



Hardwick Simmons  
Chairman and Chief Executive Officer

By Hand and First Class Mail

April 11, 2002

The Honorable Harvey L. Pitt  
Chairman  
U.S. Securities and Exchange Commission  
450 Fifth Street, NW  
Washington, D.C. 20549

Re: Your February 12, 2002 Letter Regarding Corporate Governance

Dear Mr. Chairman:

Thank you for the opportunity to respond to your February 12, 2002 letter requesting consideration of whether additional steps might be taken by the nation's stock markets to strengthen corporate governance. Recent events have focused attention on the need to assure strong corporate governance and the roles of the federal government, the markets, and listed companies in that reform. The response has been wide ranging, from legislative proposals to federalize corporate governance requirements to proposals that would address concerns through best practices that would encourage, but not require, compliance. As set forth in greater detail below, Nasdaq is actively considering this issue, and shares your belief that strong corporate governance benefits investors and the market.

Nasdaq is fully committed to promoting excellence in corporate governance. As you may be aware, we recently published a list of "Responsibilities We All Share" which was signed by our board members, sent to our listed companies, and published in a number of national publications. Further, we plan to host a series of Nasdaq Corporate Governance Summits across the country next month designed to foster a dialogue on these issues, and we appreciate your willingness to participate personally as well as to commit your senior staff resources in this important dialogue. We believe that these meetings will provide useful contributions that will be incorporated into our final conclusions on Nasdaq's appropriate role in this area.

To begin our evaluation of potential actions to strengthen corporate governance, we called upon our standing independent advisory committee on listing and corporate governance issues, the Nasdaq Listing and Hearing Review Council ("Council"). In fact, the Council had initiated last year an examination of possible improvements to corporate governance rules, including many of the issues that you raise in your letter. This has caused the Council to develop a number of tentative conclusions, as well as identify

areas that warrant further study as set forth in detail below. I believe that the Council has provided thoughtful recommendations that should be further explored and presented at Nasdaq's next board meeting, along with further input received in connection with our Corporate Governance Summits noted above.

**Codes of Conduct and Compliance Mechanisms to Support Them.** You asked whether companies should be required to adopt codes of conduct for their officers and directors. At your suggestion, the Council met with the President of Financial Executives International ("FEI") on this topic. The Council believes that marketplaces should recommend that their listed companies adopt a Code of Conduct as a best practice and that such a Code should be approved by the company's Board and, at a minimum, address conflicts of interest and compliance with applicable laws. Companies should also adopt board approved procedures for monitoring compliance with their Codes. A best practice adopted by the markets will be more effective if it operates in tandem with a new Commission rule requiring disclosure as to whether the company has a board approved Code of Conduct.

While it is our belief that many Nasdaq companies already have Codes of Conduct, there is limited data available on this issue because it is not currently a required disclosure. We are in the process of reviewing proxies filed by Nasdaq companies in order to determine how many voluntarily have disclosed the adoption of a Code. Additionally, if the Commission believes the markets should offer further guidance on Codes of Conduct, we are ready to participate in a dialogue.

**Audit Committee Qualifications and Competence.** The Council also considered whether companies should be required to take steps to ensure that officers, audit committee members and other directors have a sufficient level of competence, and whether continuing education in this area should be required. Nasdaq has historically supported minimum competence levels for corporate directors, especially for members of audit committees. In fact, in 1999 Nasdaq adopted the core competency requirements for audit committees that were recommended in the industry-wide Report by the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees ("Blue Ribbon Report"). In order to provide as much transparency as possible, Nasdaq sets forth these qualification criteria in its listing standard. Specifically, Nasdaq requires that each member of the audit committee be "able to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement." In addition, under these rules, at least one member of the audit committee 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." At the Council's request, we will be conducting a survey of a sample of Nasdaq listed companies in order to review the qualifications of audit committee members. This information will be used to assess whether the current rules go far enough to protect adequately the public interest in well-functioning audit committees.

More generally, Nasdaq supports the concept of continuing education for all board members. In addition to the Corporate Governance Summits previously discussed, Nasdaq is a continuing sponsor of several major corporate governance conferences such of the Stanford Directors College, which Nasdaq has sponsored for

many years, and the University of Wisconsin/State of Wisconsin Investment Board Director's Summit, which Nasdaq has sponsored since its inauguration last year. Further, Nasdaq has sponsored educational conferences with Corporate Board Member Magazine covering issues such as challenges facing board members, keys to good governance and best practices. In addition, since 1999 when corporate governance requirements were extended to The Nasdaq SmallCap Market, Nasdaq has sponsored a series of seminars with the NASD Insurance Agency relating to board member responsibilities and corporate governance issues. Nasdaq also works with its Issuer Affairs Committee to educate our issuers on corporate governance matters. This Committee also has a long-standing relationship with the American Society of Corporate Secretaries, which sponsors educational seminars for board members. The Council is also evaluating whether a best practice regarding continuing education is appropriate.

**Audit Committee Authority with Respect to Independent Auditors.** The Council also examined whether audit committee rules should be further strengthened, for example, by requiring that audit committees be vested with exclusive authority to hire and fire independent auditors. Our current rules require audit committees to have a charter providing that the audit committee and the board have "ultimate authority and responsibility to select, evaluate, and, where appropriate, replace the outside auditor (or to nominate the outside auditor to be proposed for shareholder approval in any proxy statement)." Therefore, all Nasdaq audit committees are already critically engaged in evaluating independent auditors. Nonetheless, the Council believes that as a best practice, the audit committee, in the first instance, should recommend the selection or replacement of the independent auditor. This will increase transparency in this process. Again, in order for this best practice to be effective, the Council believes that it should be coupled with a new Commission requirement that the company disclose in its annual report whether the board disagreed with any recommendations of the audit committee regarding the selection or replacement of the independent auditor.

It should also be noted that current Nasdaq rules require audit committees to have a charter providing that it is the audit committee's responsibility to: (i) receive a formal written statement from the independent auditor listing all relationships between the auditor and the company consistent with Independence Standards Board Standard 1; (ii) engage in active dialogue regarding any disclosed relationships or services that may impact the objectivity and independence of the auditor, and (iii) take or recommend that the board take appropriate actions to oversee the auditor's independence. The Council is studying whether there should be further adjustments to this rule.

**Corporate Governance and Foreign Issuers.** You also raised the question of whether corporate governance requirements that currently may be waived for non-US companies should, in the future, be applied without exception. Due to wide variances in foreign law and business practice, Nasdaq rules permit waivers to foreign issuers whose corporate governance practices do not conform to those otherwise required by Nasdaq's rules. To qualify for such an exemption, however, an issuer is required to demonstrate that the non-conforming practice is both legal in its home country and in accordance with the generally accepted business practices of the home country. In response to your question as to whether the existing practices could be improved, the Council is considering a recommendation that the Commission require companies to disclose whether they have received a waiver of a corporate governance standard from Nasdaq. Moreover, further improvements to our listing standards for foreign issuers are under consideration to ensure that the "spirit" of U.S. corporate governance standards is met

even when the "letter" of the foreign rules is different. Of course, it would be beneficial if all markets had the same standards in order to ensure transparency and to maximize investor protection.

**Other Adjustments to Listing Standards.** You asked whether other adjustments to listing standards could be made to help ensure the highest degree of investor confidence in our public companies. The Council is continuing to look at Nasdaq's listing standards for this purpose. As discussed in more detail below, the Council has already identified the following areas in which corporate governance and market integrity could be enhanced: (i) clarifying the definition of independent director; (ii) strengthening marketplace rules on approval of related party transactions; (iii) clarifying our news dissemination rules; and (iv) strengthening shareholder approval requirements for stock option plans involving officers and directors.

**The Director Independence Definition.** All major US markets require audit committees to be comprised solely of independent directors.<sup>1</sup> Nasdaq's rule provides that an independent director is a person other than an officer or employee or a person who, in the opinion of the board of directors, has a relationship that would interfere with the exercise of independent judgment in carrying out the responsibilities of a director. In response to the recommendations of the Blue Ribbon Committee, Nasdaq added several provisions to the rule in 1999 specifying relationships that would preclude independence. These relationships are as follows: employment with the listed company, compensation paid to directors, familial relationships with officers, payments between the listed company and a company with which the director is associated, and relationships arising from interlocking service on another company's compensation committee.<sup>2</sup>

Nasdaq adopted these bright line, objective standards, based upon existing SEC disclosure requirements, in order to provide transparency to investors and assist boards of directors in determinations of independence. We have received positive comments from the public regarding the objective criteria set forth in the rule, particularly with respect to the inclusion of specific dollar and percentage amounts in the portion of the rule addressing compensation paid to directors and payments between the listed company and a company with which the director is associated.

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<sup>1</sup> All markets provide that up to one non-independent director may serve on the audit committee in exceptional and limited circumstances, if the board finds it is in the best interest of the company and discloses this in its proxy statement.

<sup>2</sup> In particular, the Nasdaq rule precludes a director from being considered independent if: (1) the director is employed by the listed company or any of its affiliates during the current year or any of the past three years; (2) the director receives compensation from the corporation or its affiliates in excess of \$60,000 during the previous fiscal year (except for board service, retirement plan benefits, or non-discretionary compensation); (3) the director is a member of the immediate family of an individual that was employed as an executive officer of the listed company during the current year or any of the past three years, (4) the director is a partner, controlling shareholder or an executive officer of any for-profit business to which the corporation made, or from which it received, payments (other than those which arise solely from investments in the corporation's securities) that exceed five percent of the organization's consolidated gross revenues for that year, or \$200,000, whichever is more, in any of the past three years; or (5) an executive of another entity where any of the company's executives serve on that entity's compensation committee.

Nevertheless, the Council believes that, in light of the recent events, it would be appropriate to amend and tighten Nasdaq's rule to address other relationships that may impair independence. For example, some audit committee members have been criticized for lacking independence due to their business or other relationships with the company. The Council recommends modifying the definition of independence to address these situations while maintaining existing de minimus thresholds. The Council is also considering whether further changes may be appropriate, including whether a former employee of a company's auditor should be considered non-independent for a period of time. Moreover, we believe that executive officers of all listing markets should be precluded from serving on the boards of their listed companies.

**Related Party Transactions.** Nasdaq's current rules require that companies "shall conduct an appropriate review of all related party transactions on an ongoing basis and shall utilize the company's audit committee or a comparable body of the board of directors for the review of potential conflict of interest situations where appropriate." The Council believes that it would be appropriate to consider strengthening this rule to require that related party transactions not only be reviewed, but also approved by the audit committee and the Board. Again, such a requirement could be complemented by an adjustment to required Commission disclosure.

**Enhancements to News Dissemination.** Nasdaq's current rules require that companies disclose material information to the public through a major wire service and notify Nasdaq in advance of doing so, in order to allow an assessment of whether a news dissemination halt is appropriate. Following the adoption of the Commission's Regulation FD, which allows alternative means of dissemination including conference calls and webcasts, there has been some confusion among issuers as to acceptable means of information dissemination. For example, issuers that communicate through webcasts, as permitted by Regulation FD, may feel constrained due to the inconsistencies between Regulation FD and Nasdaq rules. In response to this confusion, the Council is recommending ways in which Nasdaq's rules can be harmonized with Regulation FD, in order to facilitate full and fair disclosure, and address the current uncertainty among issuers.

We also support the proposal to accelerate disclosure on insider sales.

**Shareholder Approval for Stock Option Plans.** We share your recently expressed view that stock option plans that include officers and directors should be subject to shareholder approval. As you know, our rules require such shareholder approval, with an exception for broadly based plans, which are primarily available to non-executive employees. We have been discussing with the Commission staff the Council's proposal to restrict even this exception by reducing the level of executive officer participation in these plans and requiring approval by disinterested directors. The Council, moreover, has been actively considering your recently expressed view that all stock option plans benefiting officers or directors should be approved by shareholders. The Council reaction has been positive, and the Council will make a proposal to our board consistent with your thinking at the Board's May meeting.

**Implementation.** You asked about the costs and benefits of these proposed changes. Our upcoming Corporate Governance Summits will be useful in answering the question. In addition, you asked how Nasdaq would monitor and enforce any new proposed corporate governance requirements. Nasdaq is committed to enhancing its

market through strong corporate governance requirements and a well-enforced compliance process. In this regard, Nasdaq staff currently reviews the public filings of every listed issuer, including periodic reports and proxy statements, to check for compliance with our quantitative and qualitative listing standards. However, as noted, some of the changes proposed by the Council involve matters that are not presently the subject of a Commission disclosure requirement. With the addition of such requirements, the changes discussed above could be monitored within our existing compliance program.

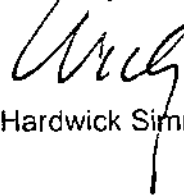
As a compliment to these reforms, Nasdaq is considering establishing an annual award for the company in each sector of our market that displays the most enlightened and progressive practices in corporate governance.

**Conclusion.** Nasdaq and the other markets have historically played an important role in corporate governance in a cooperative and non-competitive manner, and we must continue to do so in order to ensure market integrity. Therefore, it is appropriate that you have also requested that the New York Stock Exchange consider this issue. We encourage you to also include the Amex and other listed markets in this dialogue. As noted above, several of the changes under consideration would be more effective if adopted by all markets. Nevertheless, we believe that effective corporate governance standards in any form make us a better market.

While the markets play a key role, they do not operate in isolation. Effective corporate governance also depends on the integrity of corporate leaders, independent auditors, and the legal profession. And as reflected in our comments, the Commission, through, among other things, effective disclosure requirements, is an integral part in encouraging strong corporate governance practices as well. We look forward to the opportunity for further dialogue on these issues, as we bring proposals to our Board for consideration.

We appreciate the opportunity to share our views on the important issue of enhancing corporate governance. With the Commission and the markets working cooperatively, investors and the market will benefit.

Sincerely,



Hardwick Simmons