

acceptance of compensatory payments includes payments to spouses, minor children or stepchildren or children or stepchildren sharing a home with the member, as well as payments accepted by an entity in which an audit committee member is a partner, member or principal or occupies a similar position and which provides accounting, consulting, legal, investment banking, financial or other advisory services or any similar services to the issuer.⁴³

In seeking to ensure appropriate levels of independence, we recognize that some SROs currently restrict additional business or personal relationships,⁴⁴ and that some SROs are seeking to add to these requirements, in particular in the additional listing standards that are currently under consideration.⁴⁵ We support the goals the SROs are trying to achieve through these ongoing efforts, and we are committed to working with the SROs to ensure the success of these proposals. We believe that our mandate under Section 10A(m) of the Exchange Act, where independence is evaluated by reference to payments of compensatory fees, is best fulfilled by our current proposal. Our proposal would not, for example, preclude independence on the basis of ordinary course commercial business relationships between an issuer and an entity with which a director had a relationship. Our proposal also would not extend to the broad categories of family members that may be reached by SRO listing standards. Instead, our proposals build and rely on the SROs standards of independence that cover additional relationships not specified in Exchange Act Section 10A(m). Our proposal would allow the SROs to adopt further requirements of these sorts, but they would do so within the more flexible environment of listing standards. We encourage SROs that do not currently have separate independence requirements to adopt appropriate requirements in connection with their implementation of the standards in Exchange Act Section 10A(m).

As the second basic criterion for determining independence, a member of the audit committee of an issuer that is not an investment company may not be an affiliated person of the issuer or any subsidiary of the issuer apart from his or her capacity as a member of the board and any board committee. We would clarify that a director, executive officer, partner, member, principal or designee

of an affiliate would be deemed to be an affiliate. For purposes of the proposed rule, we propose to define the terms "affiliate" and "affiliated person" consistent with our other definitions of these terms under the securities laws, such as in Exchange Act Rule 12b-2⁴⁶ and Securities Act Rule 144,⁴⁷ with an additional safe harbor.⁴⁸ We propose to define "affiliate" of, or a person "affiliated" with, a specified person, to mean "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified."⁴⁹ We propose to define the term "control" consistent with our other definitions of this term under the Exchange Act⁵⁰ 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."⁵¹

Similarly, a member of the audit committee of an issuer that is an investment company could not be an "interested person" of the investment company as defined in Section 2(a)(19)⁵² of the Investment Company Act.⁵³ We have substituted the Section 2(a)(19) test for the affiliation test applied to operating companies because the Section 2(a)(19) test is tailored to capture the broad range of affiliations with investment advisers, principal underwriters, and others that are relevant to "independence" in the case of investment companies.

Our proposed definition of "affiliated person" for non-investment companies, like our existing definitions of this term for these issuers, would require a factual determination based on a consideration of all relevant facts and circumstances. However, because we recognize that it can be difficult to determine whether someone controls an issuer, we are proposing to create a safe harbor from this aspect of the proposed definition of

"affiliated person."⁵⁴ Under the proposed safe harbor, a person who is not an executive officer, director or 10% shareholder of the issuer would be deemed not to control the issuer. This test is similar to the test used for determining insider status under Section 16 of the Exchange Act.⁵⁵

This safe harbor should cover most non-affiliates without including people who control an issuer. Moreover, our proposal would create only a safe harbor position. Therefore, an audit committee member that would not be eligible to rely on the safe harbor would not be deemed an affiliated person by virtue of those facts. Those who would be ineligible to rely on the safe harbor, but believe that they do not control an issuer, still could rely on a facts and circumstances analysis.

Under Exchange Act Section 10A(m)(3)(C), we have the authority to exempt from the independence requirements particular relationships with respect to audit committee members, if appropriate in light of the circumstances. Companies coming to market for the first time may face particular difficulty in recruiting members that meet the proposed independence requirements. Before a company's initial public offering, the board of directors often will consist primarily, if not exclusively, of representatives of venture capital investors and insiders. Such representation is entirely consistent with the desire of these parties to have representation in their private venture. The difficulty of recruiting independent directors before an initial public offering, coupled with the uncertainty of whether the initial public offering will be completed, may discourage companies from accessing the public markets to grow their business and provide liquidity, as well as from achieving the other benefits of being a public company, if all of their audit committee members must be independent at the time of the initial public offering. Further, the audit committee of some new public companies may function more

⁴⁶ 17 CFR 240.12b-2.

⁴⁷ 17 CFR 230.144.

⁴⁸ Exchange Act Section 3(a)(19), in defining several terms in relation to investment companies, includes a definition of "affiliated person" by reference to the Investment Company Act. Because that definition is tailored to investment companies, our proposed definition would use a definition for non-investment companies consistent with our other definitions of "affiliate" for non-investment companies.

⁴⁹ See proposed Exchange Act Rule 10A-3(e)(1).

⁵⁰ See, e.g., Exchange Act Rule 12b-2.

⁵¹ See proposed Exchange Act Rule 10A-3(e)(3).

⁵² 15 U.S.C. 80a-2(a)(19).

⁵³ See proposed Exchange Act Rule 10A-3(b)(1)(iii)(B). The "interested person" test would apply to business development companies, as well as registered investment companies. See note 95.

⁵⁴ See proposed Exchange Act Rule 10A-3(e)(1). Note that this safe harbor does not address the question of whether a person "is controlled by, or is under common control with" the issuer. We proposed a similar safe harbor from the definition of "affiliate" for Securities Act Rule 144 in 1997. See Release No. 33-7391 (Feb. 20, 1997) [62 FR 9246].

⁵⁵ 17 U.S.C. 78p. However, unlike our rules under Section 16, for purposes of determining who is an executive officer and calculating beneficial ownership, we propose to refer to Exchange Act Rule 3b-7 [17 CFR 240.3b-7] for the definition of "executive officer" and Exchange Act Rule 13d-3(d)(1) [17 CFR 240.13d-3(d)(1)] for calculating beneficial ownership.

⁴³ See proposed Exchange Act Rule 10A-3(e)(6).

⁴⁴ See note 23 above.

⁴⁵ See note 26 above.