

SEC ISSUES FINAL RULES FOR AUDIT COMMITTEES OF LISTED COMPANIES

Last week, the Securities and Exchange Commission (the “SEC”) issued final rules¹ to implement Section 301 of the Sarbanes-Oxley Act of 2002 (the “Act”), directing the national securities exchanges and NASDAQ (“Self-Regulatory Organizations” or “SROs”) to prohibit the listing of any security of a company that does not comply with the audit committee requirements of the Act. Under the final rules:

- The audit committee of each listed company must be comprised solely of “independent” directors, subject to certain limited exemptions. To qualify as independent, an audit committee member may not accept any consulting, advisory or other compensatory fees from the company (other than board or committee fees) or be “affiliated” with the company.
- The audit committee must be directly responsible for the appointment, compensation, retention and oversight of the company’s independent auditors. The auditors must report directly to the audit committee.
- The audit committee must establish procedures for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls and auditing matters.
- The audit committee must have the authority to engage independent counsel and other advisors, as the committee determines necessary to carry out its duties.
- Listed companies must provide appropriate funding for their audit committees.
- Listed companies must disclose certain additional information regarding their audit committees.

The Self-Regulatory Organizations must file with the SEC proposed amendments to their listing standards that embody these rules by July 15, 2003, and these amendments must be approved by the SEC no later than December 1, 2003. Listed companies must comply with the new listing standards by their first annual meeting after January 15, 2004, but no later than October 31, 2004. Foreign private issuers and small business issuers must be in compliance by July 31, 2005.

¹ SEC Release Nos. 33-8220; 34-47654 (April 9, 2003).

Foreign companies with securities listed on a national securities exchange or NASDAQ, as well as closed-end investment companies, will generally be subject to the new listing standards. Asset-backed issuers, unit investment trusts and foreign government issuers would be exempt.

The SEC's rules come against the backdrop of proposals initiated by the SROs to amend their listing standards, which include further strengthening of their independence definitions. These SRO proposals have languished pending the SEC's rulemaking, but alerted listed companies to the changes that were likely to be forthcoming. In some respects, therefore, the SEC's final rules are narrower in scope and appear almost anti-climatic in comparison to the proposed SRO standards.

Independence of Audit Committee Members

Basic Requirements

Under the SEC's new rules, each audit committee member of a listed company must be a member of the board of directors and must be "independent."² To qualify as independent, an audit committee member may not, other than in his or her capacity as a member of the audit committee, the board of directors or any other board committee:

- accept, directly or indirectly, *any*³ consulting, advisory or other compensatory fee from the company or any of its subsidiaries; or
- be an affiliated person of the company or any of its subsidiaries.

Prohibited Compensation

Examples of prohibited compensation include:

- *direct* payments to employees or officers,⁴ and
- *indirect* payments, such as payments for services to law firms, accounting firms, consulting firms, investment banks or similar entities in which audit committee members

² If a listed company does not have a separate audit committee, the entire board of directors will assume that function and will be subject to the new rules, including the independence requirements.

³ The SEC's final rules do not allow for even a de minimis exception.

⁴ Prohibited compensation need not include fixed amounts received under a retirement plan (including deferred compensation) for prior service with the company (provided that such compensation is not contingent on continued service). The SROs have, accordingly, proposed to permit receipt of such amounts. See the commentary to proposed subsection 6 of Section 303A to the NYSE's Listed Company Manual and proposed NASD Rule 4200(a)(15)(B).

are partners, executive officers or hold similar positions.⁵ Payments to spouses, minor children and children sharing a home with a committee member would also be considered prohibited indirect payments.

The SEC's final rule does not specify any limits or restrictions on fees paid for services as a member of a listed company's board of directors or board committees. Payment of regular dividends to an audit committee member in his or her capacity as a shareholder would *not* automatically disqualify him from being deemed independent.

Commentary:

- The SEC's restriction on receipt of prohibited compensation applies only to current compensation and does not "look back" to periods preceding a director's appointment to the listed company's audit committee. In contrast, the SRO independence requirements extend the scope of prohibited compensation to specified amounts received during "look back" periods.⁶
- The SROs have proposed to extend the prohibition on certain indirect payments to additional family members beyond those listed in the SEC's final rules. For example, under the NYSE's proposed listing standards, prohibited payments would include annual amounts in excess of \$100,000 paid to an audit committee member's parents, in-laws and anyone (other than domestic employees) who shares a home with the audit committee member.⁷
- Similarly, the SEC prohibition on indirect payments relates to payments for accounting, consulting, legal, investment banking or financial advisory services and is not intended to cover other commercial relationships. However, the SRO rules will likely restrict other relationships as well.

⁵ Audit committee members who are limited partners, non-managing members or occupy similar positions at such firms who have no role in providing services to the company and whose compensation will not be directly affected by the payments received from the company will not be deemed to have indirectly received prohibited compensation.

⁶ The NYSE's proposed listing standards amendments provide for 5-year "look back" periods with respect to certain relationships, such as the receipt by the director or an immediate family member of certain direct compensation from the company. See the commentary to proposed subsection 2(b) of Section 303A to the NYSE's Listed Company Manual. The NASD's proposed listing standards provide for 3-year "look back" periods with respect to certain compensatory relationships. See proposed NASD Rule 4200(a)(15)(B).

⁷ See proposed subsection 2(b)(i) of Section 303A to the NYSE's Listed Company Manual and the General Commentary to subsection 2(b) of Section 303A. The NASDAQ proposal would prohibit annual payments in excess of \$60,000 to a similarly broad class of family members. See proposed NASD Rule 4200(a)(14) and (15)(B).

- In its proposed listing standard amendments, the NYSE indicated its support for the payment of additional directors' fees to audit committee members noting that, because of the significantly greater commitment of audit committee members, such fees may be greater than that paid to other directors.⁸ This provision is not inconsistent with the SEC's requirements.

Prohibited Affiliation

The final SEC rules define an "affiliated person" as one who, other than in his or her capacity as a member of the audit committee, board of directors or another board committee of a listed company or any of its affiliates, "directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with," the company. "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." An employee-director, executive officer, general partner or managing member of an affiliate will be deemed an affiliate and therefore will be disqualified from serving as an audit committee member.⁹ Investment companies are not subject to the "affiliation" restriction; rather, the members of an audit committee of an investment company may not be "interested persons" as defined in Section 2(a)(19) of the Investment Company Act.

Recognizing that determinations of "control" can be difficult, the SEC has set forth a safe harbor pursuant to which a person who is neither an executive officer nor the beneficial owner of more than 10% of any class of voting equity securities of a listed company will be deemed not to "control" the company.¹⁰

Commentary:

- Thus, unlike with respect to foreign companies as described below, the SEC's final rules do not exempt U.S. "controlled companies" from this requirement to have an independent audit committee.
- Although it refers to a facts and circumstances test in lieu of satisfaction of the safe harbor, the SEC offers no guidance as to who is to be charged with

⁸ See the commentary to proposed subsection 6 of Section 303A to the NYSE's Listed Company Manual. The NASDAQ proposal is silent on this issue.

⁹ Note that this definition excludes outside directors of affiliates, those who occupy passive, non-control positions (such as limited partners) and those who do not have policy-making functions.

¹⁰ Individuals failing to meet the safe harbor are not thereby presumed to be "affiliated persons" and may still qualify as "non-affiliates" based upon the relevant facts and circumstances.

making the factual determination.¹¹ The SROs have typically charged listed company boards of directors with the responsibility of affirmatively determining an audit committee member's independence.¹²

- The SROs have proposed to extend the scope of prohibited affiliation to include relationships with the company that are deemed to be disqualifying.¹³ Under the proposed NYSE listing amendments, significant stockholders in a company would *not*, solely by virtue of their stock ownership, be automatically disqualified from being deemed "independent," even if they could not, as a result of their shareholding, satisfy the SEC's safe harbor. The NASD, however, has proposed to disqualify individuals owning or controlling more than 20% of a listed company's voting securities.¹⁴
- The SEC's restriction on prohibited affiliations applies only to current relationships. In contrast, the SRO independence requirements extend the scope of prohibited affiliations to specified "look back" periods.¹⁵

¹¹ The SEC has stated that it does not intend to grant waivers or exemptions with respect to questionable "affiliation" situations.

¹² The determination would encompass both the prohibited compensation and affiliation aspects of independence. See proposed subsection 2(a) of Section 303A to the NYSE's Listed Company Manual and the associated commentary and proposed NASD Rule 4350(d)(2)(A).

¹³ Under the NYSE's proposal, for example, the following relationships would be deemed disqualifying: (i) employment by the audit committee member or an immediate family member with the listed company's internal or external auditor; (ii) service by the audit committee member or an immediate family member as an executive with a company whose compensation committee includes an executive of the listed company; and (iii) service by the audit committee member as an executive or employee, or an immediate family member as an executive, of another company which accounts for the greater of \$1 million or 2% of the recipient company's gross revenues. See proposed subsection 2(b) of Section 303A to the NYSE's Listed Company Manual. Under the NASDAQ's proposal, disqualifying relationships include: (i) employment by the audit committee member or immediate family member by the listed company or by any parent or subsidiary as an executive officer; (ii) status of the audit committee member as a partner, executive officer or controlling shareholder of another company which accounts for the greater of \$200,000 or 5% of the recipient company's gross revenues; (iii) service by the audit committee member as an executive with a company whose compensation committee includes an executive of the listed company; and (iv) employment by the audit committee member as a partner or employee of the listed company's external auditor. See proposed NASD Rule 4200(a)(15).

¹⁴ See proposed NASD Rule 4350(d)(2)(A).

¹⁵ As in the case of prohibited compensation, the NYSE's proposed listing standards amendments provide for 5-year "look back" periods with respect to certain prohibited relationships. See the commentary to proposed subsection 2(b) of Section 303A to the NYSE's Listed Company Manual. However, these NYSE "look-back" provisions are phased in, so they do not "look back" before the effective date of the proposals. The NASD's proposed listing standards provide for 3-year "look back" periods with respect to certain relationships. See proposed NASD Rule 4200(a)(15).

Exemptions

The SEC has provided for a limited number of exemptions from the independence requirements:

- Service as a member of the audit committee of both a company and any affiliate is permitted, if the member otherwise meets the independence requirements for each such entity, including the receipt of only ordinary-course compensation for serving as a member of each respective board of directors, audit committee and any other board committee.
- The audit committee of a company seeking to go public must have at least one fully independent member at the time of a company's listing, a majority of independent members within 90 days following the effective date of such company's IPO registration statement, and a fully independent committee within one year after such effective date.¹⁶

Commentary:

- The SEC release contemplates that the SROs will no longer be able to grant exemptions based on "exceptional and limited circumstances," a permitted standard under certain current SRO rules.¹⁷
- The SEC has stated that it will not entertain "no-action" letters or exemption requests for particular relationships on a "case-by-case" basis.

Application of Final Rules

Only companies listing their securities on a national securities exchange or NASDAQ will be subject to the final rules. Companies with securities quoted only on inter-dealer quotation systems, such as the Over-The-Counter Bulletin Board or "pink sheets", will not be subject to the new requirements.

- Companies with any listed securities, including debt securities and derivative securities, will be subject to the proposed audit committee requirements.
- Under the SEC's final rule, companies with securities listed on multiple markets must be subject to the audit committee requirements of only one such market.

¹⁶ The final rule is more lenient than the proposed exemption, which would have provided that the audit committee of a company seeking to go public may contain only one member who does not qualify as "independent" until 90 days following the effective date of the company's IPO registration statement.

¹⁷ See, e.g., subsection 2(D) of Section 303 to the NYSE's Listed Company Manual and NASD Rule 4350(d)(2)(B).

- Under the SEC’s final rule, listings of non-equity securities by a subsidiary, either consolidated with or at least 50% beneficially owned by a parent, will be exempt if the parent has a listed class of equity securities and is therefore itself subject to the proposed requirements. Listings of equity securities (other than non-convertible, non-participating preferred securities) by the subsidiary, however, will be subject to the SEC’s requirements.
- Listings of (i) a security futures product cleared by a clearing agency that is registered under Section 17A of the Securities Exchange Act of 1934 (the “Exchange Act”) or exempt from registration under Section 17A(b)(7)(A) of the Exchange Act and (ii) standardized options issued by a clearing agency registered under Section 17A of the Exchange Act are exempted from the requirements.

Commentary:

- The SROs have proposed to grant blanket exclusions to cases exempted by the SEC’s rule.¹⁸

Audit Committee Responsibilities Related to Public Accounting Firms

The audit committee of a listed company must be directly responsible for the appointment, compensation, retention, termination and oversight of the work of the auditors engaged to prepare or issue an audit report or related work or to perform other audit, review or attest services¹⁹ for the company. This would include resolving disagreements between management and the auditors regarding financial reporting. The auditors must report directly to the audit committee.

- The SEC has stated that the audit committee’s oversight responsibilities include the authority to retain or to terminate the outside auditor. The audit committee must also have ultimate authority to approve all audit engagement fees and terms. This reinforces the obligation added by Section 202 of the Act that auditing and permissible non-auditing services be pre-approved by the audit committee.

¹⁸ See proposed subsection 6 of Section 303A to the NYSE’s Listed Company Manual and proposed NASD Rule 4350(d)(2)(A). Although the proposed NASD rule does not specifically refer to the exemptions granted by the SEC’s final rules, it does so impliedly by incorporating the “criteria for independence set forth in Section 10A(m)(3)” of the Exchange Act.

¹⁹ Examples of such services include those related to the issuance of comfort letters and performance of statutory audits required for insurance companies under state law. For further discussion of the scope of audit, review and attest services, which are broader than those services required to perform an audit pursuant to generally accepted auditing standards, see SEC Release Nos. 33-8154; 34-46934 (Dec. 2, 2002).

- The SEC has stated that none of the audit committee requirements conflict with any requirement under a company's governing law that requires shareholders to elect, approve or ratify the selection of the company's auditors. When shareholder approval of auditors is required and the company provides a recommendation or nomination of the auditors, the audit committee must be responsible for making the recommendation or nomination.²⁰

Commentary:

- The SEC expressly declined to extend the audit committee's responsibilities to include the appointment, compensation, retention and oversight of a company's internal auditors.²¹

Whistleblower Procedures

In order to promote open and effective channels of information about a company's reporting policies and procedures, its audit committee must establish procedures for:

- the receipt, retention and treatment of complaints received by the company regarding accounting, internal accounting controls and auditing matters; and
- the confidential, anonymous submission by company employees of concerns regarding questionable accounting or auditing matters.
 - o No specific procedures are mandated by the final rules. The SEC has stated "that audit committees should be provided with flexibility to develop and utilize procedures appropriate for their circumstances" and that the SEC "expected each audit committee to develop procedures that work best consistent with its company's individual circumstances."²²

Commentary

- The SEC solicited comment whether listed companies should be required to disclose their whistleblower procedures and any changes to these procedures.

²⁰ If a company's home jurisdiction prohibits the full board of directors from delegating responsibility to select the company's auditors, the audit committee must be granted advisory and other powers with respect to such matters, to the extent permitted by law, including submitting nominations to the full board for its approval.

²¹ Under the NYSE's proposed listing standards amendments, a company would be required to have an internal audit function, although it could choose to outsource this function to a firm other than its independent auditor. See the commentary to proposed subsection 7(e) of Section 303A to the NYSE's Listed Company Manual.

²² See also Section 806 of the Act, which provides specific whistleblower protections.

The final rules do not contain any reference to this provision. Disclosure of standards for whistleblower complaints should, however, be addressed in public companies' codes of ethics.²³

Authority to Engage Outside Advisors

The SEC's final rules require that a listed company's audit committee have the authority to engage independent counsel and other advisors as it deems necessary. The SEC has stated that the audit committee may still obtain advice from the company's internal or regular counsel and does not have an affirmative obligation to retain independent counsel.

Funding

The SEC's final rules require every listed company to provide appropriate funding, as determined by the 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 company; and
- to any advisors employed by the audit committee.

Commentary:

- In response to comments to its proposed rule, the SEC expressly declined to set limits on the amount of funding an audit committee could seek for the compensation of the advisors it engages, noting that the audit committee members' fiduciary duties are sufficient to address concerns over compensation limits.
- A listed company must also provide appropriate funding for ordinary administrative expenses of the audit committee that are "necessary or appropriate in carrying out its duties."

Foreign Companies

Although the SEC has explicitly extended its final rules to foreign companies with U.S. listed securities, it has provided exemptions to address certain special requirements of these companies.

- An employee of a foreign company who is not an executive officer is exempt from the audit committee independence requirements if the employee is elected or named to the board of directors or audit committee pursuant to the foreign company's governing law or

²³ See Section 406 of the Act and SEC Release Nos. 33-8177; 34-47235 (January 23, 2003).

documents, an employee collective bargaining or similar agreement, or other home country legal or listing standards.²⁴

- If a foreign company has a two-tier board, with one tier designated as the “management” board and the other tier designated as the “supervisory” or “non-management” board, the supervisory or non-management board will be deemed the “board of directors” for purposes of the rules. The supervisory or non-management board may either form a separate audit committee or, if the entire supervisory or non-management board was independent within the provisions and exceptions of the rules, the entire board may be designated as the audit committee.
- To accommodate representatives of controlling shareholders of listed foreign companies, an audit committee member of such a company will not be disqualified as an “affiliate” if the member:
 - is not an executive officer of the company and satisfies the “compensation independence” requirements; and
 - has only observer status on, and is not a voting member or the chair of, the audit committee.
- Similarly, the audit committee of a listed foreign company may contain members who are representatives or designees of a foreign government affiliate of the company if such members are not executive officers of the company and otherwise satisfy the “compensation independence” requirements.²⁵
- A foreign company operating under a dual-holding company structure may designate one audit committee for both companies so long as each member of the audit committee is a member of the board of directors of at least one of the holding companies. Such dual-holding companies will not be deemed affiliates by virtue of their dual-holding company arrangements.
- Listed companies that are themselves foreign governments are entitled to a general exemption from the audit committee requirements.
- The final rules also provide a general exemption from the audit committee provisions if a foreign company meets the following requirements:

²⁴ This is meant to address the case, such as in Germany, where home country law requires non-management employees to serve on their companies’ supervisory or audit committees.

²⁵ The exemption applies regardless of the manner in which the foreign government owns its interest.

- o it has a board of auditors (or statutory auditors) separate from the board of directors, that is established and selected pursuant to home country legal or listing provisions requiring or permitting such a board or similar body;²⁶
- o members of the board of auditors are not elected by the company's management, and no executive officer of the company is a member of such board;
- o the applicable home country legal or listing provisions set forth standards for the independence of the board of auditors from the company and its management; and
- o the board of auditors, in accordance with standards prescribed by home country legal or listing provisions, is directly responsible, to the extent permitted by law, for the appointment, retention and oversight of the work of any registered public accounting firm engaged by the company.

Investment Companies

Under the final rules, closed-end investment companies and “exchange-traded funds” structured as open-end investment companies are subject to the audit committee requirements. Exchange-traded funds structured as unit investment trusts are excluded from the requirements. Restrictions on audit committee membership of non-exempt investment companies extend to “interested parties,” as defined in Section 2(a)(19) of the Investment Company Act of 1940, rather than “affiliates.”

Notification and Opportunity to Cure Defects

The SEC's final rules require that a listed company must notify its applicable SRO promptly after an executive officer becomes aware of any material non-compliance with the audit committee requirements.

The final rules also require SROs to develop procedures to provide listed companies with the opportunity to cure any defects that form the basis for delisting the companies' securities as a result of a failure to comply with the audit committee requirements. SROs may also provide that an audit committee member who ceases to be independent for reasons “outside the member's reasonable control” may remain on the audit committee until the earlier of the company's next annual meeting and one year from the occurrence of the disqualifying event, subject to notice being given by the company to its applicable SRO. Furthermore, the SEC has declined to mandate specific cure periods for the SROs. Instead, the SEC has suggested that definitive

²⁶ For example, under Japanese law, large Japanese corporations must maintain a board of corporate statutory auditors, a body legally separate and independent from the corporation's board of directors, that is elected by the corporation's shareholders.

procedures must be adopted by the SROs to specifically address issues arising under the audit committee requirements.

Commentary:

- The SEC has stated that the existing listing maintenance standards of the SROs generally provide for adequate opportunity to cure defects.²⁷
- Although the SEC expressly declined to require that listed companies provide periodic confirmations to SROs of compliance with their listing standards, the SROs have nonetheless proposed required executive certifications to such effect.²⁸

Disclosure Requirements

A listed company availing itself of an exemption under the final rules²⁹ must:

- disclose, in any proxy or information statement for a meeting of shareholders at which directors are elected, its reliance on the exemption and its assessment of whether, and if so how, such reliance materially and adversely affects the ability of the audit committee to act independently and satisfy the other requirements; and
- include such information in its annual report, or incorporate such information by reference from such proxy or information statement.
 - The required disclosure would be included under Item 10 in the annual report on Form 10-K, which may be incorporated by reference from the proxy statement.

Currently, public companies must make certain disclosures in their proxy statement about their audit committee and committee members. The final rules require listed companies to also disclose in their *annual reports* whether or not they have a standing audit committee and, if so, the names of the committee members.³⁰ As noted above, this disclosure may, subject to the

²⁷ See, e.g., NASD Rule 4800 Series and Section 804 of the NYSE's Listed Company Manual.

²⁸ See, e.g., proposed subsection 12(a) of Section 303A to the NYSE's Listed Company Manual. The NASD proposal requires a listed company to certify that it "has and will continue to have" an audit committee that meets its proposed standards. See proposed NASD Rule 4350(d)(2)(A).

²⁹ Listed companies relying solely on the multiple-listing exemption or exemption for affiliate representatives are not required to disclose their reliance on such exemptions. Issuers of security future products, standardized options, securities issued by foreign governments and securities issued by asset-backed issuers and similar passive issuers would similarly not be required to disclose their reliance on exemptions from the audit committee requirements.

³⁰ If the entire board is acting as the company's audit committee, then this fact must be disclosed as well.

SEC's customary requirements, be incorporated by reference from the company's proxy statement.

In its final rules, the SEC also required listed foreign companies to disclose whether or not their "audit committee financial expert" is independent, as that term is defined by the company's applicable SRO. If a foreign company is not a listed company, it must choose one of the SRO definitions of audit committee member independence that has been approved by the SEC in assessing the independence of its audit committee financial expert.

Implementation

The SROs must file with the SEC proposed amendments to their listing standards that embody these rules by July 15, 2003, and these amendments must be approved by the SEC no later than December 1, 2003. Listed companies must comply with the new listing standards by the earlier of (1) their first annual meeting after January 15, 2004, or (2) October 31, 2004. Foreign private issuers and small business issuers must be in compliance by July 31, 2005.

Commentary:

- It is unclear whether a non-complying company would nevertheless be considered to be "in compliance" with the SEC's requirements during the transition periods under the SRO's amended listing standards. For example, the NYSE proposed listing standards provide that a listed company must comply with its audit committee standards no later than 18 months after publication of SEC approval of the listing standards in the Federal Register.³¹ It is unclear whether a company listed on the NYSE would be forced to comply with the SEC's audit committee standards by October 31, 2004 although such date is still within the NYSE's proposed transition period. We expect this to be clarified in the revised rules issued by the SROs in response to these new SEC rules.
- The SRO proposed listing standard amendments provide for longer transition periods with respect to items not expressly mandated by the Act or governed by SEC regulations, such as the requirement that listed company boards of directors be comprised of a majority of "independent" directors. The final SRO listing standards may well retain the longer transition periods for these items.

³¹ See the introductory comments to proposed Section 303A of the NYSE's Listed Company Manual.

If you wish to obtain additional information regarding these new proposals or other initiatives, assistance in developing a detailed program to help ensure compliance or copies of any of our previous client memoranda, please contact John S. D'Alimonte (212-728-8212, jd'alimonte@willkie.com), Yaacov M. Gross (212-728-8225, ygross@willkie.com), Jeffrey S. Hochman (212-728-8592, jhochman@willkie.com), or the partner who regularly works with you.

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