

and national securities associations¹⁶ (or "SROs") to prohibit the listing of any security of an issuer that is not in compliance with several enumerated standards regarding issuer audit committees. We received over 185 comments in response to our release proposing to implement the directive in section 10A(m) of the Exchange Act.¹⁷ The final rule and form amendments we adopt today have been revised, as discussed in this release, to incorporate a number of changes recommended by commenters.

Accurate and reliable financial reporting lies at the heart of our disclosure-based system for securities regulation, and is critical to the integrity of the U.S. securities markets. Investors need accurate and reliable financial information to make informed investment decisions. Investor confidence in the reliability of corporate financial information is fundamental to the liquidity and vibrancy of our markets.

Effective oversight of the financial reporting process is fundamental to preserving the integrity of our markets. The board of directors, elected by and accountable to shareholders, is the focal point of the corporate governance system. The audit committee, composed of members of the board of directors, plays a critical role in providing oversight over and serving as a check

and balance on a company's financial reporting system. The audit committee provides independent review and oversight of a company's financial reporting processes, internal controls and independent auditors. It provides a forum separate from management in which auditors and other interested parties can candidly discuss concerns. By effectively carrying out its functions and responsibilities, the audit committee 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.

Since the early 1940s, the Commission, along with the auditing and corporate communities, has had a continuing interest in promoting effective and independent audit committees.¹⁸ It was largely with the Commission's encouragement, for instance, that the SROs first adopted audit committee requirements in the 1970s.¹⁹ Over the years, others have expressed support for strong, independent audit committees,²⁰ including the National Commission on Fraudulent Financial Reporting, also known as the Treadway Commission,²¹ and the General Accounting Office.²²

In 1998, the NYSE and the NASD sponsored a committee to study the

effectiveness of audit committees. This committee became known as the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (the "Blue Ribbon Committee"). In its 1999 report, the Blue Ribbon Committee recognized the importance of audit committees and issued ten recommendations to improve their effectiveness.²³ In response to these recommendations, the NYSE and the NASD, among others, revised their listing standards relating to audit committees,²⁴ and we adopted new rules requiring disclosure relating to the functioning, governance and independence of corporate audit committees.²⁵ Beginning last year, at the Commission's request,²⁶ the NYSE and the NASD again reviewed their corporate governance standards, including their audit committee rules, in light of several high-profile corporate failures, and have proposed changes to their rules to provide more demanding standards for audit committees.²⁷

Recent events involving alleged misdeeds by corporate executives and independent auditors have damaged investor confidence in the financial markets.²⁸ They have highlighted the need for strong, competent and vigilant audit committees with real authority.²⁹ In response to the threat to the U.S. financial markets posed by these events, Congress passed, and the President signed into law on July 30, 2002, the Sarbanes-Oxley Act. The Sarbanes-Oxley Act mandates sweeping corporate disclosure and financial reporting

(NYSE), Philadelphia Stock Exchange and Pacific Exchange. In addition, an exchange that lists or trades security futures products (as defined in Exchange Act section 3(a)(56) [15 U.S.C. 78c(56)]) may register as a national securities exchange under section 6(g) of the Exchange Act solely for the purpose of trading security futures products. Regarding security futures products, see section II.F.2.b.

¹⁶ A "national securities association" is an association of brokers and dealers registered as such under section 15A of the Exchange Act [15 U.S.C. 78o-3]. The National Association of Securities Dealers (NASD) is the only national securities association registered with the Commission under section 15A(a) of the Exchange Act. The NASD partially owns and operates The Nasdaq Stock Market (Nasdaq). Nasdaq has filed an application with the Commission to register as a national securities exchange. In addition, section 15A(k) of the Exchange Act [15 U.S.C. 78o-3(k)] provides that a futures association registered under section 17 of the Commodity Exchange Act [7 U.S.C. 21] shall be registered as a national securities association for the limited purpose of regulating the activities of members who are registered as broker-dealers in security futures products pursuant to section 15(b)(11) of the Exchange Act [15 U.S.C. 78o(b)(11)]. Regarding security futures products, see section II.F.2.b.

¹⁷ Release No. 33-8173 (Jan. 8, 2003) [68 FR 2638] ("Proposing Release"). The public comments we received, and a summary of the comments prepared by our staff (the "Comment Summary"), can be viewed in our Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549, in File No. S7-02-03. Public comments submitted by electronic mail and the Comment Summary also are available on our Web site, <http://www.sec.gov>.

¹⁸ In 1940, the Commission investigated the auditing practices of McKesson & Robbins, Inc., and the Commission's ensuing report prompted action on auditing procedures by the auditing community. In *The Matter of McKesson & Robbins*, Accounting Series Release (ASR) No. 19, Exchange Act Release No. 2707 (Dec. 5, 1940).

¹⁹ For example, in 1972, the Commission recommended that companies establish audit committees composed of outside directors. See ASR No. 123 (Mar. 23, 1972). In 1974 and 1978, the Commission adopted rules requiring disclosures about audit committees. See Release No. 34-11147 (Dec. 20, 1974) and Release No. 34-15384 (Dec. 6, 1978).

²⁰ See, e.g., Preliminary Report of the American Bar Association Task Force on Corporate Responsibility (July 16, 2002). The report is available on the American Bar Association's Web site at <http://www.abanet.org/buslaw/>.

²¹ The Treadway Commission was sponsored by the American Institute of Certified Public Accountants, the American Accounting Association, the Financial Executives Institute (now Financial Executives International), the Institute of Internal Auditors and the National Association of Accountants. Collectively, these groups were known as the Committee of Sponsoring Organizations, or COSO. The Treadway Commission's report, the Report of the National Commission on Fraudulent Financial Reporting (October 1987), is available at <http://www.coso.org>.

²² GAO, "CPA Audit Quality: Status of Actions Taken to Improve Auditing and Financial Reporting of Public Companies," at 5 (GAO/AFMD-89-38, March 1989).

²³ See Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (February 1999). The Blue Ribbon Committee Report is available at <http://www.nyse.com>.

²⁴ See, for example, Exchange Act Release No. 42231 (Dec. 14, 1999) [64 FR 71523] (Nasdaq rules) and Exchange Act Release No. 42233 (Dec. 14, 1999) (NYSE rules) [64 FR 71529]. See also Exchange Act Release No. 42232 (Dec. 14, 1999) [64 FR 71518] (American Stock Exchange rules) and Release No. 34-43941 (Feb. 7, 2001) [66 FR 10545] (Pacific Exchange rules).

²⁵ See Exchange Act Release No. 42266 (Dec. 22, 1999) [64 FR 73389].

²⁶ See Press Release No. 2002-23 (Feb. 13, 2002).

²⁷ See File Nos. SR-NASD-2002-141 and SR-NYSE-2002-33 (pending before the Commission).

²⁸ See, for example, John Waggoner and Thomas A. Fogarty, "Scandals Shred Investors' Faith: Because of Enron, Andersen and Rising Gas Prices, the Public is More Wary Than Ever of Corporate America," USA Today, May 2, 2002; and Louis Aguilar, "Scandals Jolting Faith of Investors," Denver Post, June 27, 2002.

²⁹ See, for example, John Good, "After Enron, Beef Up Those Audit Committees," The Commercial Appeal, Apr. 26, 2002; and "FT Comment After Enron: Giving Meaning to the Codes of Best Practice: Corporate Governance: Companies Need Truly Independent Directors, Strong Audit Committees, an Outlet for Whistleblowers and Tight Controls on Share Options," The Financial Times, Feb. 19, 2002.