

SEC Proposes New Audit Committee Requirements

The SEC recently proposed rules¹ implementing the audit committee requirements for listed companies established by Section 301 of the Sarbanes-Oxley Act of 2002, and updating the SEC's current disclosure requirements for audit committees. The proposal would direct the national securities exchanges and national securities associations (e.g., NYSE, Nasdaq) to prohibit the listing of any securities² of both domestic and foreign issuers that are not in compliance with the audit committee standards. The new rules would not apply to any issuer that does not have listed securities.

The new rules are subject to comment for 30 days following their publication in the *Federal Register*, and must become effective by April 26, 2003. Under the proposal, the new requirements would need to be implemented by the national securities exchanges and national securities associations no later than one year after the publication of the final rule in the *Federal Register*.³ A summary of the proposal follows:

Proposed Audit Committee Requirements

Audit Committee Member Independence

- Section 301 of Sarbanes-Oxley establishes two basic criteria for determining the independence of an audit committee member.
 - A committee member cannot accept any consulting, advisory or other compensatory fee from an issuer or an affiliate of the issuer, other than in his or her capacity as a director and member of any board committee, including fees for service on the audit committee, and
 - A committee member cannot be an "affiliated person" of the issuer or any subsidiary of the issuer apart from his or her capacity as a director and member of any board committee.⁴
- The proposal would disallow consulting, advisory or other compensatory fees paid to a committee member either directly or indirectly. Examples of prohibited indirect fees include:
 - payments to spouses, minor children or stepchildren or children or stepchildren sharing a home with the committee member⁵; and

¹ Release Nos. 33-8173; 34-47137; IC-25885.

² The proposed rule applies to all listed securities, including voting equity securities, debt securities, derivative securities and other types of listed securities.

³ The intent of the proposal is to give issuers through the 2004 proxy season to comply with the rules, but the April 26th deadline would require issuers to hold their annual meetings by that date in 2004.

⁴ A member of an audit committee of an investment company could not be an "interested person" of the investment company.

⁵ This category of family members is narrower than the category of family members included in the NYSE and NASDAQ rules.

- payments made to an entity of which a committee member is a partner, member or principal or occupies a similar position and which provides accounting, consulting, legal, investment banking, financial or other advisory services or any similar services to the issuer.
- The proposal would not preclude ordinary business transactions (outside of the disallowance of consulting, advisory or other compensatory fees) between an issuer and an entity with which an audit committee member has a relationship.
- The proposal would clarify that a director, executive officer, partner, member, principal or designee of an affiliate would be deemed to be an affiliate.
- The proposal would define the terms “affiliate” and “affiliated person,” consistent with the definitions under the Securities Act of 1933 and Securities Exchange Act of 1934, as “a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.” The term “control,” means “the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract or otherwise.”
 - The proposal would provide a safe harbor so that those who are not executive officers, directors or 10% shareholders of an issuer would be deemed not to control the issuer.
- One result of the SEC’s definitions and safe harbor would be that in many cases, 10% shareholders and their representatives will be precluded from serving on audit committees.

Exemptions from the Independence Standards

- *IPO Issuers.* For a newly listed issuer, the proposal would exempt one committee member from the proposal’s independence requirements for a period of 90 days after the effective date of the issuer’s initial public offering.
- *Subsidiary Directors.* In addition, the proposal would exempt from the “affiliated person” prohibition a committee member who sits on the board of directors of both a parent and a consolidated, majority-owned subsidiary, if the committee member would otherwise meet the independence requirements for both the parent and the subsidiary.

Responsibilities Relating to the Independent Auditor

- The proposal would require an audit committee to be directly responsible for the appointment, compensation, retention and oversight of the work of the independent auditor engaged by an issuer for the purpose of preparing or issuing an audit report or related work or performing other audit⁶, review or attest services for the issuer. The auditor would be required to report directly to the audit committee.

⁶ These would include, for example, providing comfort letters in connection with securities offerings and services related to statutory audits required for insurance companies for purposes of state law.

- The proposal would clarify that these oversight responsibilities also include the authority to terminate the independent auditor.
- In addition, the proposal would require an audit committee to have ultimate authority to approve all audit engagement fees and terms, as well as all significant non-audit engagements, of an independent auditor.

Procedures for Handling Complaints

- The proposal requires an audit committee to establish procedures for:
 - the receipt, retention and treatment of complaints received by an issuer about accounting, internal accounting controls or auditing matters; and
 - the confidential, anonymous submission by employees of concerns about questionable accounting or auditing matters.
- The proposal would not mandate any specific procedures for an issuer to establish to handle these complaints and concerns, but would allow the issuer flexibility to establish formal procedures appropriate for the circumstances of its business.

Authority to Engage Advisors

- The proposal would specifically require an issuer's audit committee to have the authority to engage outside advisors, including counsel, as the audit committee determines necessary to carry out its duties.
 - These duties may include independent investigation regarding financial reporting and securities law compliance, identifying potential conflicts of interest and assessing disclosure and other compliance obligations.

Funding

- The proposal would require an issuer to provide for appropriate funding, as determined by its audit committee, for payment of compensation to:
 - any registered public accounting firm engaged for the purpose of rendering or issuing an audit report or related work or performing other audit, review or attest services for the listed issuer; and
 - any advisors employed by the audit committee.

Multiple Listings

- The proposal would establish the minimum listing requirements for each national securities exchange and national securities association, and would allow each exchange and association to establish additional or more stringent listing requirements. If an issuer is subject to the proposed listing requirements of an exchange or association as a result of the listing of a class of its common equity or similar securities, and the issuer simultaneously has one or more additional listings of securities (such as debt or derivative securities) on a different exchange with different or more stringent listing

requirements, the proposal would exempt the issuer from the additional or more stringent requirements and would only require the issuer to meet the listing requirements of the exchange or association on which it lists its common equity or similar securities.

- The multiple listing exemption would also apply to listings of non-equity securities by a consolidated, majority-owned subsidiary of a parent issuer, if the parent issuer is subject to the listing requirements as a result of the listing of a class of its equity securities.
 - If the subsidiary were to list its own equity securities (other than non-convertible, non-participating preferred stock), it would be required to meet the proposed listing requirements.

Foreign Private Issuer Requirements

- Because the proposal would establish audit committee standards that may conflict with the legal requirements, corporate governance standards and methods for providing auditor oversight in the home jurisdictions of some foreign issuers, the proposal would provide several limited exceptions to its independence and other requirements for foreign private issuers.
 - *Employees on the Audit Committee.* The proposal would allow an employee of a foreign private issuer who is not in a management position to serve as a committee member if the employee is elected or named to the audit committee pursuant to the issuer's home country legal or listing requirements.
 - *Foreign Government Shareholders on the Audit Committee.* The proposal would allow one committee member who is not an executive officer of the issuer to be a representative of a foreign government or foreign governmental entity, provided that no payment has been provided to this committee member, directly or indirectly, of consulting, advisory or other compensatory fees other than as a director and committee member.
 - *Controlling Shareholders on the Audit Committee.* The proposal would allow one committee member who is not an executive officer of the issuer to be a shareholder, or representative of a shareholder or group, owning more than 50% of the voting securities of a foreign private issuer, provided that the committee member sits on the audit committee only as an observer (i.e., is not a voting member or the chair of the audit committee) and that no payment has been provided to this committee member, directly or indirectly, of consulting, advisory or other compensatory fees other than as a director and committee member.
 - *Alternative Oversight of the Independent Auditor.* The proposal would allow for an alternate body to oversee an independent auditor, where a foreign jurisdiction requires or provides for this oversight through a board of auditors, group of statutory auditors or a similar body that is separate from an issuer's board of directors.
 - *Two-tiered Boards.* The proposal would clarify that in the case of a foreign private issuer with a two-tiered board of directors, the term "board of directors" would mean the

supervisory or non-management tier of the board. As such, the supervisory or non-management tier could either form a separate audit committee or, if the entire supervisory or non-management tier met the proposal's independence standards, the entire tier could be designated as the audit committee.

Disclosure Requirements

Disclosure of Exemptions

- If an issuer relies on a proposed exemption from any of the listing requirements (except the multiple listing exemption), the proposal would require the issuer to disclose this reliance and its assessment of whether, and if so, how, this reliance would materially adversely affect the ability of its audit committee to act independently and to satisfy the other requirements of the proposal. The issuer would need to make this disclosure in its annual report on Form 10-K (Form 10-KSB for small business issuers, Form 20-F for foreign private issuers and Form 40-F for Canadian private issuers), proxy statements and information statements for shareholders' meetings at which elections for directors are held.⁷
- Non-listed issuers filing proxy statements and that have separately designated audit committees would be required to disclose whether their audit committee members are independent. Non-listed issuers would be allowed to choose any definition of audit committee independence of a national securities exchange or association that has been approved by the SEC.
- For a foreign private issuer that provides for its independent auditor oversight through a board of auditors, group of statutory auditors or a similar body that is separate from the issuer's board of directors, the issuer must file an exhibit to its annual report stating that it doing so.

Disclosure of Noncompliance

- The proposal would direct the national securities exchanges and national securities associations to require an issuer to notify the applicable self-regulatory organization promptly after an executive officer of the issuer becomes aware of any material noncompliance by the issuer with any of the proposal's requirements.

Identification of Audit Committee

- In addition to the audit committee disclosure currently required by the proxy rules of the Exchange Act, the proposal would require a listed issuer to disclose in its annual report the members of its audit committee.
- If an issuer has not separately designated an audit committee, it must disclose in its annual report that its entire board of directors is serving as its audit committee.

Updating SRO Independence Requirements

- The proposal would require all national securities exchanges and national securities associations to issue or modify their rules to meet, at a minimum, the proposal's listing requirements.

⁷ Because the information would be required in Part III of the Annual Report, information could be incorporated by reference from a proxy statement filed within 120 of the fiscal year end.

- The national securities exchanges or national securities associations would not be allowed to establish exemptions to the independence standards that are inconsistent with the proposal's exemptions.
- The proposal would require each SRO to provide the SEC with its proposed rules or rule amendments no later than 60 days (and have them approved by the SEC no later than 270 days) after the publication of the final rules in the *Federal Register*.

Contact Information

If you have any questions or would like to learn more about the proposal, please contact the Ropes & Gray lawyer who normally represents you.