

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-49901; File No. SR-NASD-2004-080)

June 22, 2004

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change and Amendment No. 1 Thereto by the National Association of Securities Dealers, Inc. to Conform Certain Provisions of NASD Rules 4200 and 4350 to the Rules of Another Self-Regulatory Organization, and to Make Additional Revisions

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 May 18, 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 an amendment to the proposed rule change.<sup>3</sup> Nasdaq has designated the proposed rule change as constituting a “non-controversial” rule change under subparagraph (f)(6) of Rule 19b-4 under the Act,<sup>4</sup> which renders the proposal effective upon filing with the Commission. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

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

<sup>3</sup> See letter from Edward S. Knight, Executive Vice President, Nasdaq, to Katherine A. England, Assistant Director, Division of Market Regulation, Commission, dated June 16, 2004 (“Amendment No. 1”). In Amendment No. 1, Nasdaq clarified, in the text of its proposed rule language, a reference to exemptions that are not afforded to investment companies and deleted a proposed reference to NASD Rule 4200(a)(15) in the paragraph in the Interpretive Material to Rule 4200 relating to look-back provisions.

<sup>4</sup> 17 CFR 240.19b-4(f)(6).

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

Nasdaq proposes to amend NASD Rules 4200 and 4350 as set forth below. Proposed new language is in *italics*; proposed deletions are in brackets.<sup>5</sup>

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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 of twelve consecutive months within the three years preceding the determination of independence [the current or

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<sup>5</sup> Changes are marked from the text of NASD Rules 4200 and 4350 and IM-4200, which are currently available in electronic format in the NASD Manual at [www.nasd.com](http://www.nasd.com) and [www.nasdaq.com](http://www.nasdaq.com). The relevant portion of current NASD Rule 4200 was approved in Securities Exchange Act Release No. 48745 (November 4, 2003), 68 FR 64154 (November 12, 2003). Changes with respect to NASD Rule 4350 are marked based on the rule text as amended by SR-NASD-2004-069. See Securities Exchange Act Release 49732 (May 19, 2004), 69 FR 29774 (May 25, 2004). Nasdaq represents that no other pending or approved rule filings would affect the text of these Rules.

any of the past three fiscal years], other than the following:

(i) – (iv) No change

(v) 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) – (F) No change

(G) In the case of an investment company, in lieu of paragraphs (A)- (F), a director who is an “interested person” of the company as defined in S[s]ection 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.

(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 R[r]ule'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 [U.S. Securities and Exchange] 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 SEC 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 R[r]ule (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 R[r]ule is generally intended to capture situations where a payment is made directly to (or for the benefit of) the director or a [f]Family [m]Member of the director. For example, consulting or personal service contracts with a director or [f]Family [m]Member of the director or political contributions to the campaign of a director or a [f]Family [m]Member of the director would be considered under paragraph (B) of the R[r]ule.

Paragraph (D) of the [r]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 R[r]ule 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 R[r]ule are broader than SEC 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, SEC 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 R[r]ule 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 S[s]ection 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, [would]shall not be considered [to be] independent.

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**4350. Qualitative Listing Requirements for Nasdaq National Market and Nasdaq SmallCap Market Issuers Except for Limited Partnerships**

No change.

**(a) Applicability**

(1) through (4) No change.

**(5) Effective Dates/Transition.** In order to allow companies to make necessary adjustments in the course of their regular annual meeting schedule, and consistent with [Exchange Act]SEC Rule 10A-3, Rules 4300 and 4350 are effective as set out in this subsection. During the transition period between November 4, 2003 and the effective date of Rules 4200 and 4350, companies that have not brought themselves into compliance with these [r]Rules [must]shall continue to comply with Rules 4200-1 and 4350-1, which consist of sunseting sections of previously existing Rules 4200 and 4350.

The provisions of Rule 4200(a) and Rule 4350(c), (d) and (m) regarding director independence, independent committees, and notification of noncompliance shall be implemented by the following dates:

- July 31, 2005 for foreign private issuers and small business issuers (as defined in SEC Rule 12b-2); 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 shall have until their 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 shall comply with the audit committee requirements pursuant to the implementation schedule bulleted above.

[Issuers that have listed or shall be listed in conjunction with their initial public offerings shall be afforded exemptions from all board composition requirements consistent with the exemptions afforded in Rule 10A-3(b)(1)(iv)(A) under the Act. That is, for each committee that the company adopts, the company shall 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.] A company listing in connection with its initial public offering shall be permitted to phase in its compliance with the independent committee requirements set forth in Rule 4350(c) on the same schedule as it is permitted to phase in its compliance with the independent audit committee requirement pursuant to SEC Rule 10A-3(b)(1)(iv)(A). Accordingly, a company listing in connection with its initial public offering shall be permitted to phase in its compliance with the independent committee requirements set forth in Rule 4350(c) as follows: (1) one independent member at the time of listing; (2) a majority of independent members within 90 days of listing; and (3) all independent members within one year of listing. Furthermore, a company listing in connection with its initial public offering shall have twelve months from the date of listing to comply with the majority independent board requirement in Rule 4350(c). It should be noted, however, that pursuant to SEC Rule 10A-3(b)(1)(iii) investment companies are not afforded the[se] exemptions under SEC Rule 10A-3(b)(1)(iv). Issuers may choose not to adopt a compensation or nomination committee and may instead rely upon a majority of the independent directors to discharge responsibilities under [the r]Rule[s] 4350(c). [These issuers

shall be required to meet the majority independent board requirement within one year of listing.]  
For purposes of Rule 4350 other than Rule 4350(d)(2)(A)(ii) and Rule 4350(m), a company shall 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 Act. For purposes of Rule 4350(d)(2)(A)(ii) and Rule 4350(m), a company shall be considered to be listing in conjunction with an initial public offering only if it meets the conditions in SEC Rule 10A-3(b)(1)(iv)(A) under the Act, namely, that the company was not, immediately prior to the effective date of a registration statement, required to file reports with the Commission pursuant to Section 13(a) or 15(d) of the Act.

Companies that are emerging from bankruptcy or have ceased to be Controlled Companies within the meaning of Rule 4350(c)(5) shall be permitted to phase-in independent nomination and compensation committees and majority independent boards on the same schedule as companies listing in conjunction with their initial public offering. It should be noted, however, that a company that has ceased to be a Controlled Company within the meaning of Rule 4350(c)(5) must comply with the audit committee requirements of Rule 4350(d) as of the date it ceased to be a Controlled Company. Furthermore, the executive sessions requirement of Rule 4350(c)(2) applies to Controlled Companies as of the date of listing and continues to apply after it ceases to be controlled.

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



The limitations on corporate governance exemptions to foreign private issuers shall be effective July 31, 2005. However, the requirement that a foreign issuer disclose the receipt of a corporate governance exemption from Nasdaq shall be effective for new listings and filings made after January 1, 2004.

Rule 4350(n), requiring issuers to adopt a code of conduct, shall be effective May 4, 2004.

Rule 4350(h), requiring audit committee approval of related party transactions, shall be effective January 15, 2004.

The remainder of Rule 4350(a) and Rule 4350(b) are effective November 4, 2003.

**(b) – (g)** No change

**(h) Conflict of Interest**

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 [must]shall be approved by the company’s audit committee or another independent body of the board of directors. For purposes of this rule, the term “related party transaction” shall refer to transactions required to be disclosed pursuant to SEC Regulation S-K, Item 404. However, in the case of small business issuers (as that term is defined in SEC Rule 12b-2), the term “related party transactions” shall refer to transactions required to be disclosed pursuant to SEC Regulation S-B, Item 404, and in the case of non-U.S. issuers, the term “related party transactions” shall refer to transactions required to be disclosed pursuant to Form 20-F, Item 7.B.

**(i) - (n)** No change.

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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, as amended, 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

According to Nasdaq, the purpose of this rule filing, as amended, is to change certain provisions of Nasdaq's existing corporate governance standards to conform to the corporate governance standards of another self-regulatory organization and to provide additional transparency to such standards.

(i) Rule 4200(a)(15)(B) Look-back Provision

NASD Rule 4200(a)(15)(B) currently provides that a person cannot be an independent director if the person has accepted any payments from the company or a subsidiary or parent of the company in excess of \$60,000 during the current or any of the past three fiscal years. The proposed rule filing would eliminate the use of an issuer's fiscal year in determining the three-year look-back period set forth in NASD Rule 4200(a)(15)(B). Under the proposed new rule, as amended, the look-back period would be any period of twelve consecutive months within the three years preceding the date independence is to be determined. For example, if independence were to be determined as of an issuer's annual meeting scheduled for May 1, 2004, the look-back period under the proposed new NASD Rule 4200(a)(15)(B) would be from May 1, 2001 to May 1, 2004. Under the current NASD Rule 4200(a)(15)(B), the look-back period depends on when

the issuer's fiscal year begins. Using the same example above, with independence to be determined as of the issuer's annual meeting scheduled for May 1, 2004 and with the issuer's fiscal year beginning on October 1, the look-back period would be from October 1, 2000 to May 1, 2004. Nasdaq believes that the proposed modification to NASD Rule 4200(a)(15)(B) is appropriate because it introduces a simpler calculation that is not dependent on an issuer's particular fiscal year-end.

(ii) Clarification of the Transition Rules for a Company Emerging From Bankruptcy or a Company that Ceases to be a Controlled Company

The proposed rule change, as amended, also would clarify that a company emerging from bankruptcy or a company that ceases to be a Controlled Company (as defined by NASD Rule 4350(c)(5)) will be given the same schedule for compliance with NASD Rule 4350's independent committees and majority independent board requirements as a company seeking to be listed in connection with an initial public offering ("IPO") is given pursuant to NASD Rule 4350(a)(5). In particular, for each committee that the company adopts (other than the audit committee) 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 of listing. Furthermore, the company would be required to have a majority independent board within one year of listing. Nasdaq states that it has historically given a company emerging from bankruptcy or a company that ceases to be a Controlled Company the same grace period for compliance with NASD Rule 4350 as it provides a company seeking to be listed in connection with an IPO. Nasdaq believes that providing such companies with a reasonable period of time to make adjustments to comply with the requirements of Rule 4350 is reasonable and appropriate under the circumstances. Likewise, pursuant to Section 303A of the Listed Company Manual of the New York Stock Exchange ("NYSE"), the NYSE permits a

company emerging from bankruptcy and a company that has ceased to be Controlled Company to phase-in independent nomination and compensation committees and majority independent boards on the same schedule as companies listing in conjunction with an IPO. Accordingly, Nasdaq believes the proposed rule filing, as amended, will conform Nasdaq's corporate governance standards to the NYSE's corporate governance standards, creating more uniformity across market centers with respect to transition rules for these companies.

(iii) Clarification of the definition of "related party transaction"

Further, the proposed rule change, as amended, would clarify the definition of the term "related party transaction" in NASD Rule 4350(h) with respect to small business issuers and non-U.S. issuers. The term "related party transaction" is currently defined in NASD Rule 4350(h) as any transaction that must be disclosed pursuant to SEC Regulation S-K, Item 404. Small business issuers and non-U.S. issuers, however, are not subject to SEC Regulation S-K, Item 404, but are instead subject to SEC Regulation S-B, Item 404, and Form 20-F, Item 7.B, respectively. Accordingly, the proposed rule change, as amended, corrects this discrepancy by clarifying that the term "related party transaction" for purposes of small business issuers shall refer to transactions required to be disclosed under SEC Regulation S-B, Item 404, and, with respect to non-U.S. issuers, the term "related party transactions" shall refer to those transactions required to be disclosed under Form 20-F, Item 7.B.<sup>6</sup>

2. Statutory Basis

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<sup>6</sup> The Commission notes that the proposed rule change also includes additional amendments to the text of NASD Rules 4200 and 4350 and IM-4200 that do not introduce substantive changes.

Nasdaq believes that the proposed rule change, as amended, is consistent with the provisions of Section 15A of the Act,<sup>7</sup> in general, and furthers the objectives of Section 15A(b)(6) of the Act,<sup>8</sup> 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. Nasdaq believes the proposed rule change will benefit investors, issuers, issuers' counsel, and member firms by providing additional transparency to Nasdaq's corporate governance standards and promoting greater uniformity with the existing corporate governance standards of the NYSE. Nasdaq also believes additional transparency and greater uniformity will reduce administrative costs associated with compliance with 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 result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

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 for this proposed rule change.

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 Act<sup>9</sup> and subparagraph (f)(6) of Rule 19b-4

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<sup>7</sup> 15 U.S.C. 78o-3.

<sup>8</sup> 15 U.S.C. 78o-3(b)(A).

<sup>9</sup> 15 U.S.C. 78s(b)(3)(A).

thereunder.<sup>10</sup>

The foregoing proposed rule change: (1) does not significantly affect the 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 Act<sup>11</sup> and Rule 19b-4(f)(6) thereunder.<sup>12</sup>

Pursuant to Rule 19b-4(f)(6)(iii),<sup>13</sup> 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 makes reasonable modifications that will ease the application of certain of Nasdaq’s corporate governance rules for listed issuers and conforms others to those of the NYSE, and that

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<sup>10</sup> 17 CFR 240.19b-4(f)(6).

<sup>11</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>12</sup> 17 CFR 240.19b-4(f)(6).

<sup>13</sup> 17 CFR 240.19b-4(f)(6)(iii).

acceleration of the operative date is appropriate to expedite their implementation. Therefore, the Commission designates the proposed rule change to become operative immediately.<sup>14</sup>

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.<sup>15</sup>

#### 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 E-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-NASD-2004-080 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 Number SR-NASD-2004-080. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your

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

<sup>15</sup> 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.

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 Room. Copies of such filing also will be available for inspection and copying at the principal office of Nasdaq. 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 Number SR-NASD-2004-080 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.<sup>16</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>16</sup> 17 CFR 200.30-3(a)(12).