

and that, as required by Congress, are audited by independent auditors. We believe the final rules strike a reasonable balance among commenters' differing views about the proposals while achieving our important public policy goals.⁹

As directed by the Sarbanes-Oxley Act, the rules focus on key aspects of auditor independence: the provision of certain non-audit services, the unique ability and responsibility of the audit committee to insulate the auditor from the pressures that may be exerted by management, the potential conflict of interest that can be created when a former member of the audit engagement team accepts a key management position with the audit client, and the need for effective communications between the auditor and audit committee. In addition, under the final rules, an accountant would not be independent from an audit client if any audit partner received compensation based directly on selling engagements to that client for services other than audit, review and attest services.

Title II of the Sarbanes-Oxley Act adds new subsections (g) through (l) to Section 10A of the Securities Exchange Act of 1934 as follows:

- Section 201 adds sub-section (g), which specifies that a number of non-audit services are prohibited. Many of these services were previously prohibited by the Commission's independence standards adopted in November 2000 (with some exceptions and qualifications).¹⁰ The rules we are adopting amend the Commission's existing rules on auditor independence and clarify the meaning and scope of the prohibited services under the Sarbanes-Oxley Act.

- Section 201 also adds sub-section (h), which requires that non-audit services that are not prohibited under the Sarbanes-Oxley Act and the Commission's rules be subject to pre-approval by the registrant's audit committee. These rules specify the requirements for obtaining such pre-approval from the registrant's audit committee.

- Section 202 adds sub-section (i), which requires an audit committee to

pre-approve allowable non-audit services and specifies certain exceptions to the requirement to obtain pre-approval. These rules specify the requirements of the registrant's audit committee for pre-approving non-audit services by the auditor of the registrant's financial statements.

- Section 203 adds sub-section (j), which establishes mandatory rotation of the lead partner and the concurring partner every five years. These rules expand the number of engagement personnel covered by the rotation requirement and clarify the "time out" period.

- Section 204 adds sub-section (k), which requires that the auditor report on a timely basis certain information to the audit committee. In particular, the Sarbanes-Oxley Act requires that the auditor report to the audit committee on a timely basis (a) all critical accounting policies used by the registrant, (b) alternative accounting treatments that have been discussed with management along with the potential ramifications of using those alternatives, and (c) other written communications provided by the auditor to management, including a schedule of unadjusted audit differences.¹¹ These rules strengthen the relationship between the audit committee and the auditor.

- Section 206 adds sub-section (l) addressing certain conflict of interest provisions. The Sarbanes-Oxley Act prohibits an accounting firm from performing audit services for a registrant if certain key members of management have recently been employed in an audit capacity by the audit firm. These rules clarify which members of management are covered by these conflict of interest rules.

In addition, under the final rules, an accountant would not be independent of an audit client if an audit partner received compensation based on selling engagements to that client for services other than audit, review and attest services.

As noted above, the rules establish and clarify the important roles and responsibilities of registrant audit committees as well as the registrant's independent accountant.¹²

We have adopted a separate rule under Exchange Act Section 10A (17 CFR 240.10A-2) to implement Section 3(b)(1) of the Sarbanes-Oxley Act and clarify that our rules implementing Title

II of Sarbanes-Oxley not only define conduct that impairs independence but also constitute separate violations under the Exchange Act. We have otherwise adopted rules (except for the proxy disclosure changes) as part of Regulation S-X, and placed them among the current auditor independence provisions.

II. Discussion of Rules

A. Conflicts of Interest Resulting From Employment Relationships

The Commission's previous rules deem an accounting firm to be not independent with respect to an audit client if a former partner, principal, shareholder, or professional employee of an accounting firm¹³ accepts employment with a client if he or she has a continuing financial interest in the accounting firm or is in a position to influence the firm's operations or financial policies. These rules renumber, but do not otherwise change, that existing requirement.

Consistent with Section 206 of the Sarbanes-Oxley Act, we are adding a restriction on employment with audit clients by former employees of the accounting firm. The Act specifies that an accounting firm cannot perform an audit for a registrant:

* * * [i]f a chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for the issuer, was employed by that registered independent public accounting firm and *participated in any capacity in the audit of that issuer during the 1-year period preceding the date of the initiation of the audit.*¹⁴ (emphasis added)

Thus, the Act requires a "cooling off" period of one year before a member of the audit engagement team can begin working for the registrant in certain key positions. Based on the provisions of the Act, we proposed that the employment of former audit engagement team¹⁵ members of an accounting firm in a financial reporting oversight role¹⁶ at an audit client would cause the accounting firm not to be independent with respect to that registrant if they were members of the audit engagement team within one year prior to the commencement of procedures for the current audit engagement. The rules that we proposed would have applied to employment relationships entered into between

⁹ In addition to soliciting comments in the Proposing Release, we held one roundtable (December 17, 2002). The public comments we received can be reviewed in our Public Reference Room at 450 Fifth Street, NW., Washington, DC 20549, in File No. S7-49-02. Public comments submitted by electronic mail are on our Web site, www.sec.gov.

¹⁰ The Commission adopted a set of rules governing auditor independence on November 21, 2000. See Release No. 33-7919 (Nov. 21, 2000); 65 FR 76008 (Dec. 5, 2000) (hereinafter "November 2000 release").

¹¹ SAS No. 89, "Audit Adjustments," (Dec. 1999) at AU § 380.

¹² The Commission's rules respond not only to the provisions of the Sarbanes-Oxley Act but also the rulemaking petitions filed by the AFL-CIO on December 11, 2001 and The Honorable H. Carl McCall on January 21, 2002.

¹³ Consistent with our existing rules, the terms accounting firm and accountant are used interchangeably in this release. The term "accountant" is defined in § 210.2-01(f)(1) below.

¹⁴ See, Section 206 of the Sarbanes-Oxley Act.

¹⁵ See, Rule 2-01(f)(7).

¹⁶ See, Rule 2-01(f)(3)(ii).