

auditor and, under section 32(a) of the Investment Company Act, the independent directors will be required to ratify the selection.

### C. Procedures for Handling Complaints

The audit committee must place some reliance on management for information about the company's financial reporting process. Since the audit committee is dependent to a degree on the information provided to it by management and internal and outside auditors, it is imperative for the committee to cultivate open and effective channels of information. Management may not have the appropriate incentives to self-report all questionable practices. A company employee or other individual may be reticent to report concerns regarding questionable accounting or other matters for fear of management reprisal.<sup>107</sup> The establishment of formal procedures for receiving and handling complaints should serve to facilitate disclosures, encourage proper individual conduct and alert the audit committee to potential problems before they have serious consequences.

Accordingly, under the listing standards called for by our final rules, each audit committee must establish procedures for:<sup>108</sup>

- 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 proposed, we are not mandating specific procedures that the audit committee must establish. Commenters were split over whether specific procedures should be mandated. The minority, representing primarily consultants and other third-party providers of such services, as well as several commenters representing investors, believed the Commission should mandate specific procedures, and many advocated a national "one-size-fits-all" approach.<sup>109</sup> A substantial number of commenters, however, supported the Commission's approach

of not mandating specific procedures, instead preferring to leave flexibility to the audit committee to develop appropriate procedures in light of a company's individual circumstances, so long as the required parameters are met.<sup>110</sup>

Given the variety of listed issuers in the U.S. capital markets, we believe audit committees should be provided with flexibility to develop and utilize procedures appropriate for their circumstances. The procedures that will be most effective to meet the requirements for a very small listed issuer with few employees could be very different from the processes and systems that would need to be in place for large, multi-national corporations with thousands of employees in many different jurisdictions. We do not believe that in this instance a "one-size-fits-all" approach would be appropriate. As noted in the Proposing Release, we expect each audit committee to develop procedures that work best consistent with its company's individual circumstances to meet the requirements in the final rule. Similarly, we are not adopting the suggestion of a few commenters that, despite the statutory language, the requirement should be limited to only employees in the financial reporting area.<sup>111</sup>

While the scope of the requirements generally includes complaints received by a listed issuer regardless of source, Exchange Act section 10A(m)(4)(B) and the relevant portion of the rules referring to confidential, anonymous submission of concerns are directed to employees of the issuer. One commenter noted that investment companies rarely have direct employees.<sup>112</sup> The commenter suggested that, for investment companies, the confidential, anonymous submission requirements should extend to employees of entities engaged by an investment company to prepare or assist in preparing its financial statements. We encourage the SROs to consider the appropriate scope of the requirement with regard to investment companies, taking account of the fact that most services are rendered to an investment company by employees of third parties, such as the investment adviser, rather than by employees of the investment company.<sup>113</sup>

### D. Authority to Engage Advisors

To be effective, an audit committee must have the necessary resources and authority to fulfill its function. The audit committee likely is not equipped to self-advise on all accounting, financial reporting or legal matters. To perform its role effectively, therefore, an audit committee may need the authority to engage its own outside advisors, including experts in particular areas of accounting, as it determines necessary apart from counsel or advisors hired by management, especially when potential conflicts of interest with management may be apparent.

The advice of outside advisors may be necessary to identify potential conflicts of interest and assess the company's disclosure and other compliance obligations with an independent and critical eye. Often, outside advisors can draw on their experience and knowledge to identify best practices of other companies that might be appropriate for the issuer. The assistance of outside advisors also may be needed to independently investigate questions that may arise regarding financial reporting and compliance with the securities laws. Accordingly, as proposed, the final rule specifically requires an issuer's audit committee to have the authority to engage outside advisors, including counsel, as it determines necessary to carry out its duties.<sup>114</sup> Commenters supported this requirement as proposed.<sup>115</sup>

### E. Funding

An audit committee's effectiveness may be compromised if it is dependent on management's discretion to compensate the independent auditor or the advisors employed by the committee, especially when potential conflicts of interest with management may be apparent. Accordingly, as proposed, the final rule requires the issuer to provide for appropriate funding, as determined by the audit committee, in its capacity as a

prepares, or assists in preparing, materials for a registered investment company to be submitted to or filed with the Commission by or on behalf of the investment company is appearing and practicing before the Commission); Release No. 34-47262 (Jan. 27, 2003) (disclosure required of code of ethics applicable to the principal executive officer and financial officer of a registered management investment company, or persons performing similar functions, regardless of whether they are employees of the investment company or a third party).

<sup>114</sup> As proposed, the requirement does not preclude access to or advice from the company's internal counsel or regular outside counsel. It also does not require an audit committee to retain independent counsel.

<sup>115</sup> See, e.g., the Letters of AICPA; CSC; Deloitte; FEI; ICI; PwC.

<sup>107</sup> The Sarbanes-Oxley Act provides additional protections for employees who provide evidence of fraud. See, for example, section 806 of the Sarbanes-Oxley Act.

<sup>108</sup> Exchange Act rule 10A-3 is not intended to preempt or supersede any other federal or state requirements relating to receipt and retention of records.

<sup>109</sup> See, e.g., the Letters of AuditConcerns, Inc.; CalPERS; Michael Chenkin; Confidential Communications Services, LLC; David Gold; The HR Hotline, Inc.; SWIB; Teamsters.

<sup>110</sup> See, e.g., the Letters of ABA; AICPA; American Bankers Association; Cleary; CSC; Deloitte; Edison Electric Institute; E&Y; FEI; ICI; Nasdaq; The Network, Inc.; NYCBA; NYSBA; PSEG; PwC; Ralph S. Saul; State Street Corporation.

<sup>111</sup> See, e.g., the Letter of S&C.

<sup>112</sup> See the Letter of PwC.

<sup>113</sup> Compare Release No. 33-8185 (Jan. 29, 2003) (attorney employed by an investment adviser who