

## Client Alert

# SEC Proposes New Rules on Listed Company Audit Committees

### A. Introduction

On January 8, 2003, the SEC released proposed rules implementing §301 of the Sarbanes-Oxley Act of 2002 (SOA) regarding listed company audit committees.<sup>1</sup> The proposed rules would prohibit national securities exchanges and national securities associations (also called self-regulatory organizations, or SROs) from listing equity, debt or other securities of issuers that do not comply with the SOA's requirements relating to:

- the independence of audit committee members; and
- the authority and responsibilities of audit committees, including (i) the selection and oversight of the issuer's independent accountant, (ii) establishing procedures for handling complaints regarding the issuer's accounting practices, (iii) the authority to engage outside advisors and (iv) appropriate funding for audit committees.

The SEC also proposed several amendments to current disclosure requirements regarding audit committees.

The SEC has requested that comments on the proposed rules be submitted by February 18, 2003.

### B. Audit Committee Member Independence

As mandated by SOA §301, the proposed rules would require that each member of a listed company's audit committee be an independent member of the company's board of directors. To be considered independent, an audit committee member may not, other than in his or her capacity as a board or committee member, (i) accept, directly or indirectly, any consulting, advisory or other compensatory fees from the issuer or

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<sup>1</sup> Securities and Exchange Commission Release Nos. 33-8173; 34-47137; File No. S7-02-03. A copy of the Release is available on the SEC website at <http://www.sec.gov/rules/proposed/34-47137.htm>.

(ii) be an affiliated person of the issuer or any of its subsidiaries.<sup>2</sup>

For this purpose, an audit committee member will be deemed to have accepted indirectly fees paid by the issuer to (A) a spouse, a minor child or a child sharing a home with the member or (B) a law firm, accounting firm, consulting firm, investment bank or similar entity in which the member is a partner or principal.

Consistent with existing securities laws, the proposed rules would define an “affiliated person” of an issuer to mean a person who directly, or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with the issuer. Under a proposed non-exclusive safe harbor, a person who is not an executive officer, director or 10% stockholder of an issuer would be deemed not to be an affiliate.

*Exemptions from Independence Requirements.* Recognizing the difficulties that issuers engaging in an initial public offering might face in recruiting independent directors, the SEC proposes to exempt one member of a listed issuer’s audit committee from the independence requirements for 90 days after effectiveness of the issuer’s IPO registration statement.

In addition, the proposed rules would exempt from the affiliate prohibition an audit committee member sitting on the boards of both an issuer and a direct or indirect consolidated subsidiary of the issuer if the member otherwise meets the “independence” requirements with respect to both the issuer and the subsidiary.

### C. Authority and Responsibilities of Audit Committees

*Selection and Oversight of Independent Auditor.* Under the proposed rules, listed company audit committees must be directly responsible for the appointment, compensation, retention (with authority to terminate) and oversight of the work of any registered public accounting firm<sup>3</sup> engaged for the purpose of preparing or issuing an audit report or related work or performing other audit, review or attest services for the issuer. In addition, the accounting firm must report directly to the audit committee.

The SEC noted that the audit committee’s oversight role with respect to the independent auditor would not conflict with an issuer’s governing law documents that

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<sup>2</sup> This requirement would be in addition to other independence requirements that may be imposed by the NYSE, Nasdaq or other SROs. For a discussion of the NYSE corporate governance proposals, see Chadbourne & Parke LLP August 2002 Client Alert: NYSE Files Proposed New Corporate Governance Rules with the SEC. A copy of the Client Alert is available on the Chadbourne & Parke LLP website at [www.chadbourne.com/publications/sub\\_Publications.html](http://www.chadbourne.com/publications/sub_Publications.html).

<sup>3</sup> The proposed rules provide that until the Public Accounting Oversight Board has established the registration of independent public accountants, the term “registered public accounting firm” will mean any independent public accountant engaged for the purposes indicated in the rules.

may require stockholders ultimately to approve the selection of the issuer's independent auditor. In such cases, however, the audit committee must be responsible for making any recommendation or nomination of an auditor to stockholders.

*Procedures for Handling Complaints.* As required by SOA §301, each audit committee must establish procedures for:

- the receipt, retention and treatment of complaints received by the issuer regarding accounting, internal accounting controls or auditing matters; and
- the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.

The proposed rules do not include specific procedures that an audit committee must establish; the SEC expects each audit committee to develop procedures that work best in each company's individual circumstances. Note in particular that the rules would not require that the audit committee itself administer all aspects of the handling of complaints.

*Authority to Engage Advisors and Funding.* Under the proposed rules, listed company audit committees must have the authority to engage counsel and other outside advisors, as the committee determines is necessary to carry out its duties. In addition, to ensure the effectiveness of audit committees, listed companies must provide appropriate funding, as determined by the audit committee, for:

- outside auditors engaged to provide audit, review or attest services; and
- advisors employed by the audit committee.

#### D. Foreign Private Issuers

In light of possible conflicts with audit committee and auditor oversight rules already in place in non-U.S. jurisdictions, several exemptions from the proposed rules would apply to foreign private issuers.

A non-management employee of a foreign private issuer would be exempt from the audit committee independence requirement of the rules if the employee is elected to the audit committee pursuant to home country legal requirements. The proposed rules also provide that for foreign private issuers with two-tier boards, the term "board of directors" means the non-management or supervisory board.

In addition, the proposed rules include limited exemptions that would allow controlling shareholders and government representatives to serve on audit committees.

Specifically, one member of a foreign private issuer's audit committee could be a controlling shareholder, provided the member (i) owns more than 50% of the voting

common equity of the issuer, (ii) satisfies the “no compensation” prong of the independence requirement, (iii) has only observer status and (iv) is not an executive officer. In addition, one member of the audit committee could be a representative of a foreign governmental entity that is an affiliate of the issuer if the member satisfies the “no compensation” prong of the independence requirement and is not an executive officer.

The proposed rules would also exempt foreign private issuers that have boards of auditors or statutory auditors from the requirements regarding audit committee member independence and independent auditor oversight, provided that certain conditions are satisfied.

#### E. Disclosure

*Identification of Audit Committee in Annual Reports.* Under current SEC rules, issuers are required to disclose in proxy statements (when action is to be taken with respect to the election of directors) whether the issuer has an audit committee, the names of the audit committee members, the number of audit committee meetings during the year and the functions of the audit committee. The SEC is proposing to require issuers also to include or incorporate by reference in their annual reports filed with the SEC disclosure of whether the issuer has an audit committee, and if so, the names of the audit committee members. In addition, if the entire board is acting as a company’s audit committee, this must be expressly stated in the company’s annual report and proxy statement. Information regarding the number of audit committee meetings and audit committee functions would continue to be required only in proxy statements.

*Disclosure Regarding Exemptions.* If an issuer is relying on an exemption from the audit committee requirements, such reliance must be disclosed in the issuer’s annual reports and its proxy statements for meetings at which director elections are held. An issuer would also be required to disclose its assessment of whether, and if so how, such reliance would materially adversely affect the ability of the audit committee to act independently. In addition, a foreign private issuer relying on the exemption for boards of auditors would be required to state that it is relying on this exemption in an exhibit to its annual report filed with the SEC.

#### F. Implementation and Timing of Proposed Rules

The SEC is required to adopt final rules by April 26, 2003. Each SRO must have in place and operative revised listing standards conforming with SEC requirements no later than the first anniversary of publication of the final SEC rules in the Federal

Register.<sup>4</sup> To facilitate this deadline, SROs would be required to provide to the SEC for its review any revised listing standards complying with the SEC's final rules by no later than 60 days after the publication of the final SEC rules. In addition, each SRO would be required to have revised standards approved by the SEC no later than 270 days after publication of the final SEC rules.

The proposed rules would require SROs to establish procedures for an issuer to have an opportunity to cure defects relating to audit committee standards before imposing a prohibition on listing. The proposed rules would also direct SROs to require listed companies to notify the SRO promptly after an executive officer of the listed company becomes aware of any material noncompliance with the SEC's audit committee standards.

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The SEC requests that comments on the proposed rules be received no later than February 18, 2003. Comments may be submitted electronically to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). All comment letters should refer to File No. S7-02-03 (in the subject line if sent electronically).

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<sup>4</sup> SROs may adopt additional listing standards related to audit committees, as long as they are consistent with SEC rules.

## For Additional Information

This client alert can be found, together with other recent Chadbourne & Parke LLP client alerts, at [http://www.chadbourne.com/publications/sub\\_Publications.html](http://www.chadbourne.com/publications/sub_Publications.html). If you have any questions regarding this proposal, please contact any of the following:

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