

SEC Sets Listing Standards For Audit Committees

The SEC recently adopted final rules under Section 301 of the Sarbanes-Oxley Act of 2002 prohibiting the national securities exchanges and national securities associations (“SROs”) from listing any securities of either domestic or foreign issuers that are not in compliance with specified audit committee standards.¹ The final rules also update the SEC’s current disclosure requirements for audit committees. We previously issued a Securities Alert on January 16, 2003 that describes the SEC’s proposed rules, which is available on our website at www.ropesgray.com under “News and Events.”

Audit Committee Requirements

The final rules prohibit SROs from listing any security of an issuer that is not in compliance with the following standards.

Audit Committee Member Independence

- *No Compensatory Fee.* As in the proposed rules, no committee member can accept any consulting, advisory or other compensatory fee from an issuer or a subsidiary of the issuer, other than in his or her capacity as a director and member of any board committee, including the audit committee.
 - The final rules expressly prohibit direct or indirect payments. Examples of prohibited indirect payments include:
 - payments to spouses, minor children or stepchildren or children or stepchildren sharing a home with the committee member; and
 - payments made to an entity of which a committee member is, at the time of such payment, a partner, member, executive officer or other officer, and which provides accounting, consulting, legal, investment banking or any financial advisory services to the issuer.
 - However, the final rules do not prohibit payments made to an entity of which a committee member is a limited partner, non-managing member or officer occupying a similar position who, in each case, has no active role in providing services to such entity.
 - The final rules do not preclude ordinary business transactions (outside of the disallowance of consulting, advisory or other compensatory fees) between an issuer and an entity with which a committee member has a relationship, although the SROs have proposed restrictions on additional services and activities in their own listing standards proposals.

¹ Release Nos. 33-8220; 34-47654; IC-6001.

- Unlike the proposed rules, the final rules do not include as a prohibited payment the receipt of fixed amounts of compensation under a retirement plan for a committee member's prior service to an entity so long as payment is not conditioned upon continued service.
- *No Affiliated Persons.* No committee member can be an "affiliated person" of an issuer or any subsidiary of the issuer, apart from his or her capacity as a director and member of any board committee.²
 - Consistent with the definitions under other securities laws, the final rules define the terms "affiliate" and "affiliated person" 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."
 - Persons meeting this "control" test with respect to an issuer are deemed to be affiliates, but the final rules narrow this group of "deemed affiliates" to directors (who are also employees), executive officers, general partners or managing members of the affiliate.
 - The final rules establish a safe harbor provision. Persons who are neither executive officers nor holders of more than 10% or more of any class of voting equity securities of an issuer are deemed not to control the issuer.
 - The final rules also clarify that this safe harbor does not create a presumption in any way that a person exceeding the ownership threshold is otherwise an affiliate. Whether someone is an affiliate will still be based on an evaluation of all the facts and circumstances.
 - In addition, the final rules broaden the exemption for directors who serve on the boards of multiple companies in an affiliated group. A committee member will not fail to be independent if he or she sits on the board of directors of an affiliate of the issuer, provided that he or she otherwise meets the independence requirements for each entity, including the receipt of only ordinary course director compensation.

IPO Issuers

- The final rules expand upon the transition period granted to newly listed issuers. Under the final rules, newly listed issuers are required to have one committee member meet the independence standards at the time of an IPO, a majority of committee members meet these standards within 90 days of an IPO and the entire committee meet these standards within one year after an IPO.

Responsibilities Relating to the Independent Auditor

- *Direct Responsibility for Audit Engagement.* The final rules require an audit committee to be directly responsible for the appointment, compensation, retention (or termination) and oversight of the work of the independent auditor engaged by an issuer (including resolution of disagreements both with

² A member of an audit committee of an investment company could not be an "interested person" of the investment company as defined under the Investment Company Act of 1940.

management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work or performing other audit, review or attest services for the issuer. The independent auditor is required to report directly to the audit committee.

- The final rules clarify that none of the new audit committee requirements conflict with or affect the application of any requirement or ability under an issuer's home country's governing law that requires or permits shareholders to ultimately vote on, approve or ratify a matter, such as the selection of an independent auditor.
- *Approval of Audit Engagement Fees.* The audit committee must have ultimate authority to pre-approve all audit engagement fees and terms, as well as all significant non-audit engagements, of an independent auditor.

Procedures for Handling Complaints

- The audit committee must establish procedures for:
 - the receipt, retention and treatment of complaints received by an issuer regarding accounting, internal accounting controls or auditing matters; and
 - the confidential, anonymous submission by employees of the issuer of concerns about questionable accounting or auditing matters.
- The final rules do not mandate any specific procedures for an issuer to establish to handle these complaints and concerns and do not require issuers to engage independent, third-party services to handle complaints, but allow the issuer flexibility to establish procedures appropriate for the circumstances of its business.

Authority to Engage Advisors

- The audit committee must have the authority to engage outside advisors, including counsel, as it 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 final rules require an issuer to provide appropriate funding, as determined by its audit committee, for payment of compensation to:
 - any registered public accounting firm engaged for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the listed issuer; and
 - any advisors employed by the audit committee.

- In addition, an issuer must provide appropriate funding for ordinary administrative expenses of the audit committee that are necessary or appropriate in carrying out its duties.

Multiple Listings

- The final rules establish the minimum listing requirements for audit committees, but allow each SRO to establish additional or more stringent listing requirements. If an issuer lists its common equity security or similar securities on one exchange or association and simultaneously lists one or more additional classes of securities (such as debt or derivative securities) on a different exchange with different or more stringent listing requirements, the issuer will only be required to meet the listing requirements of the exchange on which it lists its common equity or similar securities.
- The multiple listing exemption also applies to listings of non-equity securities by a direct or indirect subsidiary that is consolidated with, or at least 50% beneficially owned by 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 go public and 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

- The final rules provide several limited exceptions to the new independence and other requirements for foreign private issuers in an effort to avoid conflicts with the legal requirements, corporate governance standards and methods for providing auditor oversight in the home jurisdictions of foreign issuers.
 - *Employee Representation.* An employee of a foreign private issuer who is not in a management position may 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 Representation.* A representative of a foreign government or foreign governmental entity who is not also an executive officer of the entity may also serve as a committee member, 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.
 - *Foreign Government Issuers.* The final rules exempt foreign government issuers from compliance with the listing requirements.
 - *Controlling Shareholder Representation.* A shareholder, or representative of a shareholder or group, owning more than 50% of the voting securities of a foreign private issuer who is not an executive officer may serve as a committee member, provided that the committee member sits on the audit committee as an observer (i.e. is not a voting member or the chair of the audit committee) and no payment may be made to this

committee member, directly or indirectly, of consulting, advisory or other compensatory fees other than as a director and committee member.

- *Two-tiered Board System.* The final rules 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 can either form a separate audit committee or, if the entire supervisory or non-management tier met the proposal’s independence standards, the entire tier can be designated as the audit committee.
- *Alternative Oversight of the Independent Auditor.* Under the final rules, a foreign private issuer is exempt from all of the listing requirements regarding independent auditor oversight if (1) the issuer has a board of auditors (or similar body) established by its jurisdiction’s legal or listing provisions, (2) its board of auditors is required to be separate from the board of directors or composed of one or more members from the board and one or more members not also on the board, (3) its board of auditors is not elected by management, (4) its home jurisdiction provides for standards for the independence of the board of auditors from management, (5) its board of auditors is responsible for the appointment, retention and oversight of the work of the independent auditor, and (6) the remaining requirements of the final rules (handling of complaints, funding, etc.) apply to its board of auditors.

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 final rules 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 new rule. The issuer will 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.³
- Under current rules, non-listed issuers filing proxy statements are required to disclose whether they have separately designated audit committees and whether the members of such committees are independent. This requirement continues to apply, and such non-listed issuers are allowed to choose any SRO’s definition of audit committee independence that complies with the new independence requirements established by the final rules.
- The final rules did not adopt the proposed requirement that 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 be required to file an exhibit to its annual report stating that it is doing so.

³ Because the information would be required in Part III of the Annual Report, it can be incorporated by reference from a proxy statement filed within 120 days of the fiscal year end.

Disclosure of Noncompliance

- The final rules direct the SROs to require an issuer to notify them promptly after an executive officer of the issuer becomes aware of any material noncompliance by the issuer with any of the rule's requirements.

Identification of Audit Committee

- In addition to the audit committee disclosure currently required by the proxy rules of the Exchange Act, the final rules 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.
 - However, listed issuers that are not required to provide disclosure of their reliance on an exemption, such as a subsidiary relying on the multiple listing exemption, do not have to disclose whether they have a separate audit committee.

Updating SRO Requirements

- The final rules require and rely on the SROs to issue or modify their rules to meet, at a minimum, the new listing requirements.
- The SROs will not be allowed to establish exemptions to the independence standards that are inconsistent with the exemptions under the final rules.
- The SROs must establish their own definite procedures and time periods for an issuer to have the opportunity to cure any failure to meet the new listing requirements required by the final rules.

Effective Date

- The final rules require each SRO to provide the SEC with its proposed rules or rule amendments no later than July 15, 2003 and have them approved by the SEC no later than December 1, 2003.
- Listed issuers must be in compliance with these new listing requirements by the earlier of (1) their first annual shareholders meeting after January 15, 2004 or (2) October 31, 2004. Foreign private issuers and small business issuers that are listed must be in compliance by July 31, 2005.

Contact Information

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