

several changes to our current disclosure requirements regarding audit committees.

Under proposed Exchange Act Rule 10A-3,³⁵ SROs would be prohibited from listing any security of an issuer that is not in compliance with the following standards, as discussed in more detail below:

- 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 firm³⁶ engaged for the purpose of preparing or issuing an audit report or related work 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 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.

The standards articulated in Section 10A(m) of the Exchange Act will provide a framework in which audit committees can be more effective in protecting shareholder interests and in addressing the risk that management self-interest may diverge from shareholder interest. The audit committee is more likely to be effective in performing its oversight role when it has adequate resources and is empowered to accomplish its responsibilities independently of management, especially when potential

conflicts of interests with management may be apparent. Independent audit committee members also are more likely to be objective when evaluating financial disclosure and internal controls. There must also be frank, open and clear channels of communication so that information can reach the audit committee.

II. Proposed Changes

Under Section 3(a)(58) of the Exchange Act,³⁷ 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 would constitute the audit committee. If the entire board constituted the audit committee, our proposals for the new SRO rules, including the independence requirements, would apply to the issuer's board as a whole.

In addition, because proposed Exchange Act Rule 10A-3 would impose requirements that only would apply to issuers listed on a national securities exchange or listed in an automated inter-dealer quotation system of a national securities association,³⁸ the requirements of proposed Exchange Act Rule 10A-3 only would apply to issuers that are so listed. None of the requirements of Section 10A(m) of the Exchange Act or proposed Exchange Act Rule 10A-3 apply to other reporting companies under Section 13(a)³⁹ or 15(d)⁴⁰ of the Exchange Act.

A. Audit Committee Member Independence

As early as 1940, the Commission encouraged the use of audit committees composed of independent directors.⁴¹ 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 this problem and to align corporate interests with those of shareholders. An independent audit committee also would likely be better equipped to satisfy several other new requirements mandated by the Sarbanes-Oxley Act and the Exchange Act, such as overseeing a sound system of internal controls, approving any non-audit services by the outside auditor and enhancing the independence of the audit function.

The proposed requirements would enhance audit committee independence by implementing the two basic criteria for determining independence enumerated in Section 10A(m) of the Exchange Act. First, audit committee members would be barred from accepting any consulting, advisory or other compensatory fee from the issuer or an affiliate of the issuer, other than in the member's capacity as a member of the board of directors and any board committee.⁴² This prohibition would preclude payments to a member as an officer or employee, as well as other compensatory payments. To prevent evasion of this requirement, disallowed payments to an audit committee member would include payments made either directly or indirectly. We believe that barring indirect as well as direct compensatory payments is necessary to implement the intended purposes of Section 10A(m) of the Exchange Act. For example, payments to spouses of members raise questions regarding independence comparable to those raised by payments to members themselves. In addition, we believe that payments for services to law firms, accounting firms, consulting firms, investment banks or similar entities in which audit committee members are partners or hold similar positions are the kinds of compensatory payments that were intended to be precluded by Exchange Act Section 10A(m). We therefore propose that indirect

³⁵ Exchange Act Rule 10A-2 (17 CFR 240.10A-2) was proposed in Release No. 33-8154 (Dec. 2, 2002).

³⁶ The term "registered public accounting firm" is defined in Section 2(a)(12) of the Sarbanes-Oxley Act. See 15 U.S.C. 78c(b)(59). Until the Public Company Accounting Oversight Board that is contemplated under the Sarbanes-Oxley Act has established the registration of public accounting firms, the proposed requirement relating to the audit committee's oversight would refer to the public accounting firm employed by the issuer for the purposes indicated.

³⁷ 15 U.S.C. 78c(a)(58).

³⁸ In this release, we refer to issuers that are listed on one or more of these markets as "listed issuers."

³⁹ 15 U.S.C. 78m(a).

⁴⁰ 15 U.S.C. 78o(d).

⁴¹ See note 17 above.

⁴² See Section 10A(m)(3)(B)(i) of the Exchange Act and proposed Exchange Act Rule 10A-3(b)(1)(ii)(A) and (iii)(A). If the committee member is also a shareholder of the issuer, payments made to all shareholders generally, such as dividends, would not be prohibited by this provision.