

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