America's Community Bankers
Shaping Our Future

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April 17,2003

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

Re: Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the National Association of Securities Dealers, Inc. Relating to Proposed Amendments to NASD Rules 4200 and 4350 Regarding Board Independence and Independent Committees
File No. SR-NASD-2002-141; 68 FR 14451 (March 25,2003)

Dear Mr. Katz:

America's Community Bankers (ACB)[1] is pleased to comment on the rule changes proposed by The Nasdaq Stock Market, Inc. (Nasdaq), to revise certain requirements related to boards of directors and audit committees of listed companies.[2]

The proposal by Nasdaq is the culmination of efforts to improve corporate governance for listed companies. This effort began prior to the passage of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley)' and the proposal includes corporate governance requirements that go beyond those contemplated by the legislation. Although Nasdaq has been considering the rule changes for some time, this represents the first opportunity for many interested parties to comment.

ACB Position

It is important to the integrity of public markets that members of the board of directors thoroughly fulfill their role of overseeing management and the operations of the company. Also, investor confidence will improve only when audit committee members properly

[1] **ACB** represents the nation's community banks. **ACB** members, whose aggregate assets total more than $1 trillion, pursue progressive, entrepreneurial and service-oriented strategies in providing financial services to benefit their customers and communities.
[2] **68** Fed. Reg. 14451 (March 25,2003).
[3] Pub. L. 107-204 (2002).

fulfill their role of overseeing the preparation and audit of the company's financial statements. ACB has adopted a corporate governance and disclosure policy position that specifically supports a strong and independent-minded board of directors and audit, compensation and nominating committees. ACB also supports the promotion and enforcement of a corporate culture that expects honest and ethical conduct.

ACB's membership is composed of community banks, many of which have securities listed on Nasdaq. These members tend to be small-cap companies that have chosen to be on Nasdaq because of its more flexible standards for smaller and start-up companies. ACB feels strongly that an accommodative stance that takes into account the more limited resources of small and mid-size companies is necessary to ensure access to the public markets.

In the comment letter that Nasdaq filed with the Securities and Exchange Commission (SEC) on the proposed standards relating to listed company audit committees,[4] Nasdaq stated that

> "We do not support an across-the-board "one **size** fits all" approach. Being mindful of the needs of smaller issuers and their investors, Nasdaq believes that it is important to provide flexibility in satisfying certain of these requirements, while preserving accountability. We do not support rigid standards that effectively foreclose listing opportunities for small companies, thereby limiting the investment opportunities for investors. Thus, for example, the definition of independent director should provide issuers with sufficient flexibility, and allow appropriate *de minimis* exceptions, so that issuers are not impeded in their ability to conduct business and do not inadvertently run afoul of the rules based on immaterial transactions."

We do not believe that Nasdaq followed its own recommendations when establishing the criteria for independence. The criteria are too stringent and will make it increasingly difficult for smaller public companies to meet the rules for being **a** listed company. While we can understand Nasdaq's preference €or objective, bright-line tests, this approach does not always lead to the best result. Applying stringent, bright-line tests leads to standards that will label certain individuals as "'independent," whether these individuals have the necessary experience, education, knowledge and confidence to truly be independent in thought and act independently from management.

Therefore, certain revisions should be made to the independence criteria to better meet the goals of the rule and allow community banks to continue to attract the most qualified individuals to serve as directors. ACB also believes that many aspects of the proposal need to be clarified either with additional language in the rule or expanded commentary.

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[4] See letter from Edward S. Knight, Executive Vice President and General Counsel, The Nasdaq Stock Market, Inc., to Jonathan G. Katz, Secretary, **U.S.** Securities and Exchange Commission, dated February *27, 2003* (available at www.sec.gov/rules/proposed/s70203.shtml).

Finally, we are concerned that some community banks, faced with difficulties in complying with these requirements, may chose to delist their securities. Delisting may make these institutions more vulnerable to acquisition with the result that fewer community banks will remain.

The Proposal

The proposal would:

- Revise the criteria for determining whether a director and an audit committee member are independent.
- Require that a majority of the board members be independent and that independent directors meet in executive session.
- Require that compensation of senior officers be determined by a separate compensation committee composed of independent directors or by a majority of independent directors meeting in executive session.
- Require that nominations ***of*** directors be determined by a separate nominating committee composed of independent directors *or* by **a** majority of independent directors.
- Require that audit committee charters provide the audit committee with the authority and responsibility to take the actions required by sections 10A(i) and 10A(m) of the Securities Exchange Act of 1934, as added by Sarbanes-Oxley.

Criteria for Independence

Community banks currently have to undertake substantial efforts to find qualified directors willing to serve on the board and its various committees. Bank directors not only have responsibilities under state corporate law and Sarbanes-Oxley, but they also must understand and **enforce** a full range of banking laws and regulations. Unlike other corporate directors **who** act under the principles of the business judgment rule, bank directors have the additional responsibility and potential liability of adhering to the regulatory principles of safety and soundness. Many otherwise qualified individuals do not want to put in the necessary time and effort that **is** required, Furthermore, such individuals may not be willing to assume the liability that flows from these requirements.

The effort to find qualified directors will become even more difficult to the extent that any definition of independence limits the types of banking relationships that a director or companies in which the director has an interest may have with the bank. Many directors of community banks are successful business executives and it is likely that the companies for which these directors **serve as** directors, executive officers and/or shareholders have loans and other banking relationships with the bank, When Congress passed significant banking legislation in 1989 and 1991 to govern many aspects of the banking industry, it left in place the regulatory scheme that placed certain restrictions, but did not prohibit, loan and other banking relationships between bank directors and the banks they serve. Congress recognized that access to credit and other banking products and services is extremely important for individuals and businesses and did not want to cut off access to those individuals who take on the responsibility of serving as a *bank* director.

Banking relationships with directors and executive officers are highly regulated and the current system works well. Congress recognized the value of this system by creating an exception for banking institutions to the general prohibition on personal loans in section 402 of Sarbanes-Oxley.

Community bank directors could decide not to continue serving if they must forego obtaining financing for household or business needs from the bank, particularly in smaller communities where banking resources may be scarce and the director may be unwilling to look for financing outside of the community. Banks would confront the loss of directors who provide business and financial expertise, as well as customer perspective and continuity. This will lead community banks to have to go outside their immediate market area to find qualified individuals willing to serve. But this also may prove difficult. An individual from outside the community does not know the bank, the bank's community or the other board members, ***so*** may not be interested in serving **as** a director. **Also,** current directors are sometimes reluctant to bring in a director who is not familiar with the community since a focus on the community is what community banking is all about.

We foresee that one of the results of the Sarbanes-Oxley legislation will be a significant increase in compensation for directors and, especially, audit committee members. Increased fees are likely to be necessary in order to attract qualified individuals willing to undertake the significant duties associated with being a director, and particularly an audit committee member, of a public company. To the extent that Nasdaq imposes independence standards that are too stringent, the potential pool ***of*** qualified candidates is narrowed even further and will likely result in continued upward pressure on board compensation levels. Increased fees to directors have their own impact on the ability of **a** director to act independently, and these higher fees, coupled with the problem of finding qualified individuals willing to take on the responsibility and liability to serve **as** a director, may, in fact, foreclose listing opportunities fur small companies. Therefore, we request that certain revisions be made to the independence criteria in order to permit community banks to continue to attract the most qualified individuals to **serve** as board members.

The proposed independence criteria would require the board to make an affirmative determination that a director does not have a relationship that would interfere with the exercise of independent judgment in carrying out the responsibilities of a director. The rule then provides a list of certain relationships that preclude **a** board finding of independence. These objective measures cover employment and business relationships and receipt of compensation.

*Limit on Payments to **Directors.*** In order to meet the objective measures in the independence criteria, neither a director nor his or her family members could accept any payment from the company, or any parent or subsidiary, in excess of $60,000 during the current fiscal year or any ***of*** the past three fiscal years. There are certain exceptions to this requirement, including acceptance by a family member of compensation as an employee if the family member is not an executive officer. The rule changes should make clear that extensions of credit permitted by section 402 of Sarbanes-Oxley are not considered "payments" to a director or a family member. The rule should also allow an independent director and family members to establish deposit accounts and receive other banking products and services on the same terms and conditions offered to other customers of the bank without any related payment, such as interest on deposit accounts, included in the $60,000 limit.

We do not believe that a look-back is appropriate or necessary. In order to provide some flexibility without endangering director accountability, companies should have the ability to cease any payments and terminate any business relationships with the director that otherwise would preclude the director from being considered independent. If the director is no longer receiving any payments for additional services to the company, it should not be automatically assumed that previous payments would hinder the director's ability to act independently. Rule 4200 would continue to require the company's board to take the previous business with the director into account and determine if it would interfere with the exercise of independentjudgment. In Nasdaq's comment letter on the SEC's proposed audit committee standards, Nasdaq did not believe a look-back should be required after a person is no longer considered an affiliate of a company because of his or level of stock ownership. Nasdaq stated that the person would no longer have a relationship that would impair independence. We believe the same **case** can be made **for** directors who terminate any business relationships with the company for which he or she receives in excess of $60,000.

The rule or commentary discussing this criterion should clarify that the $60,000 limit does not address payments to organizations for which the director serves as a partner, controlling shareholder or executive officer (related organizations). The rule or commentary also should clarify that this criterion covers direct payments only **and** that **Nasdaq** is not adopting the concept of indirect payments established by the SEC for audit committee members.[5]

*Limits on Payments To or From **Related** Organizations.* **A** director would not be considered independent under the proposal if the director is a partner in, or a controlling shareholder or executive officer of, any organization to which the company made, or from which the company received, payments that exceed the greater of five percent of the recipient's consolidated gross revenues or $200,000 in the current fiscal year or any of the past three fiscal years. We believe that the scope of this limitation should be clarified to make clear that it does not cover loans made to a director's related organizations or related interest payments. While this limit has been part of the independence definition for some

[5] Standards Relating to Listed Company **Audit** Committees, 68 Fed. Reg. 18787 **(April** 16, 2003) (to be codified at 17 C.F.R. § 240.10A-3).

time, it previously only applied to audit committee members and will now apply to the determination of whether a majority of board members are independent. The five percent of consolidated gross revenue/$200,000 maximum on payments as applied to loans would not necessarily have any correlation to whether **the** size of the loan or the nature of the loan relationship would adversely affect a director's ability to exercise independent judgment.

In adopting reforms to the banking system in 1989 and 1991, Congress decided not to prohibit loans to directors and officers. Banking regulators continuously monitor relationships between banks and their directors and related organizations to ensure that directors do not get preferential treatment. Any relationship that appears to be on terms and conditions that are below market would be carefully scrutinized and subject to penalty if found to be true. Bank directors are aware that they must act in the best interests of the bank despite any lending relationships as this point is emphasized by banking regulators and monitored by examiners. Therefore, **we** do not believe that these relationships should be **assumed** to adversely affect **a** director's ability to make independent decisions on behalf of a company and its investors.

Congress carved out certain loans from the general prohibition on loans to directors **and** executive officers contained in section 402 of Sarbanes-Oxley. The loans permitted to a director under section 402 include consumer loans made in the ordinary course of business and on market terms and loans covered by Regulation O of the banking regulations.[6] Regulation **O** governs loans made to directors as well **as** their "related interests." **A** related interest is (i) a **company** that is controlled by the director, or **(ii) a** political or campaign committee that is controlled by the director or the funds or services of which will benefit the director. Control means that a director:

- owns, controls or has the power to vote 25 percent or more of any class of voting securities;
- controls in any manner the election of a majority of the directors of the company; or
- has the power to exercise **a** controlling influence over the management or policies of the company. **A** director would be presumed to have control over a company if the director (i) is an executive officer or director and directly or indirectly owns, controls or has the power to vote more than 10 percent of any class of voting securities; or (ii) has the 10 percent minimum ownership, control or vote and no other person owns, controls, or has the power to vote a greater percentage of that class of voting securities. Importantly, a person is not considered to have control merely because of the individual's position as an officer or director of the company.

Bank regulators do not consider **a** company for which an individual merely serves **as a** director or executive officer to be controlled by the individual. In addition, if an individual

[6] 12 C.F.R. pt. 215.

has a less than 25 percent ownership interest in a class of voting securities, that person is not considered to control the company unless the 10 percent threshold and the other requirements listed above are met. In cases where the thresholds are not met, neither law nor banking regulation limits or restricts the loans that can be made to the company, although the bank is always subject to the requirement that a loan be made under safe and sound underwriting standards. Furthermore, any preferential treatment would be scrutinized by regulators.

Loans covered by Regulation **O** must, among other things, be made on the same terms and conditions (including underwriting standards) that would be offered to an individual not affiliated with the bank, and cannot involve more than the normal risk of repayment or present other unfavorable features. Advance board approval of Regulation **O** loans is required in many cases.

A loan made to a related organization that is either specifically covered by Regulation O or otherwise made on terms and conditions substantially similar to loans made, or which, in good faith, would be made, to comparable borrowers in similar circumstances should not be included in the limitation on business relationships. The board of directors would still **be** required to review the loan relationship and determine whether it would interfere with the exercise of independent judgment expected from an independent director.

Providing a carve out from the limitations for Regulation **O** loans alone would not be sufficient because Regulation O, unlike the Nasdaq proposal, does not limit loans to related organizations **in** which a director is only an executive officer. Also, Regulation O contains a specific definition of control, so that lending relationships that may fall within the Nasdaq cap would not be restricted at all in Regulation **O** or by section 402 of Sarbanes-Oxley. Loans to companies for which a director is only an executive officer or in which a director has an ownership level that does not fall within the control threshold under Regulation **O still** should **be** excluded from the **cap. A** market term requirement would avoid a credit relationship that, because of favorable terms, could compromise the independence of the director.

Changes are required with respect to other aspects of this criterion. For the reasons discussed in the section immediately above, ACB does not believe that a three-year look-back should **apply** in the case of the business relationship cap. While we acknowledge that this requirement has been in place for audit committee members, it should not be used to determine whether **a** majority of the board is independent. Rule 4200 would continue to require the company's board to determine whether the previous business with the director would interfere with the exercise of independent judgment required from an independent director.

Finally, Nasdaq should provide a definition of "controlling shareholder" so that companies will clearly understand what payments need to be included in determining compliance with the business limitations.

Definition of Family Member. The proposed definition of family member would include any person who is a relative by blood, marriage or adoption or who has the same residence. This definition is much too broad and is not consistent with any other definition of family member used in SEC or banking rules and regulations. It would be difficult for some people to identify all of the potential people who they are related to through marriage or adoption. An adopted person may not themselves know the identity of his or her blood relatives, who could be considered related to the individual's adoptive parents under the proposed definition. The list of familial relationships that is currently included in the independence criteria should be sufficient to identify any situations that may create a conflict or call into question the ability of a director to act independently.

Clarification on Look-Back Requirements. While we generally do not support look-back provisions, the provisions should be clarified in several places if they are included in the final rule. The language of the rule change would preclude a finding of independence if a director or a family member is, or during the past three years was, employed by the company. If we understand the intent of the rule correctly, this language would cover a situation where the director or a family member was employed *anytime* during the past three years. The proposed language could be read to imply that there is a problem only if the individual was employed during the entire past three years. This should be clarified. Similarly, a director is not considered independent if he or she is or was a partner or employee of the company's outside auditor and worked on the company's audit during the past three years. Again, we understand the intent of the language to preclude independence if the person was so employed and worked on the audit ***anytime*** within the past three years. If that is the intent, Nasdaq should include exceptions similar to those adopted by the SEC in establishing the rotation requirements in its auditor independence rules.[7] Partners or employees who provide only a minimal amount of work on the company's audit or who are brought in to assist on technical or industry-specific issues should not be covered.

Finally, the language in the rule change would preclude a finding of independence if a director of the listed company is employed as an executive officer of another entity where any of the listed company's executive officers serve on that other entity's compensation committee, or "if such relationship existed during the past three years." It is unclear why there would be a look-back provision since independence would seem compromised only if the listed company executive officer had the current ability to participate in determining the director's Compensation as an executive officer of the other entity. If the look-back provision stays in the rule, Nasdaq should clarify the reference to "such relationship" by indicating whether the interlocking service had to take place at the same time during that three year period.

New Board of Director Requirements

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[7] Strengthening the Commission's Requirements Regarding Auditor Independence, 68 Fed. Reg. 6006, 6019-6020 (Feb. 5, 2003) (to be codified at 17 C.F.R. § 210.2-01).

We have the following request for revisions or clarifications to the proposed requirements affecting the board of directors and board committees.

Majority of ***Independent Directors.*** The proposal would require that a majority of the board be independent. As a result of the strict definition of independence, this requirement could lead either to much smaller boards or to boards composed of individuals that might not have the best or most valuable experience, expertise or business judgment. Neither of those results would further the goal of achieving better corporate governance. Utilizing rigid definitions of independence does not necessarily mean that a company will attract independent-minded individuals to the board who are willing to challenge management when necessary, We are hopeful that, at a minimum, Nasdaq will consider revising the proposed criteria for independence in response **to** our comments.

To the extent that the independence criteria are adopted in substantially the form **proposed,** some accommodation should be made for smaller companies, those with **a** public float of **less** than $75 million, with regard to the requirement that a majority of the directors meet the independence criteria set forth in the rule. For these smaller companies, we would suggest a requirement that a majority of the board be composed of directors who are not currently employed by the company (or its parent or subsidiaries), or a family member of an individual employed as **an** executive officer of the company (or its parent or subsidiaries), and who do not, in the opinion of the board, have any relationship that would interfere with their exercise of independent judgment. An alternative approach could be the additional requirement that at least a third of the board be composed of directors who meet all of the objective measures in the independence criteria. This **gives** some relief to smaller companies **while** helping to restore investor confidence. While we understand the stated desire of Nasdaq in proposing the objective measures to provide transparency to investors, facilitate uniform application of the rules and ease administration, these worthy goals need to be property balanced against the **real** threat of foreclosing listing opportunities for small companies and limiting the investment opportunities for investors. Investors can get the information they need about board composition through disclosure requirements and then make informed decisions about whether to invest in a company.

Meetings *of Independent* ***Directors.*** The proposal should clarify what is expected with regard to meetings of independent directors. The rule states that independent directors must have "regularly scheduled meetings," which implies that separate, formal meetings of independent directors are required. If that is the case, this requirement could raise issues under state law governing a director's fiduciary duties or under rules or bylaws that impose requirements that directors attend a minimum number of meetings. The rule commentary suggests that the requirement contemplates executive sessions that occur in conjunction with regularly scheduled board meetings. If that is the case, the language in the rule should be changed to more clearly describe the requirement.

Some discussion of what is expected to occur at these sessions also would be helpful. For companies that establish separate compensation and nominating committees, many issues that need to be resolved by independent directors would be covered by committee action. If the expectation is that decisions would be made at these sessions about business operations and corporate strategy, these decisions may be made without critical information available to management. This could raise liability issues for the independent directors under state law if the decisions are determined to be harmful to the company or not in its best interest.

Consideration of Officer Compensation. The language addressing the determination of officer compensation is confusing. Chief executive officer compensation must be determined either by a compensation committee composed of independent directors meeting in executive session or a majority of the independent directors meeting in executive session. There is no requirement that when compensation is determined for other officers, either the compensation committee or the board meet in executive session. The language goes on to specify, however, that the chief executive officer may be present during deliberations, but may not vote, which implies that other officers who may be directors are not permitted to attend the meeting. The rule or commentary should resolve this confusion.

Audit Committees

In establishing independence criteria for audit committee members, the rule commentary refers to the recent rules adopted by the SEC that prohibit a member of a listed company audit committee from accepting any consulting, advisory or other compensatory fee from the company, other than for board service, and from being an affiliated person of the company.[8] The SEC rule provides a definition of affiliated person. An affiliate is defined as a person that directly, or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with, an issuer. The SEC rule includes a safe harbor that a person would be deemed not to be in control of an issuer if the person (i) is not the beneficial owner, directly or indirectly, of more than 10 percent of a class of the issuer's voting equity securities, and (ii) is not an executive officer of the issuer.

The SEC rule provides that an executive officer, partner, managing member or a director who is an employee of an affiliate is also an affiliate. However, the SEC rule exempts from the affiliated person definition any audit committee member who sits on the board of two affiliates (for example, a parent holding company and a subsidiary) if the committee member otherwise meets the independence requirements for both organizations. In adopting this exemption, which we supported in written comments, the SEC recognized that many financial institutions with a holding company structure operate through subsidiaries and that the composition of the boards of the parent and subsidiary are similar. The SEC further acknowledged that merely serving on the board of a holding company and its subsidiary should not adversely affect the director's independence.

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[8] See footnote 5.

The Nasdaq rule commentary elaborates further on the SEC 's definition of affiliate in two ways. Nasdaq would treat an individual as an affiliated person of a company, and therefore prohibited from serving on the audit committee, if the individual owns or controls, directly or indirectly, 20 percent or more of the company's voting stock, or such other lower threshold as the SEC may establish. We would like clarification as to whether this 20 percent is a "class of voting equity securities" threshold or a "total voting stock" threshold. Also, we are assuming that the safe harbor adopted by the SEC does not represent the establishment of a lower threshold for purposes of the Nasdaq rule. Clarification on this point would be helpful.

The Nasdaq rule also would treat an employee of an entity that meets or exceeds the ownership threshold as an affiliated person. We request clarification that a director who serves on the boards of both **a** holding company and a subsidiary would not be considered an affiliate of either organization under the Nasdaq standards merely as a result of such service.

ACB appreciates the opportunity to comment on this important matter. **If** you have any questions, **please** contact the undersigned at (202) 857-3121 **or** via e-mail at cbahin@acbankers.org, or Diane Koonjy at (202) 857-3144 or via e-mail at dkoonjy@acbankers.org.

Sincerely,

Charlotte M Bahin

Charlotte M. Bahin
Director of Regulatory Affairs
Senior Regulatory Counsel