

more than one audit committee member be exempted from the requirements? Should a specific percentage of audit committee members be exempted? Should the exemption be conditioned on there being at least a majority of independent directors on the audit committee? Should the exemption period be longer (e.g., 1 year) or shorter (e.g., 30 days)? We are not proposing to apply this exemption to investment companies. Should this exemption apply to investment companies?

- Is the proposed exemption for independent board members that sit on both a parent's and consolidated majority-owned subsidiary's board of directors appropriate? Is the requirement that the board member also is otherwise independent of the subsidiary necessary? Should the exemption be limited only to wholly owned subsidiaries or other specified level of ownership? Should the exemption be denied if the subsidiary maintains a listing for its own securities? Is there any need for a similar exemption from the "interested person" test for investment companies?

- Should there be an exception to the independence requirements based upon exceptional and limited circumstances, if the board determines that membership on the committee by the individual is required by the best interests of the corporation and its shareholders? If so, should the board be required to disclose the nature of the relationship and the reasons for that determination? Should there be a time limit for these appointments?

- Should companies be allowed to request exemptive relief on a case-by-case basis? If so, what procedures should be used for submitting and evaluating applications for exemptive relief? What factors should the Commission consider in considering such requests? How would such a case-by-case process be consistent with the policy and purposes of Section 10A(m)? How would such a process be coordinated between the Commission and the SROs? Should companies be required to disclose publicly any exemption they receive? Should SROs be permitted to grant exemptions within defined parameters? What should those parameters be?

- Are any modifications required to the consulting, advisory or other compensatory fee prohibition for investment companies? Is it appropriate to use the definition of "interested person" as set forth in Section 2(a)(19) of the Investment Company Act to test the independence of members of investment company audit committees, as proposed? If not, should the rule

apply the affiliation test, which we propose to apply to operating companies, or a different test?

B. Responsibilities Relating to Registered Public Accounting Firms

One of the audit committee's primary functions is to enhance the independence of the audit function, thereby furthering the objectivity of financial reporting. The Commission has long recognized the importance of an auditor's independence in the audit process.⁶¹ The auditing process may be compromised when a company's outside auditors view their main responsibility as serving the company's management rather than its full board of directors or its audit committee. This may occur if the auditor views management as its employer with hiring, firing and compensatory powers. Under these conditions, the auditor may not have the appropriate incentive to raise concerns and conduct an objective review. Further, if the auditor does not appear independent to the public, then investor confidence is undermined and one purpose of the audit is frustrated. One way to help ensure that the auditor is truly independent, then, is for the auditor to be hired, evaluated and, if necessary, terminated by the audit committee. This would help to align the auditor's interests with those of shareholders.

Accordingly, under the proposed rule, an audit committee would have to be directly responsible for the appointment, compensation, retention and oversight of the work of the independent auditor engaged (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work or performing other audit, review or attest services for the issuer,⁶² and the independent auditor would have to report directly to the audit committee. We propose to clarify that these oversight responsibilities include the authority to retain the outside auditor, which would include the power

not to retain (or to terminate) the outside auditor. In addition, in connection with these oversight responsibilities, the audit committee would need to have ultimate authority to approve all audit engagement fees and terms, as well as all significant non-audit engagements of the independent auditor. In this regard, the proposed requirement would reinforce the new requirement in section 10A(i) of the Exchange Act, as added by section 202 of the Sarbanes-Oxley Act, that auditing and non-auditing services be pre-approved by the audit committee. The proposed requirement, like the other proposed requirements, also would promote compliance with an issuer's internal control requirements.

The proposed requirement does not conflict with, and would not be affected by, any requirement under a company's governing law or documents or other home country requirements that requires shareholders to elect, approve or ratify the selection of the issuer's auditor. The proposed requirement instead relates to the assignment of responsibility to oversee the auditor's work as between the audit committee and management. We propose to add an instruction to the new rule to reflect this intention. In such an instance, however, if the issuer provides a recommendation or nomination of an auditor to its shareholders, the audit committee of the issuer would need to be responsible for making the recommendation or nomination.⁶³

In addition, we are proposing to exempt investment companies from the requirement that the audit committee be responsible for the selection of the independent auditor. Section 32(a) of the Investment Company Act,⁶⁴ which requires that independent auditors of registered investment companies be selected by majority vote of the disinterested directors, already addresses the concerns behind this requirement. Investment companies

⁶³ Similarly, the proposed requirement does not conflict with any requirement in a company's home jurisdiction that prohibits the full board of directors from delegating the responsibility to select the company's auditor. In that case, the audit committee would need to be granted advisory and other powers with respect to such matters to the extent permitted by law, including submitting nominations to the full board.

⁶⁴ 15 U.S.C. 80a–31(a). The exemption would apply to business development companies because they are subject to the requirements of Section 32(a) of the Investment Company Act pursuant to Section 59 of the Investment Company Act [15 U.S.C. 80a–58]. Business development companies are a category of closed-end investment company that are not registered under the Investment Company Act, but are subject to certain provisions of that Act. See Sections 2(a)(48) and 54–65 of the Investment Company Act [15 U.S.C. 80a–2(a)(48) and 80a–53–64].

⁶¹ The federal securities laws recognize the importance of independent auditors. See, e.g., Items 25 and 26 of Schedule A of the Securities Act and Sections 12(b)(1)(j) and 13(a)(2) of the Exchange Act [15 U.S.C. 78j(b)(1)(j) and 78m(a)(2)]. See also Title II of the Sarbanes-Oxley Act.

⁶² For a further discussion of the scope of audit, review and attest services, which are broader than those services required to perform an audit pursuant to generally accepted auditing standards, see Release No. 33–8154 (Dec. 2, 2002). For example, Section 10A(i)(1)(A) of the Exchange Act [15 U.S.C. 78j–1(i)(1)(A)] identifies services related to the issuance of comfort letters and services related to statutory audits required for insurance companies for purposes of state law as audit services.