

not require companies to have audit committees, many companies may choose to establish such committees to facilitate the pre-approval requirements of the rules. Additional costs may be associated with forming such committees and, if necessary, recruiting and retaining directors to serve on those committees. One commenter noted that the costs to maintain audit committees may increase due to additional meetings required, increased compensation for members due to the increased time demands, and increased director's and officer's insurance premiums due to increased liability of audit committee members. While the rules may increase the number of meetings required and the time demands of audit committee members, we believe a properly functioning audit committee should enhance the quality and accountability of the financial reporting process and help increase investor confidence, which results in increased efficiency and competitiveness of the U.S. capital markets.

Investors' confidence in the independence of auditors and in the integrity of the financial information fuels our securities markets. These rules are designed to bolster investor confidence in the securities markets by strengthening auditor independence, improving the transparency of the role of corporate audit committees, and enhancing the reliability and credibility of financial statements of public companies. Accordingly, on the whole, we believe the final rules will promote capital formation and market efficiency.

VI. Final Regulatory Flexibility Act Analysis

This Final Regulatory Flexibility Act Analysis has been prepared in accordance with 5 U.S.C. 603. It relates to revisions to Regulation S-X and to Item 9 of Schedule 14A, and to Forms 10-K, 10-KSB, 20-F, 40-F and N-CSR. The rules strengthen the Commission's requirements regarding the independence of auditors, audit committee pre-approval of services provided by the independent accountant and related disclosures, and auditor communications with the audit committee.

A. Reasons for the Rule Amendments

The rules generally implement a congressional mandate. Some of the amendments, although not specifically required by the statute, are designed to implement the intent of the Sarbanes-Oxley Act. The rules are intended to provide greater assurance to investors that independent auditors are performing their public responsibilities.

The rules, in general:

- Revise the Commission's regulations related to the non-audit services that, if provided to an audit client, will impair an accounting firm's independence;
- Require that an issuer's audit committee pre-approve all audit and non-audit services provided to the issuer by the auditor of an issuer's financial statements;
- Prohibit certain partners on the audit engagement team from providing audit services to the issuer for more than five or seven consecutive years, depending on the partner's involvement in the audit, except that certain small accounting firms may be exempted from this requirement;
- Prohibit an accounting firm from auditing an issuer's financial statements if certain members of management of that issuer had been members of the accounting firm's audit engagement team within the one-year period preceding the commencement of audit procedures;
- Require that the auditor of an issuer's financial statements report certain matters to the issuer's audit committee, including "critical" accounting policies used by the issuer; and
- Require disclosures to investors of information related to audit and non-audit services provided by, and fees paid to, the auditor of the issuer's financial statements.
- Provide that an accountant will not be independent from 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, except that the rules exempt certain small accounting firms from this requirement.

B. Objectives

Our objectives in implementing Title II of the Sarbanes-Oxley Act are to increase investor confidence in the independence of auditors, in the audit process, and in the reliability of reported financial information. The rules accomplish these objectives by having: (1) Clearer auditor independence regulations that will assure investors that auditors are placing the interests of investors over financial or personal incentives, (2) rules mandating that auditors communicate certain matters to audit committees which should enhance the opportunities for meaningful audit committee oversight of the financial reporting process, and (3) enhanced disclosure of the non-audit services provided by, and fees paid to, the accounting firm that audits the

company's financial statements and disclosure of the audit committee policies for pre-approving the provision of non-audit services by the accounting firm that audits the company's financial statements. We believe that these factors will improve the efficiency of the markets and result in a lower cost of capital.

C. Significant Issues Raised by Public Comment

Several commenters indicated that the partner rotation and compensation rules might be particularly difficult for small accounting firms to implement. They stated that if the rotation requirements were applied to small accounting firms, many of these firms would be unable to provide audit services to their public clients and would be forced to give them up. They further suggested a number of accommodations for small issuers and small firms including: exempting the firms based on criteria such as number of partners, number of SEC clients, firm revenue, or number of professional personnel; and exempting accountants of small issuers as measured by revenue, assets, market capitalization or profitability.

The U.S. Small Business Administration's Office of Advocacy ("Advocacy") was among the commenters recommending that the Commission include a small firm exemption from the audit partner rotation requirements. Advocacy stated that the exemption would ensure that small issuers would not incur marked increases in audit costs. It also expressed the concern that small issuers retaining the services of accounting firms that previously were exempt from audit rotation requirements may no longer be able to retain such firms if the firms lose the exemption and decline to offer audit services as a result. Advocacy asserted that if the small issuers then have to engage the services of larger firms, the costs incurred by these companies would increase due to the need of the new firms to familiarize themselves with the issuers' industries and business practices. Advocacy further stated that an effect of the elimination of small firms from the competitive market for audit services and market consolidation would be an increase in audit prices because of larger firms' gain in power over pricing.

The final amendments provide an alternative application for small accounting firms to address commenters' concerns. Under the final rules, accounting firms with fewer than five audit clients that are issuers and fewer than ten partners may qualify for the exemption from partner rotation, but