

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.

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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

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