

reform to improve the responsibility of public companies for their financial disclosures. This release is the most recent of several that we have issued to implement provisions of the Sarbanes-Oxley Act.<sup>30</sup>

Under new Exchange Act Rule 10A-3, SROs will be prohibited from listing any security of an issuer that is not in compliance with the following standards, as discussed in more detail in this release:

- Each member of the audit committee of the issuer must be independent according to specified criteria;
- The audit committee of each issuer must be directly responsible for the appointment, compensation, retention and oversight of the work of any registered public accounting firm<sup>31</sup> engaged for the purpose of preparing or issuing an audit report 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;
- Each 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

<sup>30</sup> For example, see Release No. 34-46421 (Aug. 27, 2002) [67 FR 56462] (Ownership reports and trading by officers, directors and principal security holders); Release No. 33-8124 (Aug. 28, 2002) [67 FR 57276] (Certification of disclosure in companies' quarterly and annual reports); Release No. 33-46685 (Oct. 18, 2002) [67 FR 65325] (Proposals regarding improper influence on conduct of audits); Release No. 33-8138 (Oct. 22, 2002) [67 FR 66208] (Proposals regarding internal control reports); Release No. 33-8170 (Dec. 20, 2002) [67 FR 79466] (Proposals regarding mandated electronic filing and Web site posting for Forms 3, 4 and 5); Release No. 33-8176 (Jan. 22, 2003) [68 FR 4820] (Conditions for use of non-GAAP financial information); Release No. 34-47225 (Jan. 22, 2003) [68 FR 4338] (Insider trades during pension plan blackout periods); Release No. 33-8177 (Jan. 23, 2003) [68 FR 5110] (Disclosure regarding audit committee financial experts and company codes of ethics); Release No. 33-8180 (Jan. 24, 2003) [68 FR 4862] (Retention of records relevant to audits and reviews); Release No. 34-47262 (Jan. 27, 2003) [68 FR 5348] (Adoption of Form N-CSR); Release No. 33-8182 (Jan. 28, 2003) [68 FR 5982] (Disclosure about off-balance sheet arrangements); Release No. 33-8183 (Jan. 28, 2003) [68 FR 6006] (Strengthening the Commission's requirements regarding auditor independence); Release Nos. 33-8185 (Jan. 29, 2003) [68 FR 6296] and 33-8186 (Jan. 29, 2003) [68 FR 6324] (Implementation of standards of professional conduct for attorneys); and Release No. 33-8212 (Mar. 21, 2003) [68 FR 15600] (Certification of disclosure in certain Exchange Act reports).

<sup>31</sup> The term "registered public accounting firm" is defined in section 2(a)(12) of the Sarbanes-Oxley Act. See 15 U.S.C. 78c(a)(59). We anticipate that the Public Company Accounting Oversight Board will have established the registration of public accounting firms by the time the implementing listing rules are operative.

regarding questionable accounting or auditing matters;

- Each audit committee must have the authority to engage independent counsel and other advisors, as it determines necessary to carry out its duties; and
- Each issuer must provide appropriate funding for the audit committee.

With the exceptions specified below, listed issuers must be in compliance with the new listing rules by the earlier of (1) their first annual shareholders meeting after January 15, 2004, or (2) October 31, 2004. Foreign private issuers<sup>32</sup> and small business issuers<sup>33</sup> that are listed must be in compliance with the new listing rules by July 31, 2005.

In addition, the final rule amendments make several changes to our current disclosure requirements regarding audit committees.

## II. Discussion

Under section 3(a)(58) of the Exchange Act,<sup>34</sup> as added by section 205 of the Sarbanes-Oxley Act, the term audit committee is defined as:

- A committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and

- If no such committee exists with respect to an issuer, the entire board of directors of the issuer.

Accordingly, an issuer either may have a separately designated audit committee composed of members of its board or, if it chooses to do so or if it fails to form a separate committee, the entire board of directors will constitute the audit committee. If the entire board constitutes the audit committee, the new SRO rules adopted under Exchange Act Rule 10A-3, including the independence requirements, will apply to the issuer's board as a whole.

<sup>32</sup> The term "foreign private issuer" is defined in Exchange Act Rule 3b-4(c) [17 CFR 240.3b-4(c)]. A foreign private issuer is a non-government foreign issuer, except for a company that (1) has more than 50% of its outstanding voting securities owned by U.S. investors and (2) has either a majority of its officers and directors residing in or being citizens of the U.S., a majority of its assets located in the U.S., or its business principally administered in the U.S.

<sup>33</sup> The term "small business issuer" is defined in Exchange Act Rule 12b-2 [17 CFR 240.12b-2] as a U.S. or Canadian issuer with less than \$25 million in revenues and public float that is not an investment company. Such issuers are eligible to use Form 10-KSB [17 CFR 249.310b] for their annual reports and Form 10-QSB [17 CFR 249.308b] for their quarterly reports.

<sup>34</sup> 15 U.S.C. 78c(a)(58).

In addition, because Exchange Act section 10A(m) imposes requirements that only apply to issuers listed on a national securities exchange or listed in an automated inter-dealer quotation system of a national securities association,<sup>35</sup> the requirements of Exchange Act Rule 10A-3 only apply to issuers that are so listed. None of the requirements of section 10A(m) of the Exchange Act or Exchange Act Rule 10A-3 apply to other reporting companies under section 13(a)<sup>36</sup> or 15(d)<sup>37</sup> of the Exchange Act.<sup>38</sup>

Some commenters requested clarification regarding application of the rule to listed issuers organized as limited partnerships that do not have their own board of directors but instead rely on a managing general partner.<sup>39</sup> We have added a clarification that in the case of a listed issuer that is a limited partnership or limited liability company where such entity does not have a board of directors or equivalent body, the term "board of directors" means the board of directors of the managing general partner, managing member or equivalent body.

### A. Audit Committee Member Independence

#### 1. Scope of the Requirement

As early as 1940, the Commission encouraged the use of audit committees composed of independent directors.<sup>40</sup> An audit committee comprised of independent directors is better situated to assess objectively the quality of the issuer's financial disclosure and the adequacy of internal controls than a committee that is affiliated with management. Management may face market pressures for short-term performance and corresponding pressures to satisfy market expectations. These pressures could be exacerbated by the use of compensation or other incentives focused on short-term stock appreciation, which can promote self-interest rather than the promotion of long-term shareholder interest. An independent audit committee with adequate resources helps to overcome

<sup>35</sup> In this release, we refer to issuers that are listed on one or more of these markets as "listed issuers."

<sup>36</sup> 15 U.S.C. 78m(a).

<sup>37</sup> 15 U.S.C. 78o(d).

<sup>38</sup> Non-listed issuers should still refer to the disclosure updates adopted in this release, as those changes may provide greater flexibility to non-listed issuers in preparing the disclosures they already must make regarding audit committee member independence. See section II.G.3.

<sup>39</sup> See, e.g., the Letter of Plains All American Pipeline, L.P.

<sup>40</sup> See note 18 above.