SARBANES-OXLEY UPDATE

Enhanced Audit Committee Standards

On January 8, 2003, the Securities and Exchange Commission (the "SEC") proposed Rule 10A-3 to implement Section 10A(m)(1) of the Securities and Exchange Act of 1934 (the "Exchange Act"), as added by Section 301 of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), which directed the SEC to adopt rules prohibiting the listing of any security of an issuer that is not in compliance with certain standards relating to, among other things: the independence of audit committee members, the audit committee's authority and responsibility to engage and oversee independent auditors, procedures for handling complaints regarding accounting practices, and funding for the independent auditor and any outside advisors engaged by the audit committee. The proposal will be open for public comment for 30 days after publication, and although Sarbanes-Oxley requires the SEC to adopt final rules by April 26, 2003, the SEC has proposed that the new requirements would not need to be operative by self-regulatory organizations ("SROs") until the first anniversary of the publication of the final rule.

The proposal is intended to enhance investor confidence in the fairness and integrity of the securities markets by increasing the competence and independence, and hence, effectiveness, of listed company audit committees. In order to do so, the SEC has proposed several changes to the current disclosure requirements regarding audit committees that are intended to increase the transparency of audit committees and improve the quality and accountability of financial disclosure and oversight of the process by qualified and independent audit committees.

Who would the proposal apply to?

Section 10A(m) and Rule 10A-3, as proposed, would apply to all issuers that have any security listed on a national security exchange or association, including domestic, foreign and small business issuers, as well as certain investment companies. Asset-backed issuers and exchange-traded unit investment trusts would not be subject to the proposal. The SEC has proposed several exemptions for foreign issuers in an effort to address specific areas where foreign governance arrangements differ significantly from domestic practices. Additionally, the proposal contains significant distinctions between non-investment and investment companies.

What would Rule 10A-3 do?

Rule 10A-3 would prohibit SROs from listing any security of an issuer that is not in compliance with certain standards, including all of the following:

- all members of an issuer's audit committee must be "independent";
- the audit committee must be directly responsible for the appointment, compensation, retention and oversight of any registered public accounting firm 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, and each such registered public accounting firm 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 or auditing matters, including procedures for the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters;
- the audit committee must have the authority to engage independent counsel and other advisors, as it determines necessary to carry out its duties; and
- issuers must provide appropriate funding for the audit committee.

Issuers would be required to notify the applicable SRO promptly after an executive officer of the issuer becomes aware of any material non-compliance by the issuer with the requirements of the rule. The SROs must provide appropriate procedures for an issuer to cure any defect that would be a basis for prohibiting listing.

When would a director be deemed "independent" for purposes of Rule 10A-3?

At the heart of the proposal is the enhanced criteria to determine the independence of audit committee members. In order to be considered independent, a member of an audit committee of a non-investment company issuer must 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 consulting, advisory, or other compensatory fee from the issuer; or
- be an affiliated person of the issuer or any subsidiary thereof.

The proposal would prohibit audit committee members from receiving any consulting, advisory or other compensatory fee from the issuer or an affiliate of the issuer, other than in the member's capacity as a member of the board of directors and any board committee. In addition to direct payments being barred, the prohibition would bar indirect payments, including payments to: spouses, minor children or stepchildren, or children or stepchildren sharing a home with the member, as well as payments accepted by an entity in which an audit committee member is a partner, member or principal or occupies a similar position and that provides accounting, consulting, legal, investment banking, financial or other advisory services or any similar services to the issuer.

Other than in his or her capacity as a member of the board and any board committee, members of the audit committee must not be an "affiliated person" of the issuer or any subsidiary of the issuer. The proposal would define "affiliate" and "affiliated person" consistent with other definitions of these terms under the securities laws and provide a safe harbor. Specifically, "affiliate of," or a "person affiliated with," a specified person, would mean a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer. Further, the proposal seeks to clarify that a director, executive officer, partner, member, principal or designee of an affiliate will be deemed to be an affiliate.

The determination as to whether an audit committee member is independent is ultimately a factual determination that requires consideration of all relevant facts and circumstances. In an attempt to streamline the process, the proposed safe harbor provides that an audit committee member would not be deemed to be in control of an issuer for purposes of Rule 10A-3 if the person is not:

- the beneficial owner, directly or indirectly, of more than 10% of any class of equity securities of the issuer;
- an executive officer of the issuer; and
- a director of the issuer (since audit committee members would be required to be members of the board of directors, this last safe harbor provision appears to be a vestige of an earlier proposed safe harbor on related subject matter).

The inability of an audit committee member to satisfy the safe harbor provisions would not serve as the final determination of whether such person is deemed to be an affiliated person as a facts and circumstances analysis could still be utilized.

What exemptions are available?

Section 10A(m)(3)(C) provides the SEC with authority to exempt particular relationships from the proposed independence requirements, and while the SEC does not currently propose to entertain exemptions for particular relationships or on a case-by-case basis, they have proposed two exemptions for domestic issuers. The first exemption would allow one member of a non-investment company issuer's audit committee to not satisfy the independence requirements for a period 90 days from the effective date of the issuer's initial registration statement under Section 12 of the Exchange Act or a registration statement under the Securities Act of 1933 covering an initial public offering of securities of the issuer. The second exemption would allow an audit committee member that sits on the board of directors of both a parent and a direct or indirect consolidated majority-owned subsidiary to be exempt from the "affiliated person" requirement, if such member otherwise meets the independence requirements for both the parent and the subsidiary.

Are there any disclosure requirements?

Issuers would be required to include or incorporate by reference in the issuer's annual report the identity of the members of the audit committee. Additionally, issuers that rely on the various exemptions afforded under the proposal would be required to disclose their reliance on the exemption and their assessment of whether, and if so, how, such reliance would materially adversely affect the ability of their audit committee to act independently and to satisfy the other requirements of Rule 10A-3. The requisite disclosure would need to appear in (i) annual reports filed with the Commission (the information may be incorporated by reference) and (ii) proxy statements or information statements for shareholders' meetings at which elections for directors are held.

What other requirements are being proposed?

The proposal also addresses the audit committee's authority and responsibility to engage and oversee independent auditors, procedures for handling complaints regarding accounting practices and funding for the independent auditor and any outside advisors engaged by the audit committee.

As a backstop to Section 202 of Sarbanes-Oxley (which requires audit committees to pre-approve audit and non-audit services), proposed Rule 10A-3(b)(2) stresses the fact that audit committees, in order to operate freely from management, would have to be directly responsible for the appointment, compensation, retention and oversight of the work of the independent auditor engaged (including resolution of disagreements between 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, and the independent auditor would have to report directly to the audit committee. Additionally, audit committees must be given the authority to engage outside advisors, including experts in particular areas of accounting and legal counsel, as the audit committee may determine necessary to carry out its duties.

To further bolster the separation between management and the audit committee, the proposal would require issuers to provide audit committees with appropriate funding, as determined by the audit committee, in its capacity as a committee of the board of directors, for payment of compensation to registered public accounting firms 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 advisors employed by the audit committee. As indicated in the proposal, requiring audit committees to bear responsibility to appoint, compensate, retain and oversee an outside auditor or to engage independent advisors without providing a means for the audit committee to compensate such parties would do little to eliminate reliance on management.

As a means to facilitate disclosures, encourage proper individual conduct and alert the audit committee to potential problems, the proposal would require audit committees to implement formal 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. As specific procedures will not be mandated, issuers should tailor procedures for their individual circumstances.

Practical Considerations

Given the potential length of time before the proposed rules need to be operative by SROs, issuers should have the necessary time to review existing situations and relationships and adopt an appropriate strategy to ensure timely compliance.

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Endnotes

[1] SEC Release No. 34-47137, available at http://www.sec.gov/rules/proposed/34-47137.htm.

[2] In order to address established governance arrangements, numerous exemptions are available for foreign private issuers. See, Proposed Rule 10A-3(b)(1)(iv)(C)-(E).