

NASD-00-73.<sup>6</sup> The *Subscriber Bulletin* also announced that the increased cost of the expanded bandwidth (\$375 per month per circuit) would be passed on to Nasdaq subscribers beginning December 1, 2000. Nasdaq absorbed all of increased costs for the month of November 2000.

Because the original filing relating to NASD members was made under section 19(b)(3)(A)(ii), which makes the rule change immediately effective upon filing with the Commission, the fee increase became effective as of December 13, 2000. In this filing, Nasdaq seeks to recover the costs associated with the expanded bandwidth for the period of December 1-12, 2000, as announced in the *Subscriber Bulletin*.

### III. Commission's Findings and Order Granting Accelerated Approval of Proposed Rule Change

The Commission has reviewed the Nasdaq's proposed rule change and finds, for the reasons set forth below, that the proposal is consistent with the requirements of section 15A of the Act<sup>7</sup> and the rules and regulations thereunder applicable to a national securities exchange. Specifically, the Commission believes the proposal is consistent with sections 15A(b)(5) of the Act.<sup>8</sup> Section 15A(b)(5) requires that the rules of a registered securities association provide for the equitable allocation of reasonable dues, fees and other charges among members and issuers and other persons using any facility or system which the association operates or controls. The fee increases proposed by Nasdaq would pass on the costs associated with increasing the capacity of EWN II to users of the Nasdaq Workstation II service.

The Commission believes that Nasdaq's proposal to increase NASD members' fees relating to the EWN II for the period December 1-12, 2000 is a fair means of recovering the costs associated with increasing the bandwidth of the EWN II. The Commission finds that the proposal is consistent with section 15A(b)(5)<sup>9</sup> insofar as the new fees reflect the additional cost that Nasdaq is incurring as a result of the expanded bandwidth. The Commission believes that such fee increases, necessitated by recent system volume increases, are a reasonable means by which Nasdaq intends to ensure adequate capacity of its EWN II system and thus, protect the

ongoing integrity of the Nasdaq market.<sup>10</sup>

Nasdaq has requested that the Commission approve this proposed rule change on an accelerated basis.<sup>11</sup> The original EWN II fee increases for members were effective upon filing with the Commission on December 13, 2000, and have been subject to a full notice and comment period,<sup>12</sup> and that this current proposal imposing the same fees for the period of December 1-12, 2000, has been subject to a full notice and comment period.<sup>13</sup> No comments were received on either filing. Thus, the proposed rule change concerns issues that previously have been the subject to a full comment period pursuant to section 19(b) of the Act.<sup>14</sup> For these reasons, the Commission believes accelerated approval of the proposal is appropriate. Accordingly, the Commission finds good cause for approving the proposed rule change (SR-NASD-00-79) prior to the thirtieth day after the date of publication of notice thereof in the **Federal Register**.

### IV. Conclusion

*It is therefore Ordered*, pursuant to section 19(b)(2) of the Act,<sup>15</sup> that the proposed rule change (SR-NASD-00-79) is approved.

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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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-43941; File No. SR-PCX-00-40]

### Self-Regulatory Organizations; Order Approving a Proposed Rule Change by the Pacific Exchange, Inc. Relating to Audit Committee Requirements for Listed Companies

#### I. Introduction

On October 23, 2000, the Pacific Exchange, Inc. ("PCX" or "Exchange"), through its wholly-owned subsidiary, PCX Equities, Inc. ("PCXE"), submitted to the Securities and Exchange Commission ("SEC" or "Commission"), 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> a proposed rule change amending the PCXE's audit committee requirements. PCXE filed Amendment No. 1 to the proposed rule change on November 22, 2000.<sup>3</sup> The **Federal Register** published the proposed rule change for comment on December 7, 2000.<sup>4</sup> The Commission received no comments on the proposal. This order approves the proposed rule change.

#### II. Description of the Proposed Rule Change

PCXE proposes to modify PCXE Rule 5.3(b), regarding audit committee requirements for listed domestic issuers, to conform to recommendations made by the Blue Ribbon Committee on Improving Effectiveness of Corporate Audit Committees and rule changes adopted by other self-regulatory organizations ("SROs").<sup>5</sup> The proposed rule change specifies four requirements for qualified audit committees, defines certain terms for purposes of the proposed audit committee requirements, and sets forth requirements for companies listing on PCXE in conjunction with an initial public offering.

First, proposed rule 5.3(b)(1) requires the board of directors of companies listed on PCXE to adopt and approve a

<sup>10</sup> In approving this rule, the Commission notes that it has also considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>11</sup> Telephone conversation between Mary Dunbar, Vice President, Nasdaq, and Geoffrey Pemble, Attorney, Division of Market Regulation, Commission, on February 7, 2001.

<sup>12</sup> Securities Exchange Act Release No. 43769 (December 22, 2000) (SR-NASD-00-73), 66 FR 826 (January 4, 2001).

<sup>13</sup> Securities Exchange Act Release No. 43814 (January 8, 2001) (SR-NASD-00-79), 66 FR 3630 (January 16, 2001).

<sup>14</sup> 15 U.S.C. 78s(b).

<sup>15</sup> 15 U.S.C. 78s(b)(2).

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

<sup>6</sup> Securities Exchange Act Release No. 43769 (December 22, 2000) (SR-NASD-00-73), 66 FR 826 (January 4, 2001).

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

<sup>8</sup> 15 U.S.C. 78o-3(b)(5).

<sup>9</sup> *Id.*

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

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

<sup>3</sup> Letter dated November 20, 2000 from Cindy L. Sink, Senior Attorney, PCX, to Nancy Sanow, Assistant Director, Division of Market Regulation, Commission ("Amendment No. 1"). Amendment No. 1 specifies an implementation plan for the proposed rule change.

<sup>4</sup> Securities Exchange Act Release No. 43641 (Nov. 29, 2000), 64 FR 55514.

<sup>5</sup> See Securities Exchange Act Release Nos. 42231 (Dec. 14, 1999), 64 FR 71523 (Dec. 21, 1999) (approving SR-NASD-99-48); 42232 (Dec. 14, 1999), 64 FR 71518 (Dec. 21, 1999) (approving SR-AMEX-99-38); 42233 (Dec. 14, 1999), 64 FR 71529 (Dec. 21, 1999) (approving SR-NYSE-99-39).

formal written charter for the audit committee. The audit committee must review and reassess the adequacy of the formal written charter on annual basis. The charter must specify: (i) The scope of the audit committee's responsibilities and how it carries out those responsibilities, including structure, processes, and membership requirements; (ii) that the outside auditor is ultimately accountable to the board of directors and the audit committee of the company, and that the audit committee and board of directors have the 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); (iii) that the audit committee is responsible for ensuring that the outside auditor submits on a periodic basis to the audit committee a formal written statement delineating all relationships between the auditor and the company; (iv) that the audit committee is responsible for actively engaging in a dialogue with the outside auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the outside auditor; and (v) that the audit committee is responsible for recommending that the board of directors take appropriate action in response to the outside auditor's report to satisfy itself of the outside auditor's independence.

Second, proposed Rule 5.3(b)(2) sets forth the composition and expertise requirements of audit committee members. The proposal requires: (i) Each audit committee to consist of at least three independent directors, all of whom have no relationship to the company that may interfere with the exercise of their independence from management and the company ("Independent"); (ii) each member of the audit committee to be financially literate, as such qualification is interpreted by the company's board of directors in its business judgment, or to become financially literate within a reasonable period of time after his or her appointment to the audit committee; and (iii) at least one member of the audit committee to have accounting or related financial management expertise, as the board of directors interprets such qualification in its business judgment.

Third, proposed Rule 5.3(b)(3) provides the independence requirements of audit committee members. In addition to the definition of Independent provided in Rule 5.3(b)(2)(i), the following restrictions apply to every audit committee member:

(i) *Employees*. A director who is an employee (including non-employee executive officers) of the company or any of its affiliates may not serve on the audit committee until three years following the termination of his or her employment. In the event the employment relationship is with a former parent or predecessor of the company, the director could serve on the audit committee after three years following the termination of the relationship between the company and the former parent or predecessor. "Affiliate" includes a subsidiary, sibling company, predecessor, parent company, or former parent company.

(ii) *Business Relationship*. A director: (a) who is a partner, controlling shareholder, or executive officer of an organization that has a business relationship with the company; or (b) who has a direct business relationship with the company; or (b) who has a direct business relationship with the company (e.g., a consultant) may serve on the audit committee only if the company's board of directors determines in its business judgment that the relationship does not interfere with the director's exercise of independent judgment. In making a determination regarding the independence of a director pursuant to this provision, the board of directors should consider, among other things, the materiality of the relationship to the company, to the director, and, if applicable, to the organization with which the director is affiliated. "Business relationships" can include commercial, industrial, banking, consulting, legal, accounting and other relationships. A director can have this relationship directly with the company, or the director can be a partner, officer or employee of an organization that has such a relationship. The director may serve on the audit committee without the above-referenced board of director's determination after three years following the termination of, as applicable: (a) the relationship between the organization with which the director is affiliated and the company; (b) the relationship between the director and his or her partnership status, shareholder interest or executive officer position; or (c) the direct business relationship between the director and the company.

(iii) *Cross Compensation Committee Link*. A director who is employed as an executive of another corporation where any of the company's executives serves on that corporation's compensation committee may not serve on the audit committee.

(iv) *Immediate Family*. A director who is an Immediate Family member of an individual who is an executive officer of the company or any of its affiliates cannot serve on the audit committee until three years following the termination of such employment relationship. "Immediate Family" includes a person's spouse, parents, children, siblings, mothers-in-law and fathers-in-law, sons and daughters-in-law, and anyone (other than employees) who shares such person's home.

(v) Notwithstanding the requirements of subparagraphs (3)(i) and (30)(iv) of Rule 5.3(b), one director who is no longer an employee or who is an Immediate Family member of a former executive officer of the company or its affiliates, but is not considered Independent pursuant to these provisions due to the three-year restriction period, may be appointed, under exceptional and limited circumstances, to the audit committee if the company's board of directors determines in its business judgment that membership on the committee by the individual is required by the best interests of the corporation and its shareholders, and the company discloses, in the next annual proxy statement subsequent to such determination, the nature of the relationship and the reasons for that determination.

Fourth, proposed Rule 5.3(b)(4) sets forth an ongoing written affirmation requirement. The proposal provides that as part of the initial listing process, and with respect to any subsequent changes to the composition of the audit committee, and otherwise approximately once each year, each company must provide the Exchange written confirmation regarding: (i) any determination that the company's board of directors has made regarding the independence of directors; (ii) the financial literacy of the audit committee members; (iii) the determination that at least one of the audit committee members has accounting or related financial management expertise; and (iv) the annual review and reassessment of the adequacy of the audit committee charter.

Proposed Rule 5.3(b)(5) defines "Officer" to have the meaning specified in Rule 16a-1(f) under the Act,<sup>6</sup> or any successor rule. Moreover, proposed Rule 5.3(b)(6) provides that companies listing in conjunction with their initial public offering (including spin-offs and carve outs) will be required to have two qualified audit committee members in place within three months of listing and

<sup>6</sup> 17 CFR 240.16a-(f).

a third qualified member in place within twelve months of listing.

Finally, PCXE proposes to implement a transition period in order to provide its issuers with sufficient time to come into compliance with the proposed rule change.<sup>7</sup> Specifically, PCXE proposes: (i) to “grandfather” all public company audit committee members qualified under current PCX rules until they are re-elected or replaced; and (ii) give companies eighteen months from the date of Commission approval of this rule filing to recruit the requisite members for their audit committees. Issuers listed on PCXE as of the effective date of the proposed rule change will have six months to adopt a formal written audit committee charter.

### III. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.<sup>8</sup> In particular, the Commission finds that the proposed rule change furthers the objectives of Section 6(b)(5) of the Act,<sup>9</sup> in that it is designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system and, in general, to protect investors and the public interest.

The Commission believes that the proposed rule change will protect investors by improving the effectiveness of audit committee of companies listed on PCXE. The Commission also believes that the new requirements will enhance the quality and reliability of financial statements of companies listed on PCXE by making it more difficult for companies to inappropriately distort their true financial performance. These new provisions should help to assure that investors have quality and reliable financial information regarding PCXE listed issuers, including for investors who decide to buy or sell the securities of these issuers in secondary market transactions.

Specifically, the Commission believes that the proposed definition of independence will promote the objectivity and reliability of a company's financial statements. The Commission believes that directors without financial, familial, or other material personal ties to management will be more likely to objectively evaluate the propriety of management's accounting, internal control, and financial reporting practices. In addition, the Commission considers that the proposed provision permitting a company to appoint one non-independent director to its audit committee, if the board determines that membership on the committee by the individual is required by the best interests of the corporation and its shareholders, adequately balances the need for objective, independent directors with the company's need for flexibility in exceptional and unusual circumstances. The Commission believes that the proposal's requirement that the company disclose in its next annual proxy statement the nature of the relationship and the board's reasons for determining that the appointment was in the best interests of the corporation will adequately guard against abuse of the proposed exception to the independence requirement.

In addition, the Commission believes that requiring boards of directors of listed companies to adopt formal written charters specifying the audit committee's responsibilities, and how it carries out those responsibilities, will help the audit committee, management, investors, and the company's auditors recognize, and understand the function of the audit committee and the relationship among the parties. Moreover, the Commission believes that the proposal's requirement that companies provide yearly written confirmation regarding the independence, financial literacy, and financial expertise of directors, as well as the adequacy of the audit committee charter, will help the Exchange to ensure that listed companies are complying with the proposed rule change.

The Commission believes that the proposed rule change's requirement that each issuer have an audit committee composed on three independent directors who are able to read and understand fundamental financial statements, will enhance the effectiveness of the audit committee and help to ensure that audit committee members are able to adequately fulfill their responsibilities. The Commission believes that requiring each audit committee member to satisfy this

standard will help to ensure that the committee as a whole is financially literate. Moreover, the Commission believes that requiring one member of the audit committee to have accounting or related financial management expertise will further enhance the effectiveness of the audit committee in carrying out its financial oversight responsibilities.

Finally, the Commission believes that the proposed transition period will enable issuers to determine when they must comply with the new requirements and will enable investors to determine when the protections afforded by the proposed rule change will be operational.

### IV. Conclusion

For the foregoing reasons, the Commission finds that the proposal to amend PCXE's audit committee requirements is consistent with the requirements of the Act and the rules and regulations thereunder.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,<sup>10</sup> that the proposed rule change (SR-PC-00-40) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>11</sup>

**Margaret H. McFarland,**  
*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-43939; File No. SR-Phlx-01-05]

### Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the Philadelphia Stock Exchange, Inc. Relating to the Prohibition Against Off-Floor Members Functioning as Market Makers.

February 7, 2001.

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 January 17, 2001, the Philadelphia Stock Exchange, Inc. (“Phlx” or “Exchange”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange.

<sup>10</sup> 15 U.S.C. 78s(b)(2).

<sup>11</sup> 17 CFR 200.30-3(a)(12).

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

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

<sup>7</sup> See Amendment No. 1 *supra* note 3.

<sup>8</sup> In approving the proposal, the Commission has considered its impact on efficiency, competition, and capital formation, 15 U.S.C. 78c(f).

<sup>9</sup> 15 U.S.C. 78f(b)(5). Section 6(b)(5) requires the rules of an exchange to be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.