Standards for Listed Company Audit Committees

In another piece of Sarbanes-Oxley Act rulemaking, the Securities and Exchange Commission recently adopted a new rule for audit committees of companies listed on national securities exchanges and national securities associations ("SROs"). Release No. 33-8220 (Apr. 9, 2003) http://www.sec.gov/rules/final/33-8220.htm. The final rule -- Rule 10A-3 under the Securities Exchange Act of 1934 -- implements Section 301 of the Sarbanes-Oxley Act of 2002, which directs SROs to prohibit the listing of any security of an issuer that is not in compliance with certain audit committee standards.

Background

Even before recent high-profile corporate failures, the SEC and SROs have focused on the need for effective and independent audit committees. This focus intensified in 1999 when the Blue Ribbon Commission of the New York Stock Exchange and Nasdaq Stock Market reviewed audit committee practices and issued ten recommendations to improve their effectiveness and enhance the reliability of financial reporting. These recommendations resulted in revised listing standards and new SEC rules with respect to the functioning, governance and independence of audit committees. The Sarbanes-Oxley Act and required SEC rules have now added another level of regulatory focus in this area.

The new audit committee rule prohibits SROs from listing securities of an issuer whose audit committee does not comply with the following standards: (i) each audit committee member must be independent, (ii) the audit committee must be directly responsible for the appointment, compensation, retention and oversight of the issuer's registered independent accountant, (iii) the audit committee must establish procedures for handling complaints regarding the issuer's accounting practices, (iv) the audit committee must have authority to engage advisors, and (v) the issuer must provide funding for the independent auditor and any outside advisors engaged by the audit committee. In addition, the SEC has made several amendments to its disclosure requirements regarding audit committees.

The rule provides a baseline for the listing standards of the NYSE, the Nasdaq Stock Market and other exchanges. In its adopting release, the SEC noted that it expects the SROs to adopt additional listing standards, including additional independence requirements on top of the standards set forth in the final rule; however, any such additional requirements must be consistent with the basic standards in the audit committee rule.

The rule was proposed by the SEC in January 2003. Release No. 33-8173 (Jan. 8, 2003) http://www.sec.gov/rules/proposed/34-47137.htm. There were a considerable number of comment letters with respect to the proposed rule, the majority of which concerned the provisions relating to foreign private issuers. The final rule, however, is largely consistent with the SEC's proposal.

Independence

Listed companies are required to have audit committees consisting entirely of independent directors. In order for a director to be considered "independent", he or she needs to satisfy two basic criteria:

- an audit committee member must not accept any consulting, advisory or other compensatory fees from the issuer other than compensation received for membership on the board or audit committee; and
- an audit committee member must not be an "affiliated person" of the issuer or any subsidiary of the issuer, apart from serving as a director on the board.

The first requirement prohibits an audit committee member from accepting payments for, among other things, serving as an officer or employee.[1] The prohibition also extends to indirect payments, such as payments to certain family and other related persons (see box). The rule does not extend to the broad categories of family members and business relationships that are covered under current and proposed rules of the NYSE and the Nasdaq Stock Market. The rule also does not include a de minimis payment exception, which had been suggested by some of the comment letters.

Related Party Payments

Payments to the following would be deemed indirect payments to a director:

- spouses and minor children and stepchildren;
- children or stepchildren sharing a home with the audit committee member; and
- entities in which an audit committee member is a partner, member, managing director or executive officer, or occupies a similar position (except persons who have no active role in providing services to the entity) and which provide accounting, consulting, legal, investment banking or financial advisory services to the issuer or any subsidiary.[2]

For the second independence criterion, an "affiliated person" is defined consistently with current SEC definitions of the term: an "affiliate" is a person that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with, the other person. "Control" is the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through ownership of voting securities, by contract or otherwise. The determination of whether someone is an affiliated person will be based on all relevant facts and circumstances. The rule expressly provides, however, that executive officers, directors who are also employees of an affiliate and general partners and managing members of an affiliate are "affiliated persons".

The rule includes a safe harbor for a person who is not an executive officer of the issuer or a shareholder owning 10% or more of any class of voting equity securities. This safe harbor, however, is not a ceiling. A person who is ineligible for the safe harbor may still rely on particular facts and circumstances to establish a non-affiliate status.

The Sarbanes-Oxley Act does not require that an issuer have a separately designated audit committee. Thus, an issuer that doesn't designate an audit committee may consider the entire board of directors to be the audit committee. In this case, the independence requirements would apply to the entire board.[3]

Exemptions from Independence Requirements

The rule includes exemptions from the audit committee independence requirements for new issuers and holding companies with overlapping boards.

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[1] Unless the applicable listing standards provide otherwise, the prohibition on compensatory fees does not cover compensation under a retirement plan or other deferred compensation for prior service with the issuer if the compensation is not contingent on continued service.

[2] This would preclude an issuer's outside counsel from serving on its audit committee.

[3] For listed issuers organized as limited partnerships or limited liability companies, the term "board of directors" means the board of directors of the managing partner, managing member or equivalent body.

- New Issuers. Under the final rule, new public companies are only required to have one independent audit committee member at the time of listing. Thereafter, these new companies must have a majority of independent audit committee members within 90 days after listing and a fully independent audit committee one year after listing. This aspect of the rule is broader than what was originally proposed.
- Overlapping Board Relationships. The second exemption is an accommodation for interlocking directors of holding companies and their subsidiaries. Under this exemption, an audit committee member may sit on the board of directors of a listed issuer and any affiliate so long as, except for being a director on each such board, 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 the board of directors, audit committee or any other board committee of each such entity. As described below, a similar accommodation, along with others, is provided for foreign private issuers that operate under a dual holding company structure.

Responsibilities of Audit Committees

Oversight of Independent Auditors

In conjunction with Section 202 of the Sarbanes-Oxley Act (which requires audit committees to pre-approve audit and non-audit services), Rule 10A-3(b)(2) promotes the independence of the audit function by requiring that the listed company's audit committee be directly responsible for the appointment, compensation, retention and oversight of the work of the independent auditor engaged to perform audit, review or attest services.[4] The audit committee must have ultimate responsibility to approve the terms and fees of each audit engagement. The independent auditor must report directly to the audit committee and may be terminated only by the audit committee. The rule gives the audit committee the discretion to determine the appropriate level of oversight based on the issuer's individual circumstances.[5]

Complaint Procedures

In order to facilitate disclosures by employees and other individuals who could alert the audit committee to potential problems, each audit committee must develop procedures for (i) the receipt, retention and treatment of complaints received by the issuer regarding accounting, internal accounting controls and auditing matters, and (ii) the confidential, anonymous submission of employee concerns regarding accounting or auditing matters. The rule does not mandate specific procedures, and the SEC expects that each company will adopt procedures appropriate for its circumstances.

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[4] The proposed rule included an exemption for investment companies from the requirement that the audit committee select the independent auditor, because Section 32(a) of the Investment Company Act of 1940 requires independent auditors to be approved by the disinterested directors. In order to conform the final rule to new auditor independence rules, however, the SEC decided not to include this exemption. Accordingly, audit committees of investment companies also will be required to select independent auditors, and the independent directors will be required to ratify that selection.

[5] The rule's instructions clarify that none of the requirements conflict with the issuer's governing law or documents or other home country legal or listing provisions. Thus, the rule would yield to a home jurisdiction requirement for shareholders to approve the appointment of the independent auditor or a prohibition on board delegation to committee.

Authority to Engage Advisors and Funding

The audit committee must have the authority to engage outside advisors, including counsel, as it determines necessary to carry out its duties. In order to ensure appropriate separation between management and the audit committee, the issuer is required to provide sufficient funding to the audit committee to pay the auditors and employ outside advisors. In addition, the issuer must provide funding for ordinary administrative expenses of the audit committee.

Applicability of the Rule

The rule applies to domestic and foreign companies of all sizes that have securities listed on an SRO, but not companies whose securities are quoted only on the OTC Bulletin Board or that trade over-the-counter. Additionally, because the Sarbanes-Oxley Act did not make a distinction regarding the types of securities covered, the final rule applies to any listed security, including equity, debt, derivative and other types of listed securities. However, in addition to exemptions for new issuers and overlapping boards referred to previously, to avoid unduly burdening certain issuers, the SEC adopted the following exemptions from the audit committees requirements.

Multiple Listings

The final rule includes an exemption for issuers that list multiple classes of securities through various ownership structures. If an issuer is already subject to the requirements of new Rule 10A-3 as a result of the listing of a class of common equity or similar securities on one market, the listing of additional classes of securities will be exempt from the audit committee requirements. This is relevant to the extent any such additional class could impose additional burdens on the issuer under SRO rules. This exemption also applies to the listing of non-equity securities through direct or indirect subsidiaries that are consolidated or at least 50% beneficially owned by a parent company that is subject to the audit committee requirements as a result of the listing of a class of its equity securities. The SEC's position is that the parent company's audit committee is in an appropriate position to provide oversight for the financial reporting of these subsidiaries. However, if the subsidiary registrant were to list its own equity securities (other than non-convertible, non-participating preferred securities, trust preferred and similar securities) then it would be required to meet the audit committee requirements.

Securities Future Products and Standardized Options

The rule exempts from audit committee requirements securities future products and standardized options cleared by a clearing agency that is registered under Section 17A of the Exchange Act or exempt from registration under Section 17A(b)(7) of the Exchange Act.

Issuers of Asset-Backed Securities and Certain Other Passive Issuers

Because asset-backed issuers are typically holders of passive pools of assets without a board of directors and are subject to substantially different reporting requirements than other companies, these issuers are excluded from the audit committee requirements. Additionally, the final rule permits the SROs to exclude from the audit committee requirements issuers that are organized as trusts or other unincorporated associations that do not have a board of directors and whose activities are limited to passively owning or holding certain assets for the benefit of its securityholders.

Investment Companies

Exchange-traded unit investment trusts are also excluded from the audit committee requirements, but the rule does apply to closed-end investment companies and exchange traded open-end investment companies.

Foreign Private Issuers

Because there is no blanket exemption from the audit committee requirements for foreign private issuers, as a general matter such companies will be required to have audit committees. The final rule, however, does include certain accommodations for foreign private issuers in an attempt to address potential conflicts with legal requirements, corporate governance standards and the methods for providing auditor oversight in the home jurisdictions of foreign private issuers. These accommodations are discussed below.

- **Employee Representation.** Certain jurisdictions, such as Germany, require non-management employees to serve on the audit committee as an independent check on management. To accommodate this practice, the final rule allows a non-executive employee to sit on the audit committee of a foreign private issuer if the employee is elected or named to the board of directors or audit committee of the foreign private issuer pursuant to the issuer's governing law or documents, an employee collective bargaining or similar agreement or other home country legal or listing requirements.
- **Two-Tier Board Systems.** The rule clarifies that if a foreign private issuer has a two-tier board system, the term "board of directors" means the supervisory or non-management board for purposes of Rule 10A-3. For example, a specific feature of German corporate law is a two-tier board system separating the management board from the supervisory board. The supervisory board can either form a separate audit committee or, if the entire supervisory board is independent within the meaning of the rule, the entire board can be designated as the audit committee.
- **Controlling Shareholder Representation.** Because controlling shareholder representation on audit committees is a common practice in certain foreign jurisdictions, the rule contains a limited exception for these representatives from the independence requirements. The rule allows an audit committee member to be a representative of an affiliate of the foreign private issuer if the representative receives no compensation other than as a board or committee member, the member only has observer status on, and is not a voting member or chair of, the audit committee, and the member is not an executive officer of the issuer.
- **Foreign Government Representation.** In situations where a foreign government has significant shareholdings in a foreign private issuer, the final rule permits any audit committee member to be a representative of a foreign government or governmental entity, if the "no compensation" prong of the independence requirement is satisfied and the member is not an executive officer of the issuer.[6]

[6] In response to several commenters, the final rule specifically exempts listed issuers that are themselves foreign governments, as these issuers most likely would not be able to comply with the audit committee requirements.

- **Board of Auditors.** In the adopting release, the SEC noted that several foreign jurisdictions provide for auditor oversight through a board of auditors or statutory auditors that is separate from the board of directors. In order to avoid a duplication of efforts and responsibilities, the rule exempts from the audit committee requirements the listing of securities of a foreign private issuer if the issuer has a board of auditors (or similar body) or statutory auditor that meets a separate test for independence.[7] The final rule does not require that the issuer be listed on a market outside the U.S., as was included in the proposed rules.
- **Clarifications Regarding Possible Conflicts with Other Requirements.** The final rule includes several clarifying instructions that make clear that the requirements regarding audit committees do not conflict with, and are not affected by, a requirement or ability under an issuer's governing law or documents or other home country legal or listing provisions that requires or permits shareholders to vote on, approve or ratify such requirements. Instead, the SEC clarified that the audit committee requirements relate to the allocation of auditor oversight responsibility between the audit committee and management.

As discussed below, a foreign private issuer that avails itself of any of the foregoing exemptions will be required to disclose that fact in its annual reports. In its adopting release, the SEC acknowledged that corporate governance structures throughout the world will continue to evolve and that all future conflicts with the audit committee rule cannot be anticipated at this time.

Application to Pre-Approval Requirements and Auditor Independence Rules

In its adopting release, the SEC clarified that the audit committee of the parent company that controls another entity within the consolidated group can pre-approve audit and non-audit services for the parent company and any consolidated subsidiaries both with respect to the consolidated financial statements and with respect to the financial statements of any consolidated subsidiary that is also an issuer. In the event that both parent and subsidiary have audit committees, the SEC stated that it would not expect both committees to pre-approve the services, but that the relevant facts and circumstances should be evaluated to determine which audit committee is the most appropriate to review the impact of the services on the auditor's independence.

Determining Compliance; Opportunity to Cure

Responsibility for ensuring compliance with the audit committee requirements rests with the SROs and, therefore, the final rule instructs the SROs to require a listed issuer to notify the applicable SRO promptly after an executive officer of the issuer becomes aware of any material noncompliance by the issuer with the requirements. Additionally, SROs must establish procedures giving an issuer the opportunity to cure any defects before they prohibit the listing of or delist any security of the issuer.[9]

Effective Dates

The audit committee listing standards apply to all SROs. SROs are required to provide the SEC with proposed rules or amendments that comply with the audit committee requirements no later than July 15, 2003. Final rules or amendments must be approved by the SEC no later than December 1, 2003. The final rule makes clear that

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[7] Rule 10A-3(c)(3).

[9] In the event that an audit committee member ceases to be independent for reasons outside his or her control, the final rule permits the SROs to provide additional time to cure such defect.

SROs may adopt additional listing standards as long as they are consistent with the rules.

Listed issuers, other than foreign private issuers and small business issuers, must be in compliance with the new listing rule 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 must be in compliance with the new listing rule by July 31, 2005.

Disclosure Changes Regarding Audit Committees

Disclosures Regarding Exemptions

Under additional related final rules, issuers are required to disclose in their annual reports on Form 10-K, 20-F or 40-F and proxy statements their reliance on exemptions (e.g., for new issuers or foreign private issuers) from the audit committee requirements and their assessment of whether, and if so, how, such reliance would materially adversely affect the ability of the audit committee to act independently.[10]

Disclosure Regarding Identification of Audit Committees

Issuers subject to the proxy rules under Section 14 of the Exchange Act must already disclose in their proxy or information statement, if an action is to be taken with respect to the election of directors, certain information with respect to the issuer's audit committee, including whether the issuer has a standing audit committee and the names of each committee member.[11] In its adopting release, the SEC recognized the importance of this information to investors and accordingly the rules require that such information be included or incorporated by reference in the issuer's annual report.[12] In addition, because the Sarbanes-Oxley Act states that in the absence of an audit committee the entire board of directors will be considered to be the audit committee, the issuer must disclose whether the entire board is acting as the audit committee.

Issuers will be required to comply with the new disclosure requirements regarding use of exemptions, identification of audit committee members in annual reports and the independence disclosure updates beginning with reports covering periods ending on or after (or proxy or information statements for actions occurring on or after) the compliance date for listing standards applicable to the particular issuer. With respect to non-listed issuers, they should use the date that would apply as if they were listed issuers.

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[10] The proposed rules had required foreign issuers that rely on an exemption to disclose such reliance in an separate exhibit to their annual report. The SEC acknowledged that this requirement would be unnecessarily duplicative and, thus, it was not adopted.

[11] The final rules update the information that an issuer must disclose about the independence of its audit committee in its proxy or information statement. If the registrant is a listed issuer, it must disclose whether or not the audit committee members are independent using the definition of independence included in the listing standards applicable to the listed issuer. If the issuer does not have an audit committee, it must provide the disclosure with respect to all members of its boards of directors. Non-listed issuers that have separately designated audit committees will be allowed to choose any SRO definition for audit committee member independence that has been approved by the SEC.

[12] The final rules exclude issuers that rely on the multiple listing exemption, foreign government issuers, asset-backed issuers and unit investment trusts from these disclosure requirements.

Audit Committee Financial Expert Disclosure for Foreign Private Issuers

The final rules include an amendment to the audit committee financial disclosure provisions as they apply to foreign private issuers. If the foreign private issuer is a listed issuer, such issuer must disclose on Form 20-F or 40-F whether its audit committee financial expert is independent as defined by the applicable SRO listing standards. If a foreign private issuer is not a listed issuer, it must choose one of the SRO definitions of audit committee member independence that have been approved by the SEC in determining whether its audit committee financial expert, if it has one, is independent.

Conclusion

The Sarbanes-Oxley Act and the SEC's implementing rules endeavor to restore investor confidence in the capital markets and in the reliability of public companies' financial disclosures. Important steps have already been taken through recent SEC rulemaking aimed at improving audit practices and strengthening auditor independence. Through new Rule 10A-3 and amendments to existing rules, the SEC seeks to expand the function and responsibility of audit committees in establishing and implementing appropriate corporate governance standards. Listed issuers should also be mindful that the SROs may impose additional requirements on the audit committees in their final listing standards. However, the SEC's rule provides a consistent starting point for these listing standards and the delayed implementation dates will assist issuers that must recruit qualified independent directors.

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