

of the Sarbanes-Oxley Act and new Section 10A(m)(1) of the Exchange Act. The proposals are intended to enhance investor confidence in the fairness and integrity of the securities markets by increasing the competence and independence, and hence effectiveness, of listed company audit committees. In addition, our proposals would make several changes to our current disclosure requirements regarding audit committees to increase the transparency of these committees. We believe that these proposals will help to improve the quality and accountability of financial disclosure and oversight of the process by qualified and independent audit committees.

### B. Legal Basis

We are proposing the new rule and amendments under the authority set forth in Sections 2,<sup>152</sup> 6,<sup>153</sup> 7,<sup>154</sup> 8,<sup>155</sup> 10,<sup>156</sup> 17<sup>157</sup> and 19<sup>158</sup> of the Securities Act, Sections 3(b), 10A, 12, 13, 14, 15, 23 and 36<sup>159</sup> of the Exchange Act, Sections 8,<sup>160</sup> 20,<sup>161</sup> 24(a),<sup>162</sup> 30<sup>163</sup> and 38<sup>164</sup> of the Investment Company Act of 1940 and Sections 3 and 301 of the Sarbanes-Oxley Act.

### C. Small Entities Subject to the Proposed Amendments

The proposals will directly affect the national securities exchanges that trade listed securities, none of which is a small entity as defined by Commission rules. Exchange Act Rule 0-10(e)<sup>165</sup> states that the term "small business," when referring to an exchange, means any exchange that has been exempted from the reporting requirements of Exchange Act Rule 11Aa3-1.<sup>166</sup> The proposals also will directly affect national securities associations. No national securities association is a small entity, as defined by 13 CFR 121.201.

The proposals may have an indirect effect on some small entities. We also have defined the term "small business" in Exchange Act Rule 0-10(a) to be an issuer, other than an investment company, that, on the last day of its most recent fiscal year, had total assets

of \$5 million or less and when used with reference to an investment company, an investment company together with other investment companies in the same group of related investment companies with net assets of \$50 million or less as of the end of its most recent fiscal year.<sup>167</sup> Under these limits, depending on other restrictions imposed by the various SROs, such as quantitative listing standards, a small entity may be listed on a national securities exchange or a national securities association. We estimate that 7,250 issuers are listed on a national securities exchange or traded on Nasdaq, and we estimate that 6,640 of these issuers are not investment companies.<sup>168</sup> We estimate that less than 225, or approximately 3%, of the issuers that are not investment companies,<sup>169</sup> and less than 25, or approximately 4% of the issuers that are investment companies,<sup>170</sup> are "small entities" for purposes of the Regulatory Flexibility Act that possibly could be restricted by the proposals.

We request comment on the number of small entities that would be impacted by our proposals, including any available empirical data.

### D. Reporting, Recordkeeping, and Other Compliance Requirements

Under the proposals, national securities exchanges and national securities associations are directed to prohibit the listing of any security of an issuer, both large and small, that is not in compliance with certain enumerated standards regarding the issuer's audit committee. These standards relate to: the independence of audit committee members; the audit committee's responsibility to select and oversee the issuer's independent accountant; procedures for handling complaints regarding the issuer's accounting practices; the authority of the audit committee to engage advisors; and funding for the independent auditor and any outside advisors engaged by the audit committee.

Small entities would need to comply with these standards if they wished to have their securities listed on a national securities exchange or a national securities association. The rules would not require an entity to maintain an audit committee. However, the Exchange Act now provides that in the absence of an audit committee the entire board of directors will be considered to

be the audit committee. There are reasons to believe that many small entities currently have separately-designated audit committees.<sup>171</sup> However, not all of the audit committees of these small entities may comply with the requirements of the proposed rule. A small entity whose board or audit committee did not comply with the proposed rules would need to spend additional time and incur additional costs in modifying their audit committees or board to comply with the standards. Small entities may face particular difficulties in recruiting directors that meet the independence requirements of the proposed rules.

There also may be ongoing costs in monitoring compliance with the standards or maintaining any additional procedures established by the standards, such as the procedures for handling complaints. To the extent the audit committee engages independent counsel or other advisors where it could not do so previously, there would be additional costs for the payment of compensation to these advisors. Due to the small size of these small entities, these additional costs may have a larger proportional impact on these entities than larger listed issuers.

In addition, the small entity may need to make additional disclosure about its audit committee in its annual report as well as its proxy or information statement if directors are being elected. This may require additional costs in order to collect, record and report the information to be disclosed under the proposed rules. Small entities subject to the proxy rules are already required to disclose most of the information affected by our proposals in proxy or information statements where directors are being elected. This information should be readily available to small entities. Further, the disclosure regarding any exemption from the listing standards should entail only a minimal additional statement.

We have little data to determine how many small entities do not already comply with the proposals or how much it would cost to comply. We recognize that because the proposals apply only to listed issuers, the quantitative listing standards applicable to listed securities, such as minimum revenue, market capitalization and shareholder equity requirements, will limit the size of issuers that will be affected by the requirements. We request comment on the ability of affected small entities to meet the proposals. How many small entities already comply with the

<sup>152</sup> 15 U.S.C. 77b.

<sup>153</sup> 15 U.S.C. 77f.

<sup>154</sup> 15 U.S.C. 77g.

<sup>155</sup> 15 U.S.C. 77h.

<sup>156</sup> 15 U.S.C. 77j.

<sup>157</sup> 15 U.S.C. 77q.

<sup>158</sup> 15 U.S.C. 77s.

<sup>159</sup> 17 U.S.C. 78mm.

<sup>160</sup> 15 U.S.C. 80a-8.

<sup>161</sup> 15 U.S.C. 80a-20.

<sup>162</sup> 15 U.S.C. 80a-24(a).

<sup>163</sup> 15 U.S.C. 80a-29.

<sup>164</sup> 15 U.S.C. 80a-37.

<sup>165</sup> 17 CFR 240.0-10(e).

<sup>166</sup> 17 CFR 240.11Aa3-1.

<sup>167</sup> See Exchange Act Rule 0-10(a).

<sup>168</sup> See note 119 above.

<sup>169</sup> We derived this estimate from the Standard & Poors Research Insight Compustat Database.

<sup>170</sup> We derived this estimate from information compiled by Commission staff.

<sup>171</sup> See, e.g., NACD, 2001-2002 Public Company Governance Survey (Nov. 2001).