

association.<sup>54</sup> Specifically, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of section 15A of the Act in general,<sup>55</sup> and section 15A(b)(6) of the Act in particular,<sup>56</sup> which provides that the rules of the association be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principals of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, 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.

The Commission believes that the establishment of an NOCP and a trade report modifier with which to identify that price to the public may be a reasonable alternative closing price that industry participants may choose to use. The Commission also notes that Nasdaq has represented that the NOCP methodology would only impact the Individual Market Close for Nasdaq and would not impact the Consolidated Close or Individual Market Closes of the Nasdaq UTP Plan exchanges that are disseminated by the ESIP. While the NOCP is based on an actual trade, it is not necessarily an actual trade report. Therefore, the Commission believes that the NOCP may provide benefits to the marketplace and investors so long as investors are aware of the nature of the NOCP and its calculation. The Commission also believes that the elements of Nasdaq's proposal appear to be a reasonable attempt at increasing transparency and providing stability and predictability to the closing prices in Nasdaq securities.

Furthermore, in response to the procedural objections against Nasdaq for not consulting with and receiving approval from the UTP Operating Committee prior to filing the proposed rule change, the Commission notes that Nasdaq received a unanimous approval for the establishment and use of the .M modifier from the UTP Operating Committee and has also agreed to delay its implementation of the NOCP until April 14, 2003 in order to provide members of the UTP Operating Committee with additional time to consider the technical specifications

prior to implementing the proposed modifier in their own markets.<sup>57</sup>

With regard to the other issues raised by commenters, the Commission is satisfied that Nasdaq has reasonably addressed the commenters' concerns.

Furthermore, the Commission finds good cause for approving Amendment No. 1 prior to the thirtieth day after the date of publication of the notice of filing thereof in the **Federal Register**.<sup>58</sup> Nasdaq filed Amendment No. 1 in response to comments it received after the publication of the notice of filing of the proposed rule change to address certain commenters' concerns.<sup>59</sup> Because Amendment No. 1 is responsive to these commenters' concerns, the Commission finds good cause for accelerating approval of Amendment No. 1.

#### V. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning Amendment No. 1, including whether Amendment No. 1 is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to Amendment No. 1 that are filed with the Commission, and all written communications relating to Amendment No. 1 between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to File No. SR-NASD-2002-158 and should be submitted by April 15, 2003.

#### VI. Conclusion

It is therefore ordered, pursuant to section 19(b)(2) of the Act,<sup>60</sup> that the proposed rule change (SR-NASD-2002-

158) be, and it hereby is, approved, and that Amendment No. 1 to the proposed rule change be, and it hereby is, approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>61</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

[FR Doc. 03-6985 Filed 3-24-03; 8:45 am]

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-47516; File No. SR-NASD-2002-141]

### Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the National Association of Securities Dealers, Inc. Relating to Proposed Amendments to NASD Rules 4200 and 4350 Regarding Board Independence and Independent Committees

March 17, 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 October 9, 2002, the National Association of Securities Dealers, Inc. ("NASD"), through its subsidiary, The Nasdaq Stock Market, Inc. ("Nasdaq"), 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 Nasdaq. On March 11, 2003, Nasdaq submitted Amendment No. 1 to the proposed rule change.<sup>3</sup> 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 the Substance of the Proposed Rule Change

Nasdaq proposes amendments to NASD Rules 4200 and 4350 to modify the definition of the term "independent director."

<sup>61</sup> 17 CFR 200.30-3(a)(12).

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

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

<sup>3</sup> See letter from Mary M. Dunbar, Vice President and Deputy General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division of Market Regulation ("Division"), Commission, dated March 11, 2003 ("Amendment No. 1"). In Amendment No. 1, Nasdaq proposed revisions to (1) the definition of "independent director" and (2) Nasdaq's listing standards with respect to provisions governing independent directors and audit committees. Amendment No. 1 supersedes and replaces in its entirety the original proposed rule change that Nasdaq filed with the Commission on October 9, 2002.

<sup>54</sup> In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>55</sup> 15 U.S.C. 78o-3.

<sup>56</sup> 15 U.S.C. 78o-3(b)(6).

<sup>57</sup> See Second Response Letter, *supra* note 6.

<sup>58</sup> 15 U.S.C. 78s(b)(2).

<sup>59</sup> Certain commenters objected to Nasdaq's proposal to adjust the NOCP only if the Predicate Trade is cancelled or corrected by 4:30:00 PM, even though Nasdaq would continue to accept trade cancel and correction messages via ACT until 5:15:00 p.m. See CSE Letter and Institute Letter, *supra* note 4. However, in response to comments, Nasdaq revised its proposal in Amendment No. 1 to consider cancelled or corrected trades submitted until 5:15:00 PM rather than 4:30:00 PM for the calculation of the NOCP. See Amendment No. 1, *supra* note 5.

<sup>60</sup> 15 U.S.C. 78s(b)(2).

The text of the proposed rule change is below. Proposed new language is italicized; proposed deletions are in brackets.<sup>4</sup>

\* \* \* \* \*

#### Rule 4200. Definitions

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

(1)–(13) No change.

(14) “*Family Member*” means any person who is a relative by blood, marriage or adoption or who has the same residence.

(15) “Independent director” means a person other than an officer or employee of the company or its subsidiaries or any other individual having a relationship, which, in the opinion of the company’s board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director. The following persons shall not be considered independent:

(A) a director who is, or during the past three years was, employed by the [corporation] company or by any parent or subsidiary of the company [any of its affiliates for the current year or any of the past three years];

(B) a director who accepts or who has a Family Member who accepts any [compensation] payments from the [corporation] company or any [of its affiliates] parent or subsidiary of the company in excess of \$60,000 during the current fiscal year or any of the past three fiscal years [previous fiscal year], other than compensation for board service, payments arising solely from investments in the company’s securities, compensation paid to a Family Member who is an employee of the company or a parent or subsidiary of the company (but not if such person is an executive officer of the company or any parent or subsidiary of the company), benefits under a tax-qualified retirement plan, or non-discretionary compensation (provided, however, that audit committee members are subject to heightened requirements under Rule 4350(d));

(C) a director who is a [member of the immediate] [f]Family Member of an individual who is, or [has been in any of] during the past three years was, employed by the [corporation] company

or by any [of its affiliates] parent or subsidiary of the company as an executive officer[. Immediate family includes a person’s spouse, parents, children, siblings, mother-in-law, father-in-law, brother-in-law, sister-in-law, son-in-law, daughter-in-law, and anyone who resides in such person’s home];

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

(E) a director of the listed company who is employed as an executive officer of another entity where any of the [company’s] executive[s] officers of the listed company serve on [that entity’s] the compensation committee of such other entity, or if such relationship existed during the past three years; or

(F) a director who is or was a partner or employee of the company’s outside auditor, and worked on the company’s audit, during the past three years.

Former (15)–(37) renumbered as (16)–(38).

#### IM—4200 Definition of Independence—Rule 4200(a)(15)

*It is important for investors to have confidence that individuals serving as independent directors do not have a relationship with the listed company that would impair their independence. The board has a responsibility to make an affirmative determination that no such relationships exist through the application of Rule 4200. Rule 4200 also provides a list of certain relationships that preclude a board finding of independence. These objective measures provide transparency to investors and companies, facilitate uniform application of the rules, and ease administration. Because Nasdaq does not believe that ownership of company stock by itself would preclude a board finding of independence, it is not included in the aforementioned objective factors. The Rule’s reference to a “parent or subsidiary” is intended to cover entities that are consolidated with the issuer’s financial statements. It should also be noted that there are additional, more stringent requirements that apply to audit committees, as specified in Rule 4350.*

#### Rule 4350. Qualitative Listing Requirements for Nasdaq National Market and Nasdaq Small Cap Market Issuers Except for Limited Partnerships

(a)–(b) No change.

(c) Independent Directors

[Each issuer shall maintain a sufficient number of independent directors on its board of directors to satisfy the audit committee requirement set forth in Rule 4350(d)(2).]

(1) A majority of the board of directors must be comprised of independent directors as defined in Rule 4200.

(2) Independent directors must have regularly scheduled meetings at which only independent directors are present (“executive sessions”).

(3) Compensation of Officers

(A) Compensation of the chief executive officer of the company will be determined either by:

(i) a majority of the independent directors meeting in executive session, or

(ii) a compensation committee comprised solely of independent directors meeting in executive session.

(B) Compensation of all other officers, as that term is defined in section 16 of the Act and Rule 16a-1 thereunder, will be determined either by:

(i) a majority of the independent directors, or

(ii) a compensation committee comprised solely of independent directors.

The chief executive officer may be present during deliberations, but may not vote.

(C) Notwithstanding paragraphs (3)(A)(ii) and (3)(B)(ii) above, if the compensation committee is comprised of at least three members, one director who is not independent as defined in Rule 4200 and is not a current officer or employee or a Family Member of such person, may be appointed to the compensation 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, the nature of the relationship and the reasons for the determination. A member appointed under this exception may not serve longer than two years.

(4) Nomination of Directors

(A) The nomination of company directors will be determined either by:

(i) a majority of the independent directors, or

<sup>4</sup> At Nasdaq’s request, a few nonsubstantive changes were made to the proposed rule text as filed with the Commission to correct formatting errors. Telephone calls between Sara Bloom, Office of General Counsel, Nasdaq, and Jennifer Lewis, Attorney, Division of Market Regulation (“Division”), Commission, on March 14, 2003 and Eleni Constantine, Office of General Counsel, Nasdaq, and Jennifer Lewis, Attorney, Division, Commission, on March 17, 2003.

(ii) a nominations committee comprised solely of independent directors.

(B) Notwithstanding paragraph (4)(A)(ii) above, if the nominations committee is comprised of at least three members, one director, who is not independent as defined in Rule 4200 and is not a current officer or employee or a Family Member of such person, may be appointed to the nominations 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, the nature of the relationship and the reasons for the determination. A member appointed under this exception may not serve longer than two years.

(C) Notwithstanding paragraph (4)(A)(ii) above, if the nominations committee is comprised of at least three members, and if the exception described in paragraph (4)(B) is not relied upon, one director who owns 20% or more of the company's common stock or voting power outstanding, and is not independent as defined in Rule 4200 because that director is also an officer, may be appointed to the nominations committee if the board 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, the nature of the relationship, and the reasons for the determination.

(5) A Controlled Company is exempt from the requirements of this subsection (c). A Controlled Company is a company of which more than 50% of the voting power is held by an individual, a group or another company. A Controlled Company relying upon this exemption must disclose in its annual meeting proxy statement that it is a Controlled Company and the basis for that determination.

#### (d) Audit Committee

##### (1) Audit Committee Charter

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

(A)–(B) No change.

(C) [the outside auditor's ultimate accountability to the board of directors and the audit committee, as representatives of shareholders, and these shareholder representatives' ultimate authority and responsibility to select, evaluate, and, where appropriate, replace the outside auditor (or to nominate the outside auditor to be proposed for shareholder approval in any proxy statement)] the committee's purpose of overseeing the accounting and financial reporting processes of the issuer and the audits of the financial statements of the issuer;

(D) the following specific audit committee responsibilities and authority:

(i) the pre-approval of all audit services and permissible non-audit services as set forth in section 10A(i) of the Act;

(ii) the sole authority to appoint, determine funding for and oversee the outside auditors as set forth in section 10A(m)(2) of the Act;

(iii) the responsibility to establish procedures for complaints as set forth in section 10A(m)(4) of the Act; and

(iv) the authority to engage and determine funding for independent counsel and other advisors as set forth in section 10A(m)(5) of the Act.

##### (2) Audit Committee Composition

(A) Each issuer must have, and certify that it has and will continue to have, an audit committee of at least three members, [comprised solely of independent directors] each of whom [is]:

(i) must: (a) be independent as defined under Rule 4200, (b) meet the criteria for independence set forth in section 10A(m)(3) of the Act, and (c) not own or control 20% or more of the issuer's voting securities (or such lower measurement as may be established by the SEC in rulemaking under section 10A(m) of the Act); and

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

officer with financial oversight responsibilities.

(B) Notwithstanding paragraph (2)(A)(i), one director who: (i) Is not independent as defined in Rule 4200, [and] (ii) meets the criteria set forth in section 10A(m)(3) of the Act and the rules thereunder, (iii) does not own or control 20% or more of the issuer's voting securities (or such lower measurement as may be established by the SEC in rulemaking under section 10A(m)(3) of the Act), and (iv) is not a current officer or employee or a[n immediate] F[f]amily M[m]ember of such [employee] 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 corporation and its shareholders, and the board discloses, in the next annual proxy statement subsequent to such determination, the nature of the relationship and the reasons for that determination. A member appointed under this exception may not serve longer than two years and may not chair the audit committee.

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

(e)–(l) No change.

IM–4350–4 Board Independence and Independent Committees

#### Independent Directors and Independent Committees—Rule 4350(c)

*Majority Independent Board. Independent directors (as defined in Rule 4200(A)(15)) play an important role in assuring investor confidence. Through the exercise of independent judgment, they act on behalf of investors to maximize shareholder value in the companies they oversee and guard against conflicts of interest. Requiring that the board be comprised of a majority of independent directors will empower such directors to more effectively carry out these responsibilities.*

*Executive Sessions of Independent Directors. Regularly scheduled executive sessions will encourage and enhance communication among independent directors. It is contemplated that executive sessions will occur at least twice a year, and perhaps more frequently, in conjunction with regularly scheduled board meetings.*

*Independent Director Oversight of Executive Compensation.* Independent director oversight of executive officer compensation will help assure that appropriate incentives are in place, consistent with the board's responsibility to maximize shareholder value. The Rule is intended to provide flexibility for an issuer to choose an appropriate 3 board structure and to reduce resource burdens, while ensuring independent director control of compensation decisions.

*Independent Director Oversight of Director Nominations.* Independent director oversight of nominations enhances investor confidence in the selection of well-qualified director nominees, as well as independent nominees as required by the Rules. This Rule is also intended to provide flexibility for a company to choose an appropriate board structure and reduce resource burdens, while ensuring that independent directors approve all nominations.

This Rule will not apply in cases where the right to nominate a director legally belongs to a third party. For example, investors may negotiate the right to appoint directors in connection with an investment in the company, holders of preferred stock may be permitted to nominate or appoint directors upon certain defaults, or the company may be a party to a shareholder's agreement that allocates the right to nominate some directors. Because the right to nominate directors in these cases does not reside with the company, independent director approval would not be required.

*Controlled Company Exception.* This exception recognizes that majority shareholders, including parent companies, have the right to select directors and control certain key decisions, such as executive officer compensation, by virtue of their ownership rights. In order for a group to exist for purposes of this Rule, the shareholders must have publicly filed a notice that they are acting as a group (e.g., a Schedule 13D). It should be emphasized that this controlled company exception does not extend to the audit committee requirements under Rule 4350.

#### **Audit Committees—Rule 4350(d)**

*Audit Committee Charter.* A company's audit committee is required to adopt a formal written charter that specifies the scope of its responsibilities and the means by which it carries out those responsibilities; the outside auditor's accountability to the audit committee; and the audit committee's responsibility to ensure the

independence of the outside auditor. Consistent with this, the charter must specify all audit committee responsibilities set forth in section 10A of the Act. The rights and responsibilities as articulated in the audit committee charter empower the audit committee and enhance its effectiveness in carrying out its responsibilities. While the audit committee is empowered to retain outside consultants, it is not expected to do so routinely. Rather, it is expected that such authority would be exercised in response to specific circumstances giving rise to an audit committee determination that such action is in the best interest of the company and its shareholders.

*Audit Committee Composition.* Audit committees are required to have a minimum of three members and be comprised only of independent directors. In addition to satisfying the independent director requirements under Rule 4200, audit committee members must satisfy the heightened independence standards provided in section 10A(m)(3) of the Act: they must not accept any consulting, advisory, or other compensatory fee from the company other than for board service, and they must not be an affiliated person of the company. For purposes of determining whether a person is an affiliate solely by virtue of stock ownership, an audit committee member will be considered an affiliated person of the issuer if such member owns or controls, directly or indirectly, 20% or more of the company's voting stock, or such other lower threshold as the SEC may establish. Nasdaq would also consider the employee of an entity that owns or controls such securities as an affiliated person.

All audit committee members must be able to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement at the time they join the board. In addition, at least one audit committee member must have past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.

It should be noted that, under exceptional and limited circumstances, one director who is not considered independent under Rule 4200, but meets the independence requirements of

section 10A(m)(3) of the Act, may serve on the audit committee, provided that the board determines it to be in the best interests of the company and its shareholders, and the board discloses the reasons for the determination in the company's next annual proxy statement.

\* \* \* \* \*

## **II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change**

In its filing with the Commission, Nasdaq included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. Nasdaq has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

### *A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change*

#### **1. Purpose**

Nasdaq is proposing a comprehensive package of corporate governance reforms relating to NASD Rules 4200 and 4350, in order to provide greater transparency as to certain relationships that would preclude a board of directors finding that an individual can serve as an independent director and to increase the role of independent directors on board committees, in order to enhance investor confidence in the companies that list on Nasdaq.

#### *The Definition of Independence*

Nasdaq believes that it is important for investors to have confidence that individuals serving as independent directors do not have a relationship with the issuer that would impair their independence. Proposed interpretive material to NASD Rule 4200 states that the board has a responsibility to make an affirmative determination that no such relationships exist through the application of this rule. The rule also would specify specific relationships that would preclude a board finding of independence. The proposed rule change would expand and clarify this list of relationships. Nasdaq believes that these objectively measured relationships would provide transparency to investors and companies, facilitate uniform application of the rules, and ease administration. The rule's reference to parent or subsidiary is intended to cover

entities that are consolidated with the issuer's financial statements.

It should also be noted that additional, more stringent requirements for audit committees would be provided in NASD Rule 4350.

#### *Independent Board Committees*

The proposed rule would require a majority of independent directors on the issuer's board. Nasdaq believes that independent directors play an important role in assuring investor confidence. Through the exercise of independent judgment, they act on behalf of investors to maximize shareholder value in the companies they oversee, and guard against conflicts of interest. Requiring that the board be comprised of a majority of independent directors would empower such directors to more effectively carry out these responsibilities.

The proposed rule also would require regularly convened executive sessions of the independent directors. Nasdaq believes that regularly scheduled executive sessions would encourage and enhance communication among independent directors. Nasdaq contemplates that executive sessions would occur at least twice a year, and perhaps more frequently, in conjunction with regularly scheduled board meetings.

Independent director approval of executive officer compensation would also be required. This oversight would help assure that appropriate incentives are in place, consistent with the board's responsibility to maximize shareholder value. The proposed rule is intended to provide flexibility for an issuer to choose an appropriate board structure and to reduce resource burdens, while ensuring independent director control of compensation decisions.

Independent director approval would also be required for director nominations. Independent director oversight of nominations enhances investor confidence in the selection of well-qualified director nominees, as well as independent nominees as required by the rules. This rule is also intended to provide flexibility for an issuer to choose an appropriate board structure and reduce resource burdens, while ensuring that independent directors approve all nominations.

This rule would not apply in cases where the right to nominate a director legally belongs to a third party. For example, investors may negotiate the right to appoint directors in connection with an investment in the company, holders of preferred stock may be permitted to nominate or appoint directors upon certain defaults, or the

issuer may be a party to a shareholder's agreement that allocates the right to nominate some directors. Because the right to nominate directors in these cases does not reside with the Company, independent director approval would not be required.

A Controlled Company would be exempt from the requirements of proposed NASD Rule 4350(c). A Controlled Company is defined in proposed NASD Rule 4350(c) as a company of which more than 50% of the voting power is held by an individual, a group or another company. A Controlled Company relying upon this exemption would be required to disclose in its annual meeting proxy statement that it is a Controlled Company and the basis for that determination. This exception recognizes that majority shareholders, including parent companies, have the right to select directors and control certain key decisions, such as executive officer compensation, by virtue of their ownership rights. In order for a group to exist for purposes of this rule, the shareholders would be required to publicly file a notice that they are acting as a group (e.g., a Schedule 13D). Nasdaq emphasizes that this Controlled Company exemption would not extend to the audit committee requirements under Rule 4350.

#### *Audit Committee Requirements*

The proposed rule would expand the items that must be specified in the charter of the issuer's audit committee. In particular, the charter would be required to specify all audit committee responsibilities required under the Act. The rights and responsibilities as articulated in the audit committee charter empower the audit committee and enhance its effectiveness in carrying out its responsibilities. Proposed interpretive material to NASD Rule 4350 states that while the audit committee would be empowered to retain outside consultants, it would not be expected to do so routinely. Rather, it would be expected that such authority would be exercised in response to specific circumstances giving rise to an audit committee determination that such action was in the best interest of the company and its shareholders.

The proposal also would expand and tighten audit committee composition requirements. In addition to satisfying the independent director requirements under NASD Rule 4200, the proposal would require audit committee members to satisfy the heightened independence standards provided in section 10A(m)(3) of the Act, which provides that an audit committee

member may not accept any consulting, advisory, or other compensatory fee from the issuer other than for board service, and may not be an affiliated person of the issuer. For purposes of determining whether a person would be an affiliate solely by virtue of stock ownership, proposed revisions to NASD Rule 4350 provide that an audit committee member would be considered an affiliated person of the issuer if such member owns or controls, directly or indirectly, 20% or more of the issuer's voting stock, or such other lower threshold as the Commission may establish.

The proposal would also tighten the current requirement that all audit committee members must be able to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement within a reasonable time of joining the board, by providing that they must meet these qualifications at the time they join the board. Finally, the proposal would remove the exception applicable to Small Business filers in order to further strengthen the rule.

#### *Timing for Effectiveness of Proposal*

Nasdaq proposes to make the proposed rule change effective as follows: Requirements that may call for an adjustment to the composition of the company's board or committees ("board composition requirements") would be required to be implemented by the company's next annual meeting occurring after January 1, 2004. These include: NASD Rule 4200(a)(15), relating to the definition of independence; NASD Rule 4350(c)(1), requiring a majority of independent board members; NASD Rule 4350(c)(3), relating to independent director approval of executive compensation; NASD Rule 4350(c)(4), relating to independent approval of director nominations; and NASD Rule 4350(d)(2), relating to audit committee composition. This would allow companies to make necessary adjustments in the course of their regular annual meeting schedule. All other independence-related corporate governance requirements, including NASD Rule 4350(c)(2), relating to executive sessions and NASD Rule 4350(d)(1), relating to audit committee charters, would be required to be implemented six months after Commission approval.

Following Commission approval of the proposed rule change, newly listed companies would be afforded two years to comply with all board composition requirements and also would be

afforded any remaining balance of the six month grace period for compliance with all other requirements. Companies transferring from other markets with substantially similar requirements would be afforded the balance of any grace period afforded by the other market.

## 2. Statutory Basis

Nasdaq believes that the proposed rule change is consistent with the provisions of section 15A of the Act,<sup>5</sup> in general, and with section 15A(b)(6) of the Act,<sup>6</sup> in particular, in that the proposed rules are designed 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.

### *B. Self-Regulatory Organization's Statement on Burden on Competition*

Nasdaq does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

### *C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others*

Written comments were neither solicited nor received.

## III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

A. By order approve such proposed rule change, or

B. Institute proceedings to determine whether the proposed rule change should be disapproved.

## IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Persons making written submissions

should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to File No. SR-NASD-2002-141 and should be submitted by April 15, 2003.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>7</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

**[Release No. 34-47500; File No. SR-Phlx-2001-28]**

### **Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Philadelphia Stock Exchange Relating to Who Allocates Options Trades**

March 13, 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 March 9, 2001, the Philadelphia Stock Exchange, Inc. ("Phlx" 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. On January 31, May 17, July 8, 2002, and March 12, 2003, the Phlx filed Amendment Nos. 1, 2, 3, and 4 to the proposed rule change, respectively.<sup>3</sup>

<sup>7</sup> 17 CFR 200.30-3(a)(12).

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

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

<sup>3</sup> See letter from Edith Hallahan, First Vice President and Deputy General Counsel, Phlx, to Nancy J. Sanow, Assistant Director, Division of Market Regulation ("Division"), Commission, dated January 30, 2002 (Amendment No. 1); and letters from Richard S. Rudolph, Director and Counsel, to Nancy J. Sanow, Assistant Director, Division,

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 Phlx proposes to amend Option Floor Procedure Advice F-2 ("Advice F-2"), "Allocation, Time Stamping, Matching and Access to Matched Trades." The Phlx further proposes to codify paragraph (a) of Advice F-2, as amended—regarding who allocates options trades—in the Exchange's rules, as new paragraph (vi) of Phlx rule 1014(g).

The Phlx also proposes to amend the fine schedule associated with Advice F-2, and thereby to amend its minor rule violation enforcement and reporting plan ("minor rule plan")<sup>4</sup> and the Exchange's sanctioning guidelines<sup>5</sup> accordingly.

Finally, the Exchange is proposing corresponding amendments to Option Floor Procedure Advice F-12 ("Advice F-12"), "Responsibility for Assigning Participation," to replace the term "largest participant" with "Allocating Participant" and to cross-reference that new term to new rule 1014(g)(vi). The Exchange is also proposing to change Advice F-12 by correcting the fine schedule so that it does not apply a minor rule plan fine to paragraph (d), dealing with disputes, which is a process-oriented provision, and not one which could give rise to a violation.

Below is the text of the proposed amendments to Advice F-2 and Advice F-12. Paragraph (a) of Advice F-2, as amended, would also be codified in the Phlx's rules as rule 1014(g)(vi). Deleted language is in brackets. Proposed new language is *italicized*.

\* \* \* \* \*

Commission, dated May 16, 2002, July 5, 2002, and March 12, 2003 (Amendment Nos. 2, 3, and 4). The changes made by these amendments have been incorporated into this notice.

<sup>4</sup> The Phlx's minor rule plan, codified in rule 970, consists of advices, such as Advice F-2, with accompanying fine schedules. Rule 19d-1 under the Act authorizes national securities exchanges to adopt minor rule plans for summary discipline and abbreviated reporting. Rule 19d-1 requires prompt filing with the Commission of any final disciplinary actions. However, minor rule plan violations not exceeding \$2,500 are deemed not final, thereby permitting periodic, as opposed to immediate, reporting. See also Securities Exchange Act Release No. 44537 (July 11, 2001), 66 FR 37511 (July 18, 2001) (SR-Phlx-2001-36).

<sup>5</sup> See Securities Exchange Act Release No. 45569 (March 15, 2002), 67 FR 13397 (March 22, 2002) (SR-Phlx-2001-60).

<sup>5</sup> 15 U.S.C. 78o-3.

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