

#### 4. Nomination of Directors

Nasdaq proposes to amend NASD Rule 4350(c) to require director nominees to either be selected or recommended for the board's selection either by a majority of independent directors, or by a nominations committee comprised solely of independent directors ("Nasdaq Director Nomination Provision").<sup>141</sup>

If the nominations committee is comprised of at least three members, one director, who is not independent (as defined in NASD Rule 4200) and is not a current officer or employee or a Family Member of such person, would be permitted to be appointed to the 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 (of, if the issuer does not file a proxy, in its Form 10-K or 20-F), the nature of the relationship and the reasons for the determination.<sup>142</sup> A member appointed under such exception would not be permitted to serve longer than two years.

Further, Nasdaq proposes to require each issuer to certify that it has adopted a formal written charter or board resolution, as applicable, addressing the nominations process and such related matters as may be required under the federal securities laws.<sup>143</sup> Nasdaq also proposes that the Nasdaq Director Nomination Provision would not apply in cases where either the right to nominate a director legally belongs to a third party,<sup>144</sup> or the company is subject to a binding obligation that requires a director nomination structure inconsistent with this provision and

such obligation pre-dates the date the provision is approved.<sup>145</sup>

#### 5. Controlled Companies Exempt

Nasdaq proposes generally to exempt any Controlled Company from the requirement to have a majority of independent directors and from the compensation and nomination committee requirements discussed above. However, the independent directors would still be required to have regularly scheduled meetings at which only independent directors are present.<sup>146</sup> A Controlled Company would be defined as a company of which more than 50% of the voting power is held by an individual, a group, or another company. A company relying upon the exemption would be required to disclose in its annual proxy statement (or, if the issuer does not file a proxy, in its Form 10-K or 20-F) that it is a Controlled Company and the basis for that determination. To determine whether a group exists for purposes of this exception, the shareholders must have publicly filed a notice that they are acting as a group (e.g., a Schedule 13D).<sup>147</sup>

#### 6. Audit Committee Charter and Responsibilities

NASD Rule 4350(d) would retain the requirement that each issuer adopt a formal written audit committee charter, and the proposed amendment to the rule would require the charter to specify the committee's purpose of overseeing the accounting and financial reporting processes and the audits of the financial statements of the issuer.<sup>148</sup> The written charter also would be required to include specific audit committee responsibilities and authority, as set forth in the proposed amendment to Rule 4350(d)(3).<sup>149</sup> Nasdaq also

proposes to state in Interpretive Material to Rule 4350(d) that the written charter set forth the scope of the audit committee's responsibilities and the means by which the committee carries out those responsibilities; the outside auditor's accountability to the committee; and the committee's responsibility to ensure the independence of the outside auditors.<sup>150</sup>

#### 7. Audit Committee Composition

NASD Rule 4350(d) would retain the requirement that each listed issuer have an audit committee composed of at least three members.<sup>151</sup> However, under the proposed requirements, each audit committee member would be required to: (1) Be independent, as defined under NASD Rule 4200; (2) meet the criteria for independence set forth in Rule 10A-3 (subject to the exceptions provided in Rule 10A-3(c)); and (3) not have participated in the preparation of the financial statements of the company or any current subsidiary of the company at any time during the past three years, in addition to satisfying the current requirement that the member be able to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement ("Nasdaq Audit Committee Provision").<sup>152</sup>

One director who is not independent as defined in NASD Rule 4200 and meets the criteria set forth in section 10A(m)(3) of the Exchange Act<sup>153</sup> and the rules thereunder, and is not a current officer or employee of the company or a Family Member of such 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 company and

matters, (iii) authority to engage advisors, and (iv) funding as determined by the audit committee. In Amendment No. 3 to the Independent Director Proposal, *supra* note 12, Nasdaq proposes to clarify that audit committees for investment companies must also establish procedures for the confidential, anonymous submission of concerns regarding questionable accounting or auditing matters by employees of the investment adviser, administrator, principal underwriter, or any other provider of accounting related services for the investment company, as well as employees of the investment company.

<sup>150</sup> See IM-4350-4—Board Independence and Independent Committees—Audit Committees—Rule 4350(d)—Audit Committee Charter.

<sup>151</sup> See NASD Rule 4350(d)(2). See also *supra* note.

<sup>152</sup> See NASD Rule 4350(d)(2)(A)(i)–(iv). In Amendment No. 3 to the Independent Director Proposal, *supra* note 12, Nasdaq proposes to: (1) Add a cross-reference to Rule 10A-3; and (2) add the third requirement noted above.

<sup>153</sup> 15 U.S.C. 78j-1(m).

<sup>141</sup> See NASD Rule 4350(c)(4)(A). In Amendment No. 3 to the Independent Director Proposal, *supra* note 12, Nasdaq proposes to add the option that director nominees could be recommended for the board's selection.

<sup>142</sup> See NASD Rule 4350(c)(4)(C). In Amendment No. 3 to the Independent Director Proposal, *supra* note 12, Nasdaq proposes to delete another exception that it had previously proposed, which would have permitted an appointment to the nominating committee, under specified circumstances, of a non-independent director who owns 20% or more of a company's voting stock.

<sup>143</sup> See NASD Rule 4350(c)(4)(B) and Amendment No. 3 to the Independent Director Proposal.

<sup>144</sup> Nasdaq proposes to add a sentence to explain that this provision does not relieve a company's obligation to comply with the committee composition requirements under Rule 4350(c) and (d). See Amendment No. 3 to the Independent Director Proposal, *supra* note 12, and NASD Rule 4350(c)(4)(D).

<sup>145</sup> See Amendment No. 3 to the Independent Director Proposal, *supra* note 12 and NASD Rule 4350(c)(4)(E).

<sup>146</sup> See NASD Rule 4350(c)(5). In Amendment No. 3 to the Independent Director Proposal, *supra* note 12, Nasdaq proposes to clarify that the exemption does not apply to executive sessions of independent directors.

<sup>147</sup> See IM-4350-4—Controlled Company Exception.

<sup>148</sup> See NASD Rule 4350(d)(1). NASD Rule 4350(d) would retain various provisions of the current rule, including, for example, the requirements that an audit committee have a written charter and that it be comprised of at least three independent directors who meet certain financial literacy requirements.

<sup>149</sup> NASD Rule 4350(d)(3) would require the audit committee to have the specific audit committee responsibilities and authority necessary to comply with Rule 10A-3(b)(2), (3), (4) and (5) (subject to the exemptions provided in Rule 10A-3(c)), concerning responsibilities relating to: (i) Registered public accounting firms, (ii) complaints relating to accounting, internal accounting controls or auditing