

directors is better situated to assess objectively the quality of the issuer's financial disclosure and the adequacy of internal controls than a committee that includes members who are affiliated with management. By increasing the independence and competence of audit committees, the amendments are designed to further greater accountability and to improve the quality of financial disclosure and oversight of the financial reporting process. The Commission believes that vigilant and informed oversight by a strong, effective and independent audit committee should help to counterbalance pressures to misreport results and will impose increased discipline on the process of preparing financial information. Improved oversight may help detect fraudulent financial reporting earlier and perhaps thus deter it or minimize its effects. All of these benefits should promote increased market efficiency due to improved information and investor confidence in the reliability of a company's financial disclosure and system of internal controls.

The Commission notes that the NYSE and Nasdaq proposals enhance audit committee independence by implementing the criteria for independence enumerated in Rule 10A-3. In addition, the NYSE and Nasdaq amendments regarding the definition of "independent director" restrict additional relationships not specified in Rule 10A-3 and contain look-back periods to create a comprehensive overall standard for audit committee member independence. As the Commission noted in its release adopting Rule 10A-3,³⁷⁷ it expected that the definition of independence contained in Rule 10A-3 would build and rely on the enhanced independence definitions that SROs adopt through rulemaking conducted under Commission oversight to significantly improve existing standards of independence for audit committee members and thereby help assure strong, independent audit committees.

In addition, the Commission believes that requiring companies to specify the enhanced audit committee responsibilities in their formal written charters, and to delineate how the committee carries out those responsibilities, will help to assure that the audit committee, management, investors, and the company's auditors recognize the function of the audit committee and the relationship among the parties. Moreover, the NYSE and

Nasdaq proposals explicitly require the audit committee to have the duties and responsibilities specified in Rule 10A-3, including direct responsibility for the appointment, compensation, retention and oversight of the company's outside auditor; the ability to engage outside advisors; the ability to obtain funding for the audit committee and its outside advisors; and the responsibility to establish procedures for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters, including procedures for the confidential, anonymous submission of employee complaints.

The Commission notes that these heightened standards complement existing listing standards adopted by NYSE and Nasdaq as a result of the Blue Ribbon Committee's report and retained under the new proposals. The existing standards include the requirement that each issuer have an audit committee composed of at least three independent directors who are able to read and understand financial statements, thus helping to ensure that the committee as a whole is financially literate. Moreover, one member of the audit committee is required to have additional financial expertise or sophistication, thus further enhancing the effectiveness of the audit committee in carrying out its financial oversight responsibilities.

The Commission notes that the NYSE and Nasdaq amended their proposals regarding audit committees to respond to concerns raised by commenters or to adopt commenters' suggestions. In addition, the NYSE and Nasdaq made a number of revisions to their proposals to conform their original proposals, which were submitted before Commission approval of Rule 10A-3, to the requirements in Rule 10A-3 as adopted by the Commission. Several of the commenters' concerns regarding the original proposals, such as those relating to the prohibition on "affiliate" status for audit committee members, were addressed in the Commission's adoption of Rule 10A-3 and the conforming amendments submitted by NYSE and Nasdaq. In addition, in this regard, Nasdaq removed a provision in its original proposal that would have permitted directors who own or control less than 20% of a company's stock to be audit committee members. The NYSE and Nasdaq also added various clarifications in their rules in response to comment. For example, both proposals state that a person who satisfies the Commission's definition of an audit committee financial expert is presumed to have requisite financial expertise. In addition, the NYSE and

Nasdaq made changes to their proposals to address the rules' application to investment companies.

The Commission believes that the NYSE and Nasdaq proposals regarding audit committees are appropriate and are consistent with section 10A(m)³⁷⁸ of the Exchange Act and Rule 10A-3 thereunder.³⁷⁹

Code of Conduct

Both the NYSE and Nasdaq proposed to require listed issuers to adopt and make publicly available a code of conduct with enforcement provisions applicable to all directors, officer, and employees, and to require any waivers of the code for directors or executive officers to be disclosed. A number of commenters supported these rule amendments, although a few commenters provided suggestions for improving the proposals. The Commission believes that requiring listed issuers to adopt a code of conduct should help to foster the ethical behavior of directors, officers, and employees because directors, officer and employees will know the standards of conduct expected of them in ethically fulfilling the responsibilities of their positions and will be made fully cognizant that their actions will be monitored. The Commission also believes that requiring the code of conduct and any waivers of the code for directors and executive officers to be disclosed will provide shareholders the opportunity to evaluate the quality of a company's code and the ability to scrutinize significant waivers of its provisions.

Applicability to Registered Management Investment Companies, Certain Other Entities, and Foreign Private Issuers

Both the NYSE and Nasdaq proposed to exempt management investment companies that are registered under the Investment Company Act from the new requirements relating to board independence and the role of independent directors in nomination and compensation decisions. The Commission believes that this exemption is reasonable, because the Investment Company Act already assigns important duties of investment company governance, such as approval of the investment advisory contract, to independent directors. Further, many of the Commission's exemptive rules under the Investment Company Act require investment companies relying on those rules to have a majority of independent directors, and require

³⁷⁷ Securities Act Release No. 8220 (April 9, 2003), 68 FR 18788 (April 16, 2003).

³⁷⁸ 15 U.S.C. 78j-1(m).

³⁷⁹ 17 CFR 240.10A-3.