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Advisory

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SECURITIES LAW

Audit Committee Independence and the Responsibilities of Audit Committees

The Securities and Exchange Commission (SEC) recently issued final Rule 10A-3 (the "Rule") under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), implementing Section 10A(m) of the Exchange Act, which was added to the Exchange Act by Section 301 of the Sarbanes-Oxley Act of 2002 (the "Act").¹ This Rule requires audit committees of companies that are listed on a national securities exchange or national securities association (an "SRO")² to comply with certain independence, responsibility, conduct and other standards. Each SRO will prohibit the initial or continued listing of a security of a company that does not have an audit committee that is in compliance with the Rule. The Rule addresses the following topics:

- the **independence** of audit committee members;
- the audit committee's responsibility to **select and oversee the issuer's independent accountants**;
- procedures for handling **complaints regarding the issuer's accounting practices**;
- the authority of the audit committee to **engage advisors**; and
- **funding for the independent auditor and any outside advisors** engaged by the audit committee.

The SEC required each SRO to submit to the SEC, no later than July 15, 2003, proposed rules or rule amendments that comply with the Rule. The SROs' rules or rule amendments must be approved by the SEC no later than December 1, 2003, and issuers whose securities are listed or traded on an SRO must comply with the 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 will have until July 31, 2005 to comply.

As we have noted in prior Client Advisories relating to the Act, the audit committees of public companies have been the subject of particular scrutiny in light of the corporate governance and accounting scandals that gave rise to the passage of the Act. Section 301 of the Act, Section 10A(m) of the Exchange Act and the Rule form an integral part of Congress' and the SEC's response to those scandals, and represent a clear statement of how involved and active the audit committee as an entity will be required to become. As the SEC noted in the Rule's adopting release, the audit committee, if functioning properly, "plays a critical role in providing oversight over and serving as a check and balance on a company's financial reporting system[...]... provides independent review and oversight of a company's financial reporting processes, internal controls and independent auditors[.]...provides a forum

¹ The final Rule is available at <http://www.sec.gov/rules/final/33-8220.htm>.

² There are currently nine national securities exchanges: American Stock Exchange (AMEX), Boston Stock Exchange, Chicago Board Options Exchange, Chicago Stock Exchange, Cincinnati Stock Exchange, International Securities Exchange, New York Stock Exchange (NYSE), Philadelphia Stock Exchange and Pacific Exchange. The National Association of Securities Dealers, which partially owns and operates The Nasdaq Stock Market ("Nasdaq"), is currently the only national securities association. Issuers whose securities are *only* listed on the Over-the-Counter Bulletin Board or the Pink Sheets will not be required to comply with these requirements.

separate from management in which auditors and other interested parties can candidly discuss concerns, [and] helps to ensure that management properly develops and adheres to a sound system of internal controls, that procedures are in place to objectively assess management's practices and internal controls, and that the outside auditors, through their own review, objectively assess the company's financial reporting practices."

In light of the rejuvenated focus on accounting compliance and controls post-Enron, the function of the audit committee has become ever more critical to a company's overall corporate governance. The Rule adopted by the SEC helps to clarify further the expectations and demands to be faced by audit committee members of all listed companies.

Independence of Audit Committee Members

Under the Rule, each member of an audit committee must be "independent." An audit committee member will not be independent if he or she:

- accepts, directly or indirectly, any consulting, advisory or other compensatory fee from the issuer or any subsidiary thereof, other than in the member's capacity as a member of the board of directors and any board committee; or
- is an affiliated person of the issuer or any subsidiary of the issuer.

What types of compensatory fees are and are not prohibited?

Audit committee members may not receive any payments from the issuer for any compensatory purpose other than for service as an audit committee member, as a board member, or as a member of any other committee of the board of directors. Any compensatory payments to spouses, minor children or stepchildren, or children or stepchildren who share a home with the

audit committee member will be treated as indirect payments to the audit committee member. In addition, prohibited indirect payments will include any payments that are accepted by an entity in which the audit committee member is a partner, member, or executive officer, or occupies a similar position, if the entity provides accounting, consulting, legal, investment banking or financial advisory services to the issuer or any subsidiary. The prohibition will not apply if the audit committee member is only a limited partner or non-managing member of, or holds a similar position in, such entity, and, in each case, has no active role in providing services to the issuer or a subsidiary.

The prohibition on compensatory payments only applies to current relationships with the audit committee member. However, compensatory payments do not include the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the listed issuer (provided that the compensation is not contingent in any way on continued service). The Rule requires no "lookback" period relating to compensation paid prior to the time the individual became an audit committee member. The Rule also does not contain any *de minimis* exception for small amounts of compensation; any payment of prohibited compensation will cause an audit committee member to fail the independence test.

Who is an "affiliated person" of the issuer for purposes of the independence requirement?

The SEC has defined the terms "affiliate" and "affiliated person," for purposes of the Rule, in accordance with definitions of these terms under other provisions of the securities laws, such as in Rule 12b-2 under the Exchange Act and Rule 144 under the Securities Act of 1933, as amended. Accordingly, an "affiliate" of, or a person

"affiliated" with, an entity, means "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person." The term "control" is defined as "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."

As with analyses of who is considered an affiliate under other sections of the securities laws, companies will have to undertake an analysis of each of the relevant facts and circumstances in determining whether a person is an affiliate of the issuer for purposes of the Rule. Any director who is an executive officer, employee, general partner or managing member of an affiliate of an issuer will be deemed to be an affiliate of the issuer. In addition, the SEC has adopted a safe harbor under which any person who is *not* an executive officer of an issuer *or* a beneficial owner of 10% or more of any class of voting equity securities of an issuer will be deemed not to control the issuer.³

How do the SRO rules that define independence affect this Rule?

The SEC's specific mandate under Section 10A(m) of the Exchange Act was to evaluate independence by reference to payment of fees and affiliate status. The Rule was promulgated to build on and rely on existing SRO standards of independence, which are largely based on commercial and familial relationships. Listed companies will ultimately be required to evaluate their audit committee memberships based both on the requirements of the Rule and the standards of the market on which their securities are listed or traded. We understand that Nasdaq, NYSE and AMEX have been reviewing their listing standards and have submitted proposals relating to these matters to the SEC, which proposals include revised definitions of independence using more rigorous standards to eliminate

³ Beneficial ownership, for purposes of the 10% threshold calculation, must be determined in accordance with Rule 13d-3 under the Exchange Act, which provides generally that a person will be considered to have beneficial ownership of a security if he or she, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, has or shares: (1) voting power, which includes the power to vote, or to direct the voting of, such security; and/or (2) investment power, which includes the power to dispose, or to direct the disposition, of such security. Shares will also be considered to be beneficially owned if that person has the right to acquire beneficial ownership of the security within sixty days, including pursuant to the exercise of any option, warrant or right or through the conversion of a security.

potentially conflicted or non-independent members.⁴ Once these listing standards are finalized, Mintz Levin will provide a separate Client Advisory describing those requirements.

Will there be any exemptions from the Rule for companies initially going public?

Yes. The SEC, recognizing that issuers which are going public may face difficulties in recruiting fully independent audit committees, will permit such companies to have just one fully independent member on their audit committees at the time of their initial listing, as long as they have a majority of independent members within 90 days of their initial listing, and a fully independent committee within one year of the initial listing. Issuers relying on this exemption from the independence requirements will be required to disclose such reliance in, or incorporate the disclosure by reference into, annual reports filed with the SEC. The disclosure must include the issuer's assessment of whether and how its reliance on the exemption will materially adversely affect the ability of its audit committee to satisfy the requirements of the Rule.

Responsibility to Select and Oversee Independent Accountants

Also as required by Section 301 of the Act, the Rule requires that the audit committee of a listed issuer be *directly responsible* for the appointment, compensation, retention and oversight of the work of any registered public accounting firm that is engaged by the issuer to prepare or issue an audit report or to perform other audit, review or attest services for the listed issuer. These oversight responsibilities include the authority to retain or terminate the outside auditor, as well as the resolution of any disagreements between management and the auditor regarding financial reporting.

The independent auditor will be required to report directly to the audit committee with respect to its activities and the financial reporting processes of management.⁵ In addition, the audit committee must have the ultimate authority to approve all audit engagement fees and terms.⁶

In order to avoid any confusion with respect to issuers who either have voluntarily provided their stockholders with the ability to ratify the selection of their independent public accountants, or who are required to provide their stockholders with that ability pursuant to other governing laws or documents, the Rule makes clear that none of the requirements with respect to this topic conflict with, nor do they affect the application of, any requirement or ability under an issuer's governing law or other documents that either requires or permits shareholders to vote on, approve or ratify the appointment of an issuer's independent public accountants. If that responsibility is vested with an issuer's shareholders, and the issuer makes a recommendation or nomination regarding the matter to its shareholders, the audit committee of the issuer must be the entity that is responsible for making the recommendation or nomination.

Establishment of Procedures to Handle Accounting Complaints

Another requirement of Section 301 of the Act, and as set forth in the Rule, is that audit committees of listed issuers 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 Rule does not include specific procedures that an audit committee must establish; rather, the SEC expects that each company's audit committee will develop procedures that work for the individual company. There is no "one size fits all" approach to the establishment of these procedures; audit committees should begin now, in consultation with their Mintz Levin attorneys and their independent accountants, to consider which procedures will work best with their company's size, area of business, skill level and sophistication of employees, internal reporting structures, and any other relevant considerations.

Authority to Engage Advisors; Funding for Independent Auditors and Outside Advisors

The Rule also requires each listed company to provide its audit committee the authority to engage its own outside advisors, including legal counsel, as an audit committee deems necessary to fulfill its duties. Further, issuers must provide appropriate funding, as determined by their audit committees, for the payment of compensation:

- to any public accounting firm that is engaged to prepare or issue an audit report or to perform other audit, review or attest services for the listed company; and
- to any advisors that are employed by the audit committee.

Issuers must also provide any necessary funding for the ordinary administrative expenses of their audit committees. The Rule does not contain a limit on how much compensation must be made available for these purposes.

⁴ The current formulations of the Nasdaq corporate governance proposals can be found at <http://www.nasdaq.com/about/ProposedRuleChanges.stm>, the current formulations of the NYSE corporate governance proposals can be found at <http://www.nyse.com/pdfs/amend1-04-09-03.pdf> and the current formulations of the AMEX corporate governance proposals can be found at http://www.amex.com/atamex/news/am_CorGov.htm.

⁵ Rules adopted by the SEC implementing Section 204 of the Act (see <http://www.sec.gov/rules/final/33-8183.htm>), for example, contain specific substantive matters to be addressed by the independent auditor in its reports to the audit committee, including all critical accounting policies and practices of the issuer, alternative accounting treatments discussed with management of the issuer, and other material written communications between the auditors and management.

⁶ The SEC's rules with respect to the pre-approval by the audit committee of all audit and non-audit services to be provided by an issuer's independent auditors, as required by Sections 201 and 202 of the Act, are also set forth at <http://www.sec.gov/rules/final/33-8183.htm>.

Disclosure Relating to Audit Committees and their Activities

The Rule also includes certain changes to the disclosure that listed companies are required to make with respect to their audit committees. In addition to the current requirement to include information with respect to audit committees in proxy statements at which directors are to be elected, companies will now be required to include (or incorporate by reference) disclosure in each annual report as to whether or not they have separate audit committees and, if so, the identities of each of the members of the committee. If the company has not established a separate committee of its board of directors to serve as the audit committee, and therefore the entire board of directors is deemed to be serving as the audit committee, the issuer will be required to state that fact.

Issuers will be required to comply with these disclosure requirements beginning with reports that are filed covering periods ending on or after the applicable compliance date for the SRO listing standard applicable to such issuer.

Applicability to Foreign Private Issuers

Section 301 of the Act did not distinguish between domestic listed companies and foreign listed companies for purposes of compliance with the requirements relating to their audit committees. The SEC became aware that compliance with Section 301 could cause foreign companies to violate the rules of their home jurisdictions, or otherwise lead to confusion or difficulties for the foreign issuers under the governing documents and laws applicable to them. In response to these concerns, the SEC has provided for certain exceptions from the Rule for foreign private issuers, as follows:

1. **Employee Representation.** Some countries require that non-management employees serve on issuers' audit committees, as an independent check on management's activities. These employees would not qualify as "independent" under the Section 301 requirements. However, the SEC will

permit non-executive employees to serve on the audit committee of a foreign private issuer if the employee is elected or named to the issuer's board of directors or audit committee pursuant to the issuer's governing law or documents, an employee collective bargaining or similar agreement, or other home country legal or listing requirements.

2. **Two-Tiered Boards.** The Rule clarifies that the audit committee requirements of foreign private issuers with a two-tiered board system, with one tier designated as the management board and the other tier designated as a supervisory, or non-management, board, will apply to the supervisory, or non-management, board and not to the management board.
3. **Controlling Shareholder Representation.** Many foreign private issuers allow controlling shareholders to serve on their audit committees. Under the Rule, the SEC will permit a representative of an affiliate of a foreign private issuer to be a member of the issuer's audit committee if the "no compensation" prong of the independence requirements is satisfied, the member in question has only observer status on, and is not a voting member or the chair of, the audit committee, and the member in question is not an executive officer of the issuer.
4. **Foreign Government Representation.** Foreign governments may also have representatives serving on the audit committees of foreign private issuers, who may not qualify as independent under the new Rule. The SEC will permit representatives of foreign governments to serve on the audit committees of foreign private issuers if the "no compensation" prong of the independence requirements is satisfied, and the member in question is not an executive officer of the issuer.
5. **Boards of Auditors or Similar Bodies.** Some countries permit or require auditor oversight through a board of auditors or similar entity, which is not necessarily a part of the issuer's board

of directors. Rather than require foreign private issuers that have such boards of auditors to establish separate audit committees, the Rule provides an exemption from the independence requirements for foreign private issuers that have boards of auditors meeting specified requirements, including that no member may be an executive officer of the issuer, and the independence of the board must be governed by applicable home country legal requirements or listing provisions.

If a foreign private issuer chooses to rely upon any of the exemptions applicable to such issuers, it will be required to disclose such reliance in, or incorporate the disclosure into, annual reports filed with the SEC and in proxy or information statements of issuers that are subject to the SEC's proxy rules for shareholders' meetings at which directors are elected. The disclosure must include the issuer's assessment of whether and how its reliance on the exemption will materially adversely affect the ability of its audit committee to act independently and satisfy the additional requirements of the Rule.

The SEC also answered a question left open in its adopting release on audit committee financial experts. The Rule makes clear that foreign private issuers will be required to disclose in their annual reports the name of the audit committee financial expert and whether that person is "independent" as that term is defined by the SRO listing the issuer. This disclosure will be applicable commencing July 31, 2005.

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Please contact the Mintz Levin attorney who handles your corporate and securities law matters if you have any questions or concerns regarding this information.