

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-49903; File No. SR-NASD-2004-086)

June 22, 2004

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change and Amendment No. 1 Thereto by the National Association of Securities Dealers, Inc. to NASD Rule 4200 to Clarify the Treatment of Certain Non-Preferential, Ordinary-Course Payments

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on June 1, 2004, 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 June 17, 2004, Nasdaq submitted Amendment No. 1 to the proposed rule change.³ The proposed rule change has been filed by Nasdaq as a “non-controversial” rule change under Rule 19b-4 under the Act,⁴ which renders the proposal effective upon filing with the Commission.⁵ The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See letter from Edward S. Knight, Executive Vice President, Nasdaq, to Katherine A. England, Assistant Director, Division of Market Regulation (“Division”), Commission, dated June 16, 2004 (“Amendment No. 1”). Amendment No. 1 clarified the text of IM-4200 regarding the three-year “look back” periods applicable to certain provisions of the definition of “independent director” in NASD Rule 4200. The change conforms with a recent amendment to the text made by Nasdaq in another proposal. See *infra* note 6.

⁴ 17 CFR 240.19b-4.

⁵ 17 CFR 240.19b-4(f)(6).

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

Nasdaq proposes to change Rule 4200(a)(15) to clarify the treatment of certain non-preferential payments made by financial institutions to directors of listed companies and their family members in the ordinary course of business. The text of the proposed rule change is below. Proposed new language is in *italics*; proposed deletions are in brackets.⁶

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Rule 4200. Definitions

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

(1) – (14) No change

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

(A) No change

(B) a director who accepted or who has a Family Member who accepted any payments from the company or any parent or subsidiary of the company in excess of \$60,000 during any period

⁶ Changes are marked based on the text of Rule 4200 as amended by File No. SR-NASD-2004-80 and Amendment No. 1 thereto.

of twelve consecutive months within the three years preceding the determination of independence, other than the following:

- (i) – (iii) No change
- (iv) benefits under a tax-qualified retirement plan, or non-discretionary compensation; [or]
- (v) loans from a financial institution provided that the loans (1) were made in the ordinary course of business, (2) were made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with the general public, (3) did not involve more than a normal degree of risk or other unfavorable factors, and (4) were not otherwise subject to the specific disclosure requirements of SEC Regulation S-K, Item 404;
- (vi) payments from a financial institution in connection with the deposit of funds or the financial institution acting in an agency capacity, provided such payments were (1) made in the ordinary course of business; (2) made on substantially the same terms as those prevailing at the time for comparable transactions with the general public; and (3) not otherwise subject to the disclosure requirements of SEC Regulation S-K, Item 404; or
- (vii) loans permitted under Section 13(k) of the Act.

Provided however, that in addition to the requirements contained in this paragraph (B), audit committee members are also subject to additional, more stringent requirements under Rule 4350(d).

(C) – (G) No change

(16) – (38) No change

(b) No change

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. It should be noted that there are additional, more stringent requirements that apply to directors serving on audit committees, as specified in Rule 4350.

The Rule’s reference to a “parent or subsidiary” 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 statements). The reference to executive officer means those officers covered in Rule 16a-1(f) under the Act. In the context of the definition of Family Member under

Rule 4200(a)(14), the reference to marriage is intended to capture relationships specified in the Rule (parents, children and siblings) that arise as a result of marriage, such as "in-law" relationships.

The three year look-back periods referenced in paragraphs (A), (C), (E) and (F) of the Rule commence on the date the relationship ceases. For example, a director employed by the company is not independent until three years after such employment terminates.

Paragraph (B) of the Rule 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. 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 paragraph (B) of the Rule. Subparagraph (v) clarifies that a loan from a financial institution that was exempt from specific disclosure pursuant to Instruction 3 to SEC Regulation S-K, Item 404(c) will not preclude a finding of director independence. Subparagraph (vi) clarifies that certain payments from financial institutions will not preclude a finding of director independence. In particular, subparagraph (vi) is intended to capture standard, non-preferential payments made by financial institutions in the ordinary course of business such as interest payments made by a bank on deposits, certificates of deposits, or savings bonds. Furthermore, subparagraph (vi) is intended to capture technical "payments" made by a financial institution to its customers when the financial institution acts as an agent for its customers. For example, when a brokerage firm receives dividends for securities held by a customer, it will make a "payment" of the dividend amount to that customer. Likewise,

when a brokerage firm executes a customer's order to sell the customer's securities, it will make a "payment" of the proceeds to the customer. Subparagraph (vi) clarifies that agency payments, such as those described above, shall not preclude a finding of director independence.

Paragraph (D) of the Rule 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, controlling shareholder or executive officer of such entity. Under exceptional circumstances, such as where a director has direct, significant business holdings, it may be appropriate to apply the corporate measurements in paragraph (D), rather than the individual measurements of paragraph (B). Issuers should contact Nasdaq if they wish to apply the Rule in this manner. The reference to a partner in paragraph (D) is not intended to include limited partners. It should be noted that the independence requirements of paragraph (D) of the Rule are broader than Rule 10A-3(e)(8) under the Act.

Under paragraph (D), 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 5% of the charity's revenues or \$200,000. However, Nasdaq encourages companies to consider other situations where a director or their Family Member and the company each have a relationship with the same charity when assessing director independence.

For purposes of determining whether a lawyer is eligible to serve on an audit committee, Rule 10A-3 under the Act generally provides that any partner in a law firm that receives payments from the issuer is ineligible to serve on that issuer's audit committee. In determining whether a director may be considered independent for

purposes other than the audit committee, payments to a law firm would generally be considered under Rule 4200(a)(15)(D), which looks to whether the payment exceeds the greater of 5% of the recipient's gross revenues or \$200,000; however, if the firm is a sole proprietorship, Rule 4200(a)(15)(B), which looks to whether the payment exceeds \$60,000, applies.

Paragraph (G) of the Rule provides a different measurement for independence for investment companies in order to harmonize with the Investment Company Act of 1940. In particular, in lieu of paragraphs (A)-(F), a director who is an "interested person" of the company as defined in Section 2(a)(19) of the Investment Company Act of 1940, other than in his or her capacity as a member of the board of directors or any board committee, shall not be considered independent.

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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

NASD Rule 4200(a)(15)(B) generally provides that a director of a listed company will not be considered independent if that director or a family member accepted any

payments from the company in excess of \$60,000 per year in a three-year period.

According to Nasdaq, the purpose of this proposed rule change is to clarify that certain standard, non-preferential transactions by financial institutions that technically involve “payments” by the financial institution to the financial institutions’ customers will not preclude a finding of independence under this rule.

Nasdaq states that the ordinary business services provided by financial institutions, such as banks, often involve “payments” to the financial institutions’ customers. For example, a bank customer technically receives “payments” from the bank in the form of interest payments on deposits, the receipt of a loan check, or the principal and interest from a matured savings bonds. A financial institution also may make agency “payments” to its customers in connection with securities transactions. For example, when a brokerage firm’s customer receives dividends, the brokerage firm may receive the dividend from the issuer as the customer’s agent, and then make a “payment” to the customer after it has received the dividend from the issuer. Furthermore, when a brokerage firm customer sells securities, the proceeds from the sale are first received by the brokerage firm since the securities are normally held in its name. Upon receipt of the proceeds from the sale, the brokerage firm will make a “payment” in the amount of the proceeds to the customer.

Nasdaq believes that these non-preferential and ordinary-course “payments” do not raise independence concerns and, therefore, should not preclude a finding of director independence. Any type of preferential or compensatory payment to a director or Family Member of a director in excess of \$60,000 would continue to be considered pursuant to that Rule.

2. Statutory Basis

Nasdaq believes that the proposed rule change is consistent with the provisions of Section 15A of the Act,⁷ in general, and with Section 15A(b)(6) of the Act,⁸ in particular, in that it is designed to foster cooperation and coordination with persons engaged in regulating and processing information with respect to, and facilitating transactions in securities, to remove impediments to a free and open market and a national market system, and, in general, to protect investors and the public interest. In particular, the proposed rule change will benefit investors, issuers, issuers' counsel, and member firms by providing additional transparency to Nasdaq's corporate governance standards.

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

Nasdaq does not believe that the proposed rule change will impose 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

The proposed rule change has been designated by Nasdaq as a “non-controversial” rule change pursuant to Section 19(b)(3)(A) of the Act⁹ and subparagraph (f)(6) of Rule 19b-4 thereunder.¹⁰

The foregoing proposed rule change: (1) does not significantly affect the

⁷ 15 U.S.C. 78o-3.

⁸ 15 U.S.C. 78o-3(b)(6).

⁹ 15 U.S.C. 78s(b)(3)(A).

¹⁰ 17 CFR 240.19b-4(f)(6).

protection of investors or the public interest, (2) does not impose any significant burden on competition, and (3) by its terms does not become operative for 30 days after the date of this filing, or such shorter time as the Commission may designate, if consistent with the protection of investors and the public interest. Furthermore, the NASD gave the Commission written notice of its intent to file the proposed rule change, along with a brief description and text of the proposed rule change, at least five business days prior to the date of filing of the proposed rule change. Consequently, the proposed rule change has become effective pursuant to Section 19(b)(3)(A) of the Act¹¹ and Rule 19b-4(f)(6) thereunder.¹²

Pursuant to Rule 19b-4(f)(6)(iii),¹³ a proposed “non-controversial” rule change does not become operative for 30 days after the date of filing, or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest. Nasdaq has requested that the Commission waive the 30-day operative delay, to permit the NASD to implement the proposal immediately.

The Commission believes that waiving the 30-day operative delay is consistent with the protection of investors and the public interest. The Commission believes that the proposed rule change is a reasonable clarification of the rules regarding director independence, and that acceleration of the operative date should facilitate the application of those rules for listed companies. Therefore, the Commission designates the proposed

¹¹ 15 U.S.C. 78s(b)(3)(A).

¹² 17 CFR 240.19b-4(f)(6).

¹³ 17 CFR 240.19b-4(f)(6)(iii).

rule change to be operative immediately.¹⁴

At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.¹⁵

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. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File No. SR-NASD-2004-086 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File No. SR-NASD-2004-086. This file number should be included on the subject line if e-mail is used. To help the Commission process and

¹⁴ For the purposes only of accelerating the operative date of this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

¹⁵ For purposes of calculating the 60-day abrogation period, the Commission considers the period to commence on June 17, 2004, the date that Nasdaq filed Amendment No. 1.

review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). 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 Section, 450 Fifth Street, NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of the NASD. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File No. SR-NASD-2004-086 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁶

Margaret H. McFarland
Deputy Secretary

¹⁶ 17 CFR 200.30-3(a)(12).

