirements of Rule 10A-3. Nasdaq would also require a foreign private issuer to disclose each domestic requirement from which it is exempted, and to describe the home country practice, if any, followed by the issuer in lieu of domestic requirements. The Commission believes that granting exemptions to foreign private issuers in

deference to their home country practices—so long as they comply with Rule 10A-3 requirements—is appropriate, and believes that the disclosure requirement will help investors determine whether they are satisfied with the alternate standards.

#### *Nasdaq Going Concern Proposal*

Nasdaq proposed to require each listed company that receives an audit opinion that contains a going concern qualification to make a public announcement of such event. No commenters offered their views on this proposal. The Commission believes this requirement will help to bring to the attention of investors and potential investors the receipt of a going concern qualification by a company, which the Commission believes is important information for shareholders.

#### *Nasdaq Related Party Transactions Proposal*

Nasdaq proposed to strengthen its current rule addressing the review of related party transactions to provide that all such transactions would not only need to be reviewed for potential conflict of interest situations on an ongoing basis, but that all such transactions would also have to be approved by the listed company's audit committee or another independent body of the board of directors. No comments were received on this proposal. The Commission believes that requiring an independent body of the board of directors to approve all related party transactions should help to protect investors because directors not related to management should be less likely to approve of related party transactions that could be detrimental to the interests of shareholders.

#### *Implementation Dates and Transition Periods*

The Commission notes that both NYSE and Nasdaq have amended the compliance dates and the transition periods associated with the new standards relating to director independence, board committees, and notification of non-compliance so that the periods are consistent with the transition period for Rule 10A-3. The Commission believes that this revision will provide for ease of implementation. Accordingly, companies will be expected to begin complying with these new listing standards as of the earlier of their first annual meeting after January 15, 2004 or October 31, 2004, except as otherwise provided in the case of foreign private issuers, small business issuers, and initial public offerings

consistent with Rule 10A-3.<sup>380</sup> The Commission further believes that the proposed provisions relating to companies transferring their listing from one market to another are reasonable and appropriate.

#### **VI. Accelerated Approval of NYSE Amendment Nos. 2 and 3, Amendment Nos. 2, 3, 4, and 5 to the Nasdaq Independent Director Proposal, Amendment Nos. 2 and 3 to the Nasdaq Related Party Proposal, Amendment Nos. 1, 2, and 3 to the Nasdaq Issuer Applicability Proposal, and Amendment No. 2 to the Nasdaq Code of Conduct Proposal**

The Commission finds good cause for approving NYSE Amendment Nos. 2 and 3, Amendment Nos. 2, 3, 4 and 5 to the Nasdaq Independent Director Proposal, Amendment Nos. 2 and 3 to the Nasdaq Related Party Proposal, Amendment Nos. 1, 2, and 3 to the Nasdaq Issuer Applicability Proposal, and Amendment No. 2 to the Nasdaq Code of Conduct Proposal prior to the thirtieth day after the amendments are published for comment in the **Federal Register** pursuant to section 19(b)(2) of the Exchange Act.

The Commission believes that NYSE Amendment Nos. 2 and 3, Amendment Nos. 2, 3, 4, and 5 to the Nasdaq Independent Director Proposal, and Amendment Nos. 2 and 3 to the Nasdaq Issuer Applicability Proposal address many concerns raised in the comment letters. Other changes provide more guidance regarding certain provisions that needed further clarification or were added to bring greater harmony to the NYSE and Nasdaq proposals. As discussed above, the Commission believes that these proposed rule changes, as amended, are reasonable and appropriate and serve the interests of the investing public. The Commission further believes that accelerating the approval of these amendments will enable NYSE and Nasdaq to put into place a complete and comprehensive set of corporate governance standards for listed companies in time for the 2004 proxy season. In addition, the NYSE and Nasdaq provisions relating to audit committees respond to the mandate of Rule 10A-3, which requires SROs to have such rules in place by December 1, 2003.

<sup>380</sup> The Nasdaq Going Concern Proposal, however, is effective immediately upon adoption, and issuers will be required to comply with the Nasdaq Code of Conduct Proposal six months from the date of Commission approval. In addition, foreign issuers will be required to disclose receipt of a corporate governance exemption from Nasdaq for new filings and listings made after January 1, 2004.

In Amendment No. 2 to the Nasdaq Related Party Proposal, Nasdaq proposes to restore language that was deleted in the original proposal that clarifies that an issuer's review of all related party transactions must be for potential conflict of interest situations.<sup>381</sup> The Commission believes that these changes clarify the application of the proposal, and do not raise any new issues. In Amendment No. 3 to the Nasdaq Related Party Proposal, Nasdaq proposes that the Related Party Proposal become effective on January 15, 2004, in order to minimize disruption to existing issuer audit committees.<sup>382</sup> The Commission believes that this change will ease implementation of the rule.

In Amendment No. 2 to the Nasdaq Code of Conduct Proposal, Nasdaq proposes to renumber the paragraph in NASD Rule 4350(n) containing its provisions, add a cross-reference to the definition of a code of ethics promulgated under the Sarbanes-Oxley Act, and to require any waivers of a code of conduct to be disclosed in a Form 8-K within five days.<sup>383</sup> The Commission believes that the amendment clarifies the application of the proposal, provides a specific manner in which the disclosure requirement must be fulfilled, and does not raise any new issues.

The Commission therefore believes that accelerated approval of NYSE Amendment Nos. 2 and 3, Amendment Nos. 2, 3, 4, and 5 to the Nasdaq Independent Director Proposal, Amendment Nos. 2 and 3 to the Nasdaq Related Party Proposal, Amendment Nos. 1, 2, and 3 to the Nasdaq Issuer Applicability Proposal, and Amendment No. 2 to the Nasdaq Code of Conduct Proposal is appropriate. Based on the above, the Commission finds, consistent with sections 6(b)(5)<sup>384</sup> and 19(b)<sup>385</sup> of the Exchange Act, that good cause exists to accelerate approval of NYSE Amendment Nos. 2 and 3; and, consistent with sections 15A(b)(6)<sup>386</sup> and 19(b) of the Exchange Act, that good cause exists to accelerate approval of Amendment Nos. 2, 3, 4, and 5 to the Nasdaq Independent Director Proposal, Amendment Nos. 2 and 3 to the Nasdaq Related Party Proposal, Amendment Nos. 1, 2, and 3 to the Nasdaq Issuer Applicability Proposal, and Amendment

No. 2 to the Nasdaq Code of Conduct Proposal.

## VII. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning NYSE Amendment Nos. 2 and 3, Amendment Nos. 2, 3, 4, and 5 to the Nasdaq Independent Director Proposal, Amendment Nos. 2 and 3 to the Nasdaq Related Party Proposal, Amendment Nos. 1, 2, and 3 to the Nasdaq Issuer Applicability Proposal, and Amendment No. 2 to the Nasdaq Code of Conduct Proposal, including whether these amendments are consistent with the Exchange 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 offices of the NYSE and Nasdaq. All submissions should refer to File No. SR-NYSE-2002-33, SR-NASD 2002-141, SR-NASD-2002-77, SR-NASD-2002-80, SR-NASD-2002-138 and SR-NASD-2002-139, and should be submitted by December 3, 2003.

## VIII. Conclusion

For the foregoing reasons, the Commission finds that the proposed rule change, SR-NYSE-2002-33, as amended, is consistent with the Exchange Act and the rules and regulations thereunder applicable to a national securities exchange, and, in particular, with section 6(b)(5) of the Exchange Act<sup>387</sup>; and that the proposed rule changes, SR-NASD 2002-141, as amended; SR-NASD-2002-77; SR-NASD-2002-80, as amended; SR-NASD-2002-138, as amended; and SR-NASD-2002-139, as amended, are consistent with the Exchange Act and the rules and regulations thereunder applicable to a national securities association, and, in particular, with section 15A(b)(6) of the Exchange Act.<sup>388</sup>

*It is therefore ordered*, pursuant to section 19(b)(2) of the Exchange Act,<sup>389</sup> that the proposed rule changes, SR-NYSE-2002-33, as amended; SR-NASD 2002-141, as amended; SR-NASD-2002-77; SR-NASD-2002-80, as amended; SR-NASD-2002-138, as amended; and SR-NASD-2002-139, as amended, are approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>390</sup>

**Jill M. Peterson,**  
Assistant Secretary.

*Exhibit A*

*Comment Letters Relating to SR-NYSE-2002-33, the NYSE Corporate Governance Proposal*

1. Letter from Timothy J. Adams, General Counsel, Labor Ready, Inc., to Jonathan G. Katz, Office of the Secretary, Commission, dated August 22, 2002 ("Labor Ready NYSE Letter").
2. Letter from Timothy Smith, Senior Vice President, Walden Asset Management, to Mr. Harvey Pitt, Chairman, Commission, dated August 23, 2002 ("Walden NYSE Letter").
3. Letter from Frank Curtis, Special Projects Officer, Railways Pension Trustee Company Limited, to Mr. H Pitt, Chairman, Commission, dated July 31, 2002 ("Railways Pension NYSE Letter").
4. Letter from Timothy H. Smith, President, and Alisa Gravit, Vice President, Social Investment Forum, to Mr. Harvey L. Pitt, Commission, dated August 6, 2002 ("Social Investment NYSE Letter").
5. Letter from Douglas H. Philipsen, Chairman, President and Chief Executive Officer, Independent Bank Corp., to Mr. Hardwick Simmons, Chairman and Chief Executive Officer, Nasdaq, dated August 26, 2002 ("Independent Bank Corp NYSE Letter").
7. Letter from Thomas F. Ray, Brookstreet Securities, to Mr. Harvey L. Pitt, Chairman, Commission, dated September 10, 2002 ("Brookstreet Securities NYSE Letter").
8. Letter from Valerie Heinonen, o.s.u., Consultant, Corporate Social Responsibility, Ursuline Sisters of Tildonk "U.S. Province, to Harvey Pitt, Chair, Commission, dated August 27, 2002 ("Ursuline Sisters NYSE Letter").
9. Letter from David M. Dobkin, CFP, First Affirmative Financial Network, Cambridge Investment Research, Inc. to Mr. Harvey L. Pitt, Chairman, Commission, dated September 6, 2002 ("Dobkin NYSE Letter").
10. Letter from Robert Walker, Vice President, SRI Policy and Research, Ethical Funds Inc., to Mr. Harvey L. Pitt, Chairman, Ms. Cynthia A. Glassman, Commissioner, Mr. Harvey J. Goldschmid, Commissioner, Mr. Roel C. Campos, Commissioner, Mr. Paul S. Atkins, Commissioner, Commission, dated September 6, 2002 ("Ethical Funds NYSE Letter").
11. Letter from Alastair Ross Goobey, Chairman of the Board, International

<sup>381</sup> See Amendment No. 2 to the Nasdaq Related Party Proposal.

<sup>382</sup> See Amendment No. 3 to the Nasdaq Related Party Proposal.

<sup>383</sup> See Amendment No. 2 to the Nasdaq Code of Conduct Proposal.

<sup>384</sup> 15 U.S.C. 78f(b)(5).

<sup>385</sup> 15 U.S.C. 78s(b).

<sup>386</sup> 15 U.S.C. 78o-3(b)(6).

<sup>387</sup> 15 U.S.C. 78f(b)(5).

<sup>388</sup> 15 U.S.C. 78o-3(b)(6).

<sup>389</sup> 15 U.S.C. 78s(b)(2).

<sup>390</sup> 17 CFR 200.30-3(a)(12).

Corporate Governance Network, to Mr. Harvey Pitt, Chairman, Commission, dated August 16, 2002 ("International Corporate Governance NYSE Letter").

12. Letter from Sarah A.B. Teslik, Executive Director, Council of Institutional Investors, to Harvey L. Pitt, Chairman, Commission, dated August 1, 2002 ("Council of Institutional Investors NYSE Letter").

13. Letter from Linda Selbach, Barclays Global Investors, to Mr. James Cochrane, Senior Vice President, Strategy and Planning, NYSE, dated July 18, 2002 ("Barclays NYSE Letter").

14. E-mail from Walter J. Coleman, dated May 2, 2003 ("Coleman NYSE E-mail").

15. Letter from David A. Nadler, Ph.D., Mercer Delta Consulting, to Mr. Jonathan Katz, Secretary, Commission, dated November 20, 2002 ("Mercer Delta NYSE Letter").

16. Letter from Roger M. Kenny, Managing Partner, Boardroom Consultants, to Mr. Jonathan Katz, Secretary, Commission, dated December 6, 2002 ("Boardroom Consultants NYSE Letter").

17. Letter from Robert H. Cohen, Esq., Morrison Cohen Singer & Weinstein, LLP, to Commission, Attention Jonathan Katz, Secretary, dated December 17, 2002 ("Morrison Cohen NYSE Letter").

18. Memo from Wachtell, Lipton, Rosen & Katz, Financial Institutions Developments, Solving The Proposed Director Independence Standards for Bank Holding Company Directors, by Edward D. Herlihy, Craig M. Wasserman, Richard K. Kim, Lawrence S. Makow, and Nicholas G. Demmo, dated February 10, 2003 ("Wachtell NYSE Memo").

19. Letter from Jay W. Lorsch, to Ms. Janice O'Neill, Vice President, Corporate Governance, NYSE, dated May 5, 2003 ("Lorsch NYSE Letter").

20. Letter from Leon J. Level, Chief Financial Officer, Computer Sciences Corporation, to Jonathan G. Katz, Secretary, Commission, dated May 5, 2003 ("Computer Sciences NYSE Letter").

21. Letter from Eberhard G. H. Schmoller, Senior Vice President and General Counsel, CNF Inc., to Jonathan G. Katz, Secretary, Commission, dated May 5, 2003 ("CNF NYSE Letter").

22. Letter from William J. Casazza, Vice President, Deputy General Counsel and Corporate Secretary, Aetna, to Jonathan G. Katz, dated May 6, 2003 ("Aetna NYSE Letter").

23. Letter from Stuart A. Sheldon, Dow, Lohnes & Albertson, PLLC, to Jonathan G. Katz, Secretary, Commission, dated May 7, 2003 ("Dow Lohnes NYSE Letter").

24. Letter from Thomas E. Rutledge, Ogden Newell & Welch PLLC, to Jonathan G. Katz, Secretary, Commission, dated May 1, 2003 ("Ogden Newell NYSE Letter").

25. Letter from Brian Krolicki, President, National Association of State Treasurers, to Jonathan G. Katz, Secretary, Commission, dated May 2, 2003 ("National Association of State Treasurers NYSE Letter").

26. Letter from Evelyn Cruz Sroufe, Perkins Coie LLP, to Jonathan G. Katz, Secretary, Commission, dated May 5, 2003 ("Perkins Coie NYSE Letter").

27. Letter from C.W. Mueller, Chairman and CEO, Ameren Corporation, to Jonathan

G. Katz, Secretary, Commission, dated May 5, 2003 ("Ameren NYSE Letter").

28. Letter from Naohiko Matsuo, Director for International Financial Markets, Financial Services Agency, Government of Japan, to Jonathan G. Katz, Secretary, Commission, dated May 8, 2003 ("Financial Services Agency NYSE Letter").

29. Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Commission, dated May 8, 2003 ("Investment Company Institute NYSE Letter").

30. Letter from Stacy L. Fox, Senior Vice President, General Counsel and Secretary, Visteon Corporation, to Jonathan G. Katz, Secretary, Commission, dated May 6, 2003 ("Visteon NYSE Letter").

31. Letter from Simon B. Halfin, Counsel, Peoples Energy Corporation, to Jonathan G. Katz, Secretary, Commission, dated May 7, 2003 ("Peoples Energy NYSE Letter").

32. Letter from Patrick T. Mulva, Vice President, Investor Relations and Secretary, Exxon Mobil Corporation, to Jonathan G. Katz, Secretary, Commission, dated May 7, 2003 ("Exxon NYSE Letter").

33. Letter from Robert S. Singley, Vice President and Assistant Secretary, Wells Fargo & Company, to Secretary, Commission, dated May 7, 2003 ("Wells Fargo NYSE Letter").

34. Letter from Ned Barnholt, Chairman, President and CEO, Agilent Technologies, to Secretary, Commission, dated May 7, 2003 ("Agilent NYSE Letter").

35. Letter from Peter C. Clapman, Senior Vice President and Chief Counsel, Corporate Governance, TIAA-CREF, to Jonathan G. Katz, Secretary, Commission, dated May 6, 2003 ("TIAA-CREF NYSE Letter").

36. Letter from Charlotte M. Bahin, Senior Vice President, Regulatory Affairs, America's Community Bankers, to Jonathan G. Katz, Secretary, Commission, dated May 8, 2003 ("America's Community Bankers NYSE Letter").

37. Letter from Janne G. Gallagher, Vice President General Counsel, Council on Foundations, to Jonathan G. Katz, Secretary, Commission, dated May 8, 2003 ("Council on Foundations NYSE Letter").

38. Letter from Gregory E. Lau, Executive Director Global Compensation and Corporate Governance, General Motors Corporation, to Secretary, Commission, dated May 8, 2003 ("General Motors NYSE Letter").

39. Letter from Gerald S. Backman, Chairman of the Committee, New York State Bar Association, Business Law Section, Committee on Securities Regulation, to Commission, dated May 8, 2003 ("New York State Bar NYSE Letter").

40. Letter from Mark G. Heesen, President, National Venture Capital Association, to Jonathan G. Katz, Secretary, Commission, dated May 8, 2003 ("National Venture NYSE Letter").

41. Letter from KPMG LLP, to Jonathan G. Katz, Secretary, Commission, dated May 8, 2003 ("KPMG NYSE Letter").

42. Letter from Winston & Strawn, to Jonathan G. Katz, Secretary, Commission, dated May 7, 2003 ("Winston & Strawn NYSE Letter").

43. Letter from Gregory F. Pilcher, Senior Vice President, General Counsel and

Corporate Secretary, Kerr-McGee Corporation, to Secretary, Commission, dated May 7, 2003 ("Kerr-McGee NYSE Letter").

44. Letter from C.R. Cloutier, Chairman, Independent Community Bankers of America, to Jonathan G. Katz, Secretary, Commission, dated May 8, 2003 ("Independent Community Bankers NYSE Letter").

45. Letter from James P. Melican, Executive Vice President, International Paper Company, to Jonathan G. Katz, Secretary, Commission, dated May 8, 2003 ("International Paper NYSE Letter").

46. Letter from LeBoeuf, Lamb Greene & MacRae, L.L.P., to Jonathan G. Katz, Secretary, Commission, dated May 8, 2003 ("LeBoeuf NYSE Letter").

47. Letter from Suzanne Suter, Vice President, Corporate Secretary and Chief Governance Officer, Anadarko Petroleum Corporation, to Jonathan G. Katz, Secretary, Commission, dated May 8, 2003 ("Anadarko NYSE Letter").

48. Letter from Cleary, Gottlieb, Steen & Hamilton, to Jonathan G. Katz, Secretary, Commission, dated May 16, 2003 ("Cleary NYSE Letter").

49. Letter from Kathleen M. Gibson, Chairman, Taskforce on Corporate Accountability, American Society of Corporate Secretaries, to Jonathan Katz, Secretary, Commission, dated May 10, 2003 ("American Society of Corporate Secretaries NYSE Letter").

50. Letter from Charles M. Nathan, Committee on Securities Regulation of the Association of the Bar of the City of New York, to Secretary, Commission, dated May 9, 2003 ("Committee on Securities Regulation NYSE Letter").

51. Letter from Elizabeth B. Chandler, Vice President, Assistant General Counsel and Corporate Secretary, Mirant Corporation, to Jonathan G. Katz, Secretary, Commission, dated May 15, 2003 ("Mirant NYSE Letter").

52. Letter from Franklin D. Raines, Chairman and CEO, Fannie Mae, Chairman—Corporate Governance Task Force, The Business Roundtable, to Jonathan G. Katz, Secretary, Commission, dated May 15, 2003 ("Business Roundtable NYSE Letter").

53. Letter from William J. Calise, Jr., Rockwell Automation, Inc., to Mr. Jonathan G. Katz, Secretary, Commission, dated May 21, 2003 ("Rockwell NYSE Letter").

54. Letter from Melvin A. Eisenberg, Koret Professor of Law, University of California School of Law (Boalt Law), to Secretary, Commission, dated June 16, 2003, ("Eisenberg NYSE Letter").

55. Letter from Sarah A. Miller, American Bankers Association, to Jonathan G. Katz, Secretary, Commission, dated June 27, 2003 ("American Bankers Association NYSE Letter").

56. Letter from Deborah S. Lamb, Chair, U.S. Advocacy Committee of the Association for Investment Management and Research and Linda L. Rittenhouse, Staff, AIMR Advocacy, Association for Investment Management and Research, to Mr. Jonathan G. Katz, Secretary, Commission, dated July 2, 2003 ("AIMR Advocacy Letter").

57. Letter from Eugene Ellman, Executive Director, Social Investment Organization, to

Mr. Harvey L. Pitt, Chairman, Commission, dated September 13, 2002 ("SIO NYSE Letter").

58. E-mail from Tore U. Johnsson, to *rule-comments@sec.gov* dated August 23, 2002 ("Johnsson E-mail").

59. E-mail from Mark@mvcinternational.com dated September 4, 2003 ("MVC Associates NYSE E-mail").

60. Letter from Sullivan & Cromwell, to Mr. Jonathan G. Katz, Secretary, Commission, dated September 23, 2003 ("Sullivan & Cromwell NYSE Letter").

61. Letter from Henry A. McKinnell, Chairman of the Board and Chief Executive Officer, Pfizer Inc., to Mr. Richard Grasso, Chairman, NYSE, dated May 30, 2003 ("Pfizer NYSE Letter").

62. Letter from Barbara J. Krumsiek, President and CEO, Calvert Group, Ltd., to Mr. Richard A. Grasso, Chairman and Chief Executive Officer, NYSE, dated May 20, 2003 ("Calvert Letter").

63. Letter from Bob Reed, JP Financial, to Janice ("Bob Reed Letter").

*Comment Letters Relating to SR-NASD-2002-141, the Nasdaq Independent Director Proposal*

1. Letter from D. Scott Huggins, Senior Vice President and Chief Auditor, Fulton Financial Corporation, to Jonathan G. Katz, Secretary, Commission, dated April 1, 2003 ("Fulton Nasdaq Letter").

2. Letter from Joseph S. Schwertz Jr., Corporate Secretary, Whitney Holding Company, to Jonathan G. Katz, Secretary, Commission, dated April 14, 2003 ("Whitney Nasdaq Letter").

3. Letter from Janne G. Gallagher, Acting General Counsel, Council on Foundations, to Jonathan G. Katz, Secretary, Commission, dated April 15, 2003 ("Council on Foundations Nasdaq Letter").

4. Letter from Cary Klafter, Vice President, Legal and Government Affairs, Intel Corporation, to Margaret H. McFarland, Deputy Secretary, Commission, dated April 11, 2003 ("Intel Nasdaq Letter").

5. Letter from Susan D. Stanley, First Vice President and Corporate Secretary, People's Bank, to Jonathan G. Katz, Secretary, Commission, dated April 15, 2003 ("People's Bank Nasdaq Letter").

6. Letter from Charlotte M. Bahin, Director of Regulatory Affairs, Senior Regulatory Counsel, America's Community Bankers, to Jonathan G. Katz, Secretary, Commission, dated April 22, 2003 ("America's Community Bankers Nasdaq Letter").

7. Letter from Sarah A. Miller, Director, Center for Securities, Trust and Investments, American Bankers Association, to Jonathan G. Katz, Secretary, Commission, dated April 16, 2003 ("American Bankers Association Nasdaq Letter").

8. Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Commission, dated April 15, 2003 ("Investment Company Institute Nasdaq Letter").

9. Letter from David A. Kastelic, Senior Vice President and General Counsel, Cenex Harvest States Cooperatives, to Jonathan G. Katz, Secretary, Commission, dated April 21, 2003 ("Cenex Harvest Nasdaq Letter").

10. Letter from Charles M. Nathan, Committee on Securities Regulation of the Association of the Bar of the City of New York, to Secretary, Commission, dated April 25, 2003 ("Committee on Securities Regulation Nasdaq Letter").

11. Letter from C.R. Cloutier, Chairman, Independent Community Bankers of America, to Jonathan G. Katz, Secretary, Commission, dated May 6, 2003 ("Independent Community Bankers Nasdaq Letter").

12. Letter from Douglas A. Cifu, Paul, Weiss, Rifiand, Wharton & Garrison LLP, to Jonathan G. Katz, Secretary, Commission, dated May 14, 2003 ("Paul Weiss Nasdaq Letter").

13. Letter from Mark G. Heesen, President, National Venture Capital Association, to Jonathan G. Katz, Secretary, Commission, dated April 16, 2003 ("National Venture Nasdaq Letter").

14. Letter from Fritz Heimann, Chairman, and Thomas L. Milan, Director, Transparency International-USA, to Mr. Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated May 28, 2003 ("TI-USA Nasdaq Letter").

15. Letter from Bonnie K. Wachtel, CEO, Wachtel & Co., Inc., to Jonathan G. Katz, Secretary, Commission, dated June 16, 2003 ("Wachtel Nasdaq Letter").

16. Letter from Irwin M. Jacobs, Chairman and CEO, QUALCOMM, to Secretary, Commission, dated August 22, 2002 ("Qualcomm Nasdaq Letter").

17. E-mail from Tore U. Johnsson, to *rule-comments@sec.gov* dated August 23, 2002 ("Johnsson Nasdaq E-mail").

18. E-mail from George Kolber to *rules-comments@sec.gov*, dated July 1, 2003 ("Kolber Nasdaq E-mail").

19. Letter from Gary P. Kreider, Keating, Muething & Klekamp, PLL, to Secretary, Commission, dated July 1, 2003 ("Kreider Nasdaq Letter").

*Comment Letters Relating to Both SR-NYSE-2002-33 and SR-NASD-2002-141*

1. Letter from Stanley Keller, Chair, Committee on Federal Regulation of Securities, Robert Todd Lang, Chair, Task Force on Listing Standards, Committee on Federal Regulation of Securities, American Bar Association, Business Law Section, to Commission, dated June 2, 2003 ("Committee on Federal Regulation of Securities Letter").

2. E-mail from Peter Herman dated June 3, 2003 ("Herman E-mail").

3. E-mail from HarlanHobgood@cs.com to *rule-comments@sec.gov*, dated June 12, 2003 ("Hobgood E-mail").

4. Letter from Mark R. Beatty, General Counsel, Cascade Investment, to The Honorable Jonathan G. Katz, Secretary, Commission, dated July 3, 2003 ("Cascade Investment Letter").

5. Letter from Peter S. Brown, Senior Vice President and General Counsel, Arrow Electronics, Inc., to Ms. Janice O'Neill, Vice President of Corporate Compliance, NYSE, dated August 28, 2003 ("Arrow Electronics Letter").

*Comment Letters Relating to SR-NASD-2002-139, the Nasdaq Code of Conduct Proposal*

1. Letter from Dorothy M. Donohue, Associate Counsel, Investment Company Institute, to Mr. Jonathan G. Katz, Secretary, Commission, dated July 30, 2003 ("ICI 2002-139 Letter").

2. Letter from Charlotte M. Bahin, Senior Vice President, Regulatory Affairs, America's Community Bankers, to Jonathan G. Katz, Secretary, Commission, dated July 31, 2003 ("ACB 2002-139 Letter").

*Comment Letters Relating to SR-NASD-2002-138, the Nasdaq Issuer Applicability Proposal*

1. Letter from Sullivan & Cromwell LLP, to Mr. Jonathan G. Katz, Secretary, Commission, dated July 31, 2003 ("S&C 2002-138 Letter").

[FR Doc. 03-28187 Filed 11-10-03; 8:45 am]

BILLING CODE 8010-01-P

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-48746; File No. SR-PCX-2003-32]

### Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Pacific Exchange, Inc. Relating to the Exchange's Rules Under the Minor Rule Plan

November 4, 2003.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on July 8, 2003, the Pacific Exchange, Inc. ("PCX" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

#### I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The PCX is proposing to adopt new PCX Rules 10.13(h)(40)-(44) and 10.13(k)(i)(40)-(44) in order to incorporate five existing PCX rules into the Minor Rule Plan ("MRP") and Recommended Fine Schedule ("RFS"). The five PCX Rules include: (1) Failure to honor priority of bids and offers pursuant to PCX Rules 6.75 and 6.76; (2) failure to quote markets within the maximum quote spread differentials or failure to disseminate quotations accurately pursuant to PCX Rules

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.