SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 228, 229, 240, 249 and 274

[Release Nos. 33–8220; 34–47654; IC–26001; File No. S7–02–03]

RIN 3235–AI75

Standards Relating to Listed Company Audit Committees

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: As directed by the Sarbanes-Oxley Act of 2002, we are adopting a new rule to direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the audit committee requirements mandated by the Sarbanes-Oxley Act of 2002. These requirements 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. The rule implements the requirements of section 10A(m)(1) of the Securities Exchange Act of 1934, as added by section 301 of the Sarbanes-Oxley Act of 2002. Under the rule, listed issuers must be in compliance with the new listing rules by the earlier of their first annual shareholders meeting after January 15, 2004, or October 31, 2004. Foreign private issuers and small business issuers will have additional time to comply. In addition, we are adopting amendments to make several changes to our current disclosure requirements regarding audit committees.

DATES: *Effective Date:* April 25, 2003.

Compliance Dates: Each national securities exchange and national securities association must provide to the Commission, no later than July 15, 2003, proposed rules or rule amendments that comply with the requirements of Exchange Act Rule 10A–3. Further, each national securities exchange and national securities association must have final rules or rule amendments that comply with Rule 10A–3 approved by the Commission no later than December 1, 2003. Listed issuers, other than foreign private issuers and small business issuers, must be in compliance with the new listing rules by the earlier of (1) their first annual shareholders meeting after January 15, 2004, or (2) October 31, 2004. Foreign private issuers and small business issuers that are listed must be in compliance with the new listing rules by July 31, 2005. See section II.F.1 for more information regarding implementation and compliance dates. Issuers must comply with the disclosure changes in Regulation S–B, Regulation S–K, Schedule 14A, Form 20–F, Form 40–F and Form N–CSR beginning with reports covering periods ending on or after (or proxy or information statements for actions occurring on or after) the compliance date for the listing standards applicable to the particular issuer. Until such date, issuers should continue to comply with existing Items 7(d)(3)(iv) and 22(b)(14) in their proxy and information statements, if applicable.

FOR FURTHER INFORMATION CONTACT: Jeffrey J. Minton, Special Counsel, or Elizabeth M. Murphy, Chief, Office of Rulemaking, Division of Corporation Finance, at (202) 942–2910, or, with respect to investment companies, Christopher P. Kaiser, Senior Counsel, Office of Disclosure Regulation, Division of Investment Management, at (202) 942–0724, U.S. Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549.

SUPPLEMENTARY INFORMATION: We are adopting new Rule 10A–3 [1] under the Securities Exchange Act of 1934 (the ''Exchange Act''),[2] amendments to Forms 20–F [3] and 40–F [4] and Items 7 and 22 of Schedule 14A [5] under the Exchange Act, amendments to Item 401 [6] of Regulation S–B [7] and Item 401 [8] of Regulation S–K [9] under the Securities Act of 1933 (the ''Securities Act'') [10] and amendments to Form N–CSR [11] under the Exchange Act and the Investment Company Act of 1940 (the ''Investment Company Act'').[12]

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I. Background and Overview of the New Rule and Amendments

In this release, we implement section 10A(m)(1) of the Exchange Act,[13] as added by section 301 of the Sarbanes-Oxley Act of 2002 (the ''Sarbanes-Oxley Act''),[14] which requires us to direct, by rule, the national securities exchanges [15]

[1] 17 CFR 240.10A–3.

[2] 15 U.S.C. 78a *et seq.*

[3] 17 CFR 249.220f.

[4] 17 CFR 249.240f.

[5] 17 CFR 240.14a–101.

[6] 17 CFR 228.401.

[7] 17 CFR 228.10 *et seq.*

[8] 17 CFR 229.401.

[9] 17 CFR 229.10 *et seq.*

[10] 15 U.S.C. 77a *et seq.*

[11] 17 CFR 249.331 and 17 CFR 274.128.

[12] 15 U.S.C. 80a–1 *et seq.*

[13] 15 U.S.C. 78j–1(m)(1).

[14] Pub. L. 107–204, 116 Stat. 745 (2002).

[15] A ''national securities exchange'' is an exchange registered as such under section 6 of the Exchange Act [15 U.S.C. 78f]. There are currently nine national securities exchanges registered under section 6(a) of the Exchange Act: American Stock Exchange (AMEX), Boston Stock Exchange, Chicago Board Options Exchange (CBOE), Chicago Stock Exchange, Cincinnati Stock Exchange, International Securities Exchange, New York Stock Exchange

and national securities associations [16] (or ''SROs'') to prohibit the listing of any security of an issuer that is not in compliance with several enumerated standards regarding issuer audit committees. We received over 185 comments in response to our release proposing to implement the directive in section 10A(m) of the Exchange Act.[17] The final rule and form amendments we adopt today have been revised, as discussed in this release, to incorporate a number of changes recommended by commenters.

Accurate and reliable financial reporting lies at the heart of our disclosure-based system for securities regulation, and is critical to the integrity of the U.S. securities markets. Investors need accurate and reliable financial information to make informed investment decisions. Investor confidence in the reliability of corporate financial information is fundamental to the liquidity and vibrancy of our markets.

Effective oversight of the financial reporting process is fundamental to preserving the integrity of our markets. The board of directors, elected by and accountable to shareholders, is the focal point of the corporate governance system. The audit committee, composed of members of the board of directors, plays a critical role in providing oversight over and serving as a check and balance on a company's financial reporting system. The audit committee provides independent review and oversight of a company's financial reporting processes, internal controls and independent auditors. It provides a forum separate from management in which auditors and other interested parties can candidly discuss concerns. By effectively carrying out its functions and responsibilities, the audit committee helps to ensure that management properly develops and adheres to a sound system of internal controls, that procedures are in place to objectively assess management's practices and internal controls, and that the outside auditors, through their own review, objectively assess the company's financial reporting practices.

Since the early 1940s, the Commission, along with the auditing and corporate communities, has had a continuing interest in promoting effective and independent audit committees.[18] It was largely with the Commission's encouragement, for instance, that the SROs first adopted audit committee requirements in the 1970s.[19] Over the years, others have expressed support for strong, independent audit committees,[20] including the National Commission on Fraudulent Financial Reporting, also known as the Treadway Commission,[21] and the General Accounting Office.[22]

In 1998, the NYSE and the NASD sponsored a committee to study the effectiveness of audit committees. This committee became known as the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (the ''Blue Ribbon Committee''). In its 1999 report, the Blue Ribbon Committee recognized the importance of audit committees and issued ten recommendations to improve their effectiveness.[23] In response to these recommendations, the NYSE and the NASD, among others, revised their listing standards relating to audit committees,[24] and we adopted new rules requiring disclosure relating to the functioning, governance and independence of corporate audit committees.[25] Beginning last year, at the Commission's request,[26] the NYSE and the NASD again reviewed their corporate governance standards, including their audit committee rules, in light of several high-profile corporate failures, and have proposed changes to their rules to provide more demanding standards for audit committees.[27]

Recent events involving alleged misdeeds by corporate executives and independent auditors have damaged investor confidence in the financial markets.[28] They have highlighted the need for strong, competent and vigilant audit committees with real authority.[29] In response to the threat to the U.S. financial markets posed by these events, Congress passed, and the President signed into law on July 30, 2002, the Sarbanes-Oxley Act. The Sarbanes-Oxley Act mandates sweeping corporate disclosure and financial reporting

(NYSE), Philadelphia Stock Exchange and Pacific Exchange. In addition, an exchange that lists or trades security futures products (as defined in Exchange Act section 3(a)(56) [15 U.S.C. 78c(56)]) may register as a national securities exchange under section 6(g) of the Exchange Act solely for the purpose of trading security futures products. Regarding security futures products, see section II.F.2.b.

[16] A ''national securities association'' is an association of brokers and dealers registered as such under section 15A of the Exchange Act [15 U.S.C. 78o–3]. The National Association of Securities Dealers (NASD) is the only national securities association registered with the Commission under section 15A(a) of the Exchange Act. The NASD partially owns and operates The Nasdaq Stock Market (Nasdaq). Nasdaq has filed an application with the Commission to register as a national securities exchange. In addition, section 15A(k) of the Exchange Act [15 U.S.C. 78o–3(k)] provides that a futures association registered under section 17 of the Commodity Exchange Act [7 U.S.C. 21] shall be registered as a national securities association for the limited purpose of regulating the activities of members who are registered as broker-dealers in security futures products pursuant to section 15(b)(11) of the Exchange Act [15 U.S.C. 78o(b)(11)]. Regarding security futures products, see section II.F.2.b.

[17] Release No. 33–8173 (Jan. 8, 2003) [68 FR 2638] (''Proposing Release''). The public comments we received, and a summary of the comments prepared by our staff (the ''Comment Summary''), can be viewed in our Public Reference Room at 450 Fifth Street, NW., Washington, DC 20549, in File No. S7–02–03. Public comments submitted by electronic mail and the Comment Summary also are available on our Web site, *http://www.sec.gov.*

[18] In 1940, the Commission investigated the auditing practices of McKesson & Robbins, Inc., and the Commission's ensuing report prompted action on auditing procedures by the auditing community. *In the Matter of McKesson & Robbins,* Accounting Series Release (ASR) No. 19, Exchange Act Release No. 2707 (Dec. 5, 1940).

[19] For example, in 1972, the Commission recommended that companies establish audit committees composed of outside directors. See ASR No. 123 (Mar. 23, 1972). In 1974 and 1978, the Commission adopted rules requiring disclosures about audit committees. See Release No. 34–11147 (Dec. 20, 1974) and Release No. 34–15384 (Dec. 6, 1978).

[20] *See, e.g.*, Preliminary Report of the American Bar Association Task Force on Corporate Responsibility (July 16, 2002). The report is available on the American Bar Association's Web site at *http://www.abanet.org/buslaw/.*

[21] The Treadway Commission was sponsored by the American Institute of Certified Public Accountants, the American Accounting Association, the Financial Executives Institute (now Financial Executives International), the Institute of Internal Auditors and the National Association of Accountants. Collectively, these groups were known as the Committee of Sponsoring Organizations, or COSO. The Treadway Commission's report, the Report of the National Commission on Fraudulent Financial Reporting (October 1987), is available at *http://www.coso.org.*

[22] GAO, ''CPA Audit Quality: Status of Actions Taken to Improve Auditing and Financial Reporting of Public Companies,'' at 5 (GAO/AFMD–89–38, March 1989).

[23] See Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (February 1999). The Blue Ribbon Committee Report is available at *http://www.nyse.com.*

[24] See, for example, Exchange Act Release No. 42231 (Dec. 14, 1999) [64 FR 71523] (Nasdaq rules) and Exchange Act Release No. 42233 (Dec. 14, 1999) (NYSE rules) [64 FR 71529]. See also Exchange Act Release No. 42232 (Dec. 14, 1999) [64 FR 71518] (American Stock Exchange rules) and Release No. 34–43941 (Feb. 7, 2001) [66 FR 10545] (Pacific Exchange rules).

[25] See Exchange Act Release No. 42266 (Dec. 22, 1999) [64 FR 73389].

[26] See Press Release No. 2002–23 (Feb. 13, 2002).

[27] See File Nos. SR–NASD–2002–141 and SR–NYSE–2002–33 (pending before the Commission).

[28] See, for example, John Waggoner and Thomas A. Fogarty, ''Scandals Shred Investors'' Faith: Because of Enron, Andersen and Rising Gas Prices, the Public is More Wary Than Ever of Corporate America,'' USA Today, May 2, 2002; and Louis Aguilar, ''Scandals Jolting Faith of Investors,'' Denver Post, June 27, 2002.

[29] See, for example, John Good, ''After Enron, Beef Up Those Audit Committees,'' The Commercial Appeal, Apr. 26, 2002; and ''FT Comment After Enron: Giving Meaning to the Codes of Best Practice: Corporate Governance: Companies Need Truly Independent Directors, Strong Audit Committees, an Outlet for Whistleblowers and Tight Controls on Share Options,'' The Financial Times, Feb. 19, 2002.

reform to improve the responsibility of public companies for their financial disclosures. This release is the most recent of several that we have issued to implement provisions of the Sarbanes-Oxley Act.[30]

Under new Exchange Act Rule 10A–3, SROs will be prohibited from listing any security of an issuer that is not in compliance with the following standards, as discussed in more detail in this release:

- Each member of the audit committee of the issuer must be independent according to specified criteria;
- The audit committee of each issuer must be directly responsible for the appointment, compensation, retention and oversight of the work of any registered public accounting firm [31] engaged for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the issuer, and each such registered public accounting firm must report directly to the audit committee;
- Each audit committee must 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 by employees of the issuer of concerns regarding questionable accounting or auditing matters;
- Each audit committee must have the authority to engage independent counsel and other advisors, as it determines necessary to carry out its duties; and
- Each issuer must provide appropriate funding for the audit committee.

With the exceptions specified below, listed issuers must be in compliance with the new listing rules by the earlier of (1) their first annual shareholders meeting after January 15, 2004, or (2) October 31, 2004. Foreign private issuers [32] and small business issuers [33] that are listed must be in compliance with the new listing rules by July 31, 2005.

In addition, the final rule amendments make several changes to our current disclosure requirements regarding audit committees.

II. Discussion

Under section 3(a)(58) of the Exchange Act,[34] as added by section 205 of the Sarbanes-Oxley Act, the term audit committee is defined as:

- A committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and
- If no such committee exists with respect to an issuer, the entire board of directors of the issuer.

Accordingly, an issuer either may have a separately designated audit committee composed of members of its board or, if it chooses to do so or if it fails to form a separate committee, the entire board of directors will constitute the audit committee. If the entire board constitutes the audit committee, the new SRO rules adopted under Exchange Act Rule 10A–3, including the independence requirements, will apply to the issuer's board as a whole.

In addition, because Exchange Act section 10A(m) imposes requirements that only apply to issuers listed on a national securities exchange or listed in an automated inter-dealer quotation system of a national securities association,[35] the requirements of Exchange Act Rule 10A–3 only apply to issuers that are so listed. None of the requirements of section 10A(m) of the Exchange Act or Exchange Act Rule 10A–3 apply to other reporting companies under section 13(a) [36] or 15(d) [37] of the Exchange Act.[38]

Some commenters requested clarification regarding application of the rule to listed issuers organized as limited partnerships that do not have their own board of directors but instead rely on a managing general partner.[39] We have added a clarification that in the case of a listed issuer that is a limited partnership or limited liability company where such entity does not have a board of directors or equivalent body, the term ''board of directors'' means the board of directors of the managing general partner, managing member or equivalent body.

A. Audit Committee Member Independence

1. Scope of the Requirement

As early as 1940, the Commission encouraged the use of audit committees composed of independent directors.[40] An audit committee comprised of independent 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 is affiliated with management. Management may face market pressures for short-term performance and corresponding pressures to satisfy market expectations. These pressures could be exacerbated by the use of compensation or other incentives focused on short-term stock appreciation, which can promote self-interest rather than the promotion of long-term shareholder interest. An independent audit committee with adequate resources helps to overcome

[30] For example, see Release No. 34–46421 (Aug. 27, 2002) [67 FR 56462] (Ownership reports and trading by officers, directors and principal security holders); Release No. 33–8124 (Aug. 28, 2002) [67 FR 57276] (Certification of disclosure in companies' quarterly and annual reports); Release No. 33–46685 (Oct. 18, 2002) [67 FR 65325] (Proposals regarding improper influence on conduct of audits); Release No. 33–8138 (Oct. 22, 2002) [67 FR 66208] (Proposals regarding internal control reports); Release No. 33–8170 (Dec. 20, 2002) [67 FR 79466] (Proposals regarding mandated electronic filing and Web site posting for Forms 3, 4 and 5); Release No. 33–8176 (Jan. 22, 2003) [68 FR 4820] (Conditions for use of non-GAAP financial information); Release No. 34–47225 (Jan. 22, 2003) [68 FR 4338] (Insider trades during pension plan blackout periods); Release No. 33–8177 (Jan. 23, 2003) [68 FR 5110] (Disclosure regarding audit committee financial experts and company codes of ethics); Release No. 33–8180 (Jan. 24, 2003) [68 FR 4862] (Retention of records relevant to audits and reviews); Release No. 34–47262 (Jan. 27, 2003) [68 FR 5348] (Adoption of Form N–CSR); Release No. 33–8182 (Jan. 28, 2003) [68 FR 5982] (Disclosure about off-balance sheet arrangements); Release No. 33–8183 (Jan. 28, 2003) [68 FR 6006] (Strengthening the Commission's requirements regarding auditor independence); Release Nos. 33–8185 (Jan. 29, 2003) [68 FR 6296] and 33–8186 (Jan. 29, 2003) [68 FR 6324] (Implementation of standards of professional conduct for attorneys); and Release No. 33–8212 (Mar. 21, 2003) [68 FR 15600] (Certification of disclosure in certain Exchange Act reports).

[31] The term ''registered public accounting firm'' is defined in section 2(a)(12) of the Sarbanes-Oxley Act. See 15 U.S.C. 78c(a)(59). We anticipate that the Public Company Accounting Oversight Board will have established the registration of public accounting firms by the time the implementing listing rules are operative.

[32] The term ''foreign private issuer'' is defined in Exchange Act Rule 3b–4(c) [17 CFR 240.3b–4(c)]. A foreign private issuer is a non-government foreign issuer, except for a company that (1) has more than 50% of its outstanding voting securities owned by U.S. investors and (2) has either a majority of its officers and directors residing in or being citizens of the U.S., a majority of its assets located in the U.S., or its business principally administered in the U.S.

[33] The term ''small business issuer'' is defined in Exchange Act Rule 12b–2 [17 CFR 240.12b–2] as a U.S. or Canadian issuer with less than $25 million in revenues and public float that is not an investment company. Such issuers are eligible to use Form 10–KSB (17 CFR 249.310b) for their annual reports and Form 10-QSB (17 CFR 249.308b) for their quarterly reports.

[34] 15 U.S.C. 78c(a)(58).

[35] In this release, we refer to issuers that are listed on one or more of these markets as ''listed issuers.''

[36] 15 U.S.C. 78m(a).

[37] 15 U.S.C. 78o(d).

[38] Non-listed issuers should still refer to the disclosure updates adopted in this release, as those changes may provide greater flexibility to non-listed issuers in preparing the disclosures they already must make regarding audit committee member independence. See section II.G.3.

[39] *See, e.g.*, the Letter of Plains All American Pipeline, L.P.

[40] See note 18 above.

this problem and to align corporate interests with those of shareholders.

Our final rules enhance audit committee independence by implementing the two basic criteria for determining independence enumerated in section 10A(m) of the Exchange Act, which are discussed in more detail below. Commenters expressed general overall support for the Commission's approach to implementing section 10A(m) of the Exchange Act. Advocates of investors in particular endorsed the Commission's proposals, though not all believed that section 10A(m) and the Commission's proposals went far enough.[41] Several supported having the Commission mandate all independence requirements for listed issuers, not just those specified in Exchange Act section 10A(m), as compared to the proposed approach of building on additional SRO standards for independence. However, a substantial number of commenters did not support having the Commission replace the SROs' role in setting additional criteria, preferring to leave additional requirements to the SRO rulemaking process with appropriate Commission oversight.[42]

As noted in the Proposing Release, in seeking to ensure appropriate levels of independence, we recognize that SROs currently restrict additional business or personal relationships.[43] Further, several SROs are seeking significant improvements to tighten these requirements, in particular in the additional listing standards that are currently under consideration.[44] We fully support the goals the SROs are trying to achieve through these ongoing efforts, and we are firmly committed to working with the SROs to ensure the success of these proposals. Many of the additional relationships that commenters requested the Commission include in the final rule are already restricted by existing SRO rules, or would be restricted under the new SRO proposals.

We continue to believe that our specific mandate under section 10A(m) of the Exchange Act, where independence is evaluated by reference to payments of advisory and compensatory fees and affiliate status, is best fulfilled by the final rule. These requirements standing alone do not, for example, preclude independence on the basis of other commercial relationships not specified in the final rule, and they do not extend to the broad categories of family members that may be reached by SRO listing standards. Instead, as proposed, our requirements build and rely on SRO standards of independence that cover additional relationships not specified in Exchange Act section 10A(m). Our final rule allows SROs flexibility to adopt and administer additional requirements of these sorts through SRO rulemaking conducted under Commission oversight and approval. As mentioned in the Proposing Release, we encourage SROs to review and adopt rigorous independence requirements in connection with their implementation of the standards in Exchange Act rule 10A–3. We will review the rules submitted by the SROs to implement Exchange Act rule 10A–3 so that they contain appropriate overall standards for audit committee independence.

2. Advising, Consulting or Compensatory Fees

As for the two criteria for independence in Exchange Act rule 10A–3, the first is that audit committee members are barred from accepting any consulting, advisory or other compensatory fee from the issuer or any subsidiary thereof, other than in the member's capacity as a member of the board of directors and any board committee.[45] This prohibition will preclude payments to a member as an officer or employee, as well as other compensatory payments.[46]

To prevent evasion of the requirement, disallowed payments to an audit committee member includes payments made either directly or indirectly. The overwhelming majority of commenters supported our determination that barring indirect as well as direct compensatory payments is necessary to implement the intended purposes of Exchange Act section 10A(m).[47] For example, payments to spouses of members raise questions regarding independence comparable to those raised by payments to members themselves. In addition, we believe that payments for services to law firms, accounting firms, consulting firms, investment banks or financial advisory firms in which audit committee members are partners, members, executive officers or hold similar positions, as discussed in more detail below, are the kinds of compensatory payments that were intended to be precluded by Exchange Act section 10A(m). The final rules, therefore, mandate that indirect acceptance of compensatory payments includes payments to spouses, minor children or stepchildren or children or stepchildren sharing a home with the member. In addition, indirect acceptance includes payments accepted by an entity in which such member is a partner, member, officer such as a managing director occupying a comparable position or executive officer, or occupies a similar position (except limited partners, non-managing members and those occupying similar positions who, in each case, have no active role in providing services to the entity) and which provides accounting, consulting, legal, investment banking or financial advisory services to the issuer or any subsidiary.

Commenters generally supported the extent to which family members are included, although a few recommended an extension to additional members,[48] and a few others recommended narrowing the family members covered.[49] We continue to believe that an extension to all relatives is beyond the scope necessary to address the prohibitions in section 10A(m), and we are adopting the family member formulation as proposed. Also, we agree with the commenters who argued that given the limited number of immediate family members affected, an exception for family members that are non-executive employees is not necessary.[50]

Several commenters requested additional guidance regarding the types of prohibited services in the ''indirect''

[41] *See, e.g.*, the Letters of American Federation of Labor and Congress of Industrial Organizations *et al.* (''AFL–CIO''); California Public Employees' Retirement System (''CalPERS''); Council of Institutional Investors (''CII''); International Brotherhood of Teamsters (''Teamsters''); State of Wisconsin Investment Board (''SWIB''); Transparency International—USA.

[42] *See, e.g.*, the Letters of American Bar Association (''ABA''); America's Community Bankers; American Bankers Association; American Institute of Certified Public Accountants (''AICPA''); Computer Sciences Corporation (''CSC''); Deloitte & Touche LLP (''Deloitte''); Letter on behalf of German Chief Financial Officers (''German CFOs''); New York Stock Exchange, Inc. (''NYSE''); PricewaterhouseCoopers LLC (''PwC''); Public Service Enterprise Group Incorporated (''PSEG''); Ralph S. Saul; Southern Company.

[43] See note 24 above.

[44] See note 27 above.

[45] If the committee member is also a shareholder of the issuer, payments made to all shareholders of that class generally, such as dividends, will not be prohibited by this provision. Also, to conform the application of the compensatory fee prohibition with the affiliate prohibition, the final rule clarifies that the compensatory fee prohibition applies to fees from the issuer or any subsidiary thereof.

[46] The final rule does not specify any limits or restrictions on fees paid for capacity as a member of the board of directors or any board committee.

[47] Compare, for example, the Letters of CalPERS; California State Teachers' Retirement System (''CalSTRS''); CSC; NYSE with the Letter of America's Community Bankers.

[48] *See, e.g.*, the Letters of CalPERS and Marcus B. Elliott.

[49] *See, e.g.*, the Letter of State Street Corporation (''State Street'').

[50] *See, e.g.*, the Letter of NYSE.

category.[51] In particular, commenters were most concerned with the application of the prohibition to issuers or associated entities that provide financial services. To clarify application of the prohibition, the final rule specifies that the prohibition covers accounting, consulting, legal, investment banking or financial advisory services. Other commercial relationships are not covered by the final rule, although, as previously discussed, we expect that SROs will contain restrictions on additional services and activities in their own listing standards.[52] For example, the prohibitions in Exchange Act Rule 10A–3 do not include non-advisory financial services such as lending, check clearing, maintaining customer accounts, stock brokerage services or custodial and cash management services. Further, the final rule relates only to requirements for audit committee membership. They do not affect the ability of a director associated with an entity that provides such services to a listed issuer from otherwise serving on that issuer's board of directors, again to the extent other SRO rules permit such relationships.

Several commenters requested clarification regarding the types of positions that are covered at associated entities.[53] The Proposing Release would have applied the prohibition where the audit committee member was a partner, member or principal or occupied a similar position with the associated entity. Some commenters questioned whether the prohibition extended to solely passive ownership positions, such as limited partners in a limited partnership and non-managing members of a manager-managed limited liability company that have no active role in providing services to the entity. Some thought the term ''principal'' was vague outside of organizations that specifically use that term. Others noted that while the formulation correctly indicated the Commission's intention to capture all partners or limited liability company members of a law firm, accounting firm, consulting firm or other professional organization, it was not clear how the formulation was to be applied to entities that do not have or use the term partners or members, such as certain investment banking firms organized as corporations.

In response to these concerns, we have clarified that the list of covered positions includes partners and members (except for limited partners, non-managing members and those occupying similar positions who, in each case, have no active role in providing services to the entity), officers such as managing directors occupying a comparable position and executive officers (to address organizations that do not have partners and members) and others occupying a similar position. We believe extending the prohibition to any employee of an associated entity, as requested by some commenters, would be overly broad for purposes of Exchange Act Rule 10A–3, although SROs may require such an extension in their implementing rules.[54] However, we do believe the formulation should include those persons, such as partners or members in professional organizations, regardless of control, whose compensation could be directly affected by the prohibited fees, even if they are not the primary service provider. Finally, we have deleted the term ''principal'' because we believe the reference to ''those occupying similar positions'' covers entities such as professional corporations that use the ''principal'' designation for positions similar to a partner in a partnership.

The final rule, like our proposal, applies the prohibitions only to current relationships with the audit committee member and related persons. They do not extend to a ''look back'' period before appointment to the audit committee, although we expect the SROs to require such periods in their own listing standards. Similar to the comments regarding including additional independence standards in the final rule, the majority of commenters supported our proposal, arguing it is consistent with the language in Exchange Act section 10A(m) and the Commission's approach of building and relying on the SRO's independence standards that already include look back periods for a broad variety of relationships.[55]

In the Proposing Release, we requested comment on whether we should explicitly clarify whether the prohibition on ''compensatory fees'' excludes compensation under a retirement or similar plan in which a former officer or employee of the issuer participates. Many commenters supported such a clarification.[56] We believe such a clarification is appropriate particularly given that the rules apply only to current relationships, especially where the retirement compensation received is for prior service and is not contingent in any way on continued service. Accordingly, the final rule specifies that, unless an SRO's listing rules provide otherwise, compensatory fees do not include the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the listed issuer (provided that such compensation is not contingent in any way on continued service).[57]

Exchange Act section 10A(m) prohibits the receipt of ''any'' consulting, advisory or compensatory fees. While the Sarbanes-Oxley Act specifically included a *de minimis* exception with respect to other requirements, such as the audit committee pre-approval requirements in Exchange Act section 10A(i)(1)(B),[58] it provided no similar *de minimis* exception in Exchange Act section 10A(m), even though several SROs currently have such exceptions in their listing standards. Consistent with the express language in Exchange Act section 10A(m), our proposed rule did not contain a *de minimis* exception. Nevertheless, we requested comment on whether there should be such an exception. Several commenters, including those that represent investor groups, argued forcefully that no additional relationships should be exempted, including *de minimis* payments. They argued that the statutory mandate is clear, audit committee members should be truly independent, and even a *de minimis* level of payments would create the appearance of conflict.[59] Several other commenters, primarily representing issuers and their advisors, supported some form of *de minimis* or immaterial exception, believing that issuers should have flexibility to pay some level of *de*

[51] *See, e.g.*, the Letters of American Bankers Association; AXA SA; Cleary, Gottlieb, Steen & Hamilton (''Cleary''); F.N.B. Corporation; Linklaters; National Association of Real Estate Investment Trusts; PwC; Greg Swalwell.

[52] As a result, we have declined the suggestion by some commenters to codify in the final rule that additional services are expressly permitted. *See, e.g.*, the Letters of Curtis Thaxter Stevens Border & Micoleau LLC and Linklaters.

[53] *See, e.g.*, the Letters of Cleary; Cravath, Swaine & Moore (''Cravath''); Ford Motor Company; Linklaters; Sullivan & Cromwell (''S&C'').

[54] *See, e.g.*, the Letter of CII.

[55] Compare, *e.g.*, the Letters of ABA; AICPA; American Bankers Association; the Association of the Bar of the City of New York (''NYCBA''); CenturyTel, Inc.; CSC; Deloitte; New York State Bar Association (''NYSBA''); NYSE; PwC; Siemens AG with the Letters of AFL–CIO; CalPERS; CalSTRS; CII; James Fanto; Teamsters; Transparency International—USA.

[56] *See, e.g.*, the Letters of ABA; AICPA; CenturyTel, Inc.; Deloitte; NYSE; Siemens AG; S&C.

[57] The requirement that the compensation be fixed precludes retirement payments that are tied to the continued performance of the relevant entity. The requirement that the compensation be fixed does not preclude customary objectively determined adjustment provisions such as cost of living adjustments.

[58] 15 U.S.C. 78j–1(i)(1)(B).

[59] *See, e.g.*, the Letters of CalPERS; CII; SWIB.

minimis or immaterial fees to make the requirement less restrictive.[60]

We are not persuaded that such an exception is an appropriate deviation from the explicit mandate in Exchange Act section 10A(m). We believe the policies and purposes behind that section, and particularly the use of the term ''any'' when describing such fees in the statute, weighs against providing for such an exception. Further, given the narrow class of services covered by the final rule, the lack of a *de minimis* exception should be less necessary. Moreover, if the level of compensation that the member or associated entity receives is truly *de minimis* and immaterial, we are not persuaded that requiring an issuer to locate another provider so that the member can remain qualified for audit committee service would be overly burdensome. In section II.F.5, we provide a limited accommodation to address the concerns by some commenters regarding an audit committee member that ceases to be independent for reasons outside the member's reasonable control.

3. Affiliated Person of the Issuer or Any Subsidiary Thereof

Consistent with the express requirement in Exchange Act section 10A(m)(3)(B)(ii), the second basic criterion for determining independence is that a member of the audit committee of an issuer that is not an investment company may not be an affiliated person of the issuer or any subsidiary of the issuer apart from his or her capacity as a member of the board and any board committee. Consistent with the Proposing Release, we are defining the terms ''affiliate'' and ''affiliated person'' consistent with our other definitions of these terms under the securities laws, such as in Exchange Act rule 12b–2 [61] and Securities Act rule 144,[62] with an additional safe harbor.[63] We are defining ''affiliate'' of, or a person ''affiliated'' with, a specified person, to mean ''a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.'' [64] We are defining the term ''control'' consistent with our other definitions of this term under the Exchange Act [65] as ''the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.'' [66] Commenters generally supported this approach.[67]

Our definition of ''affiliated person'' for non-investment companies, like our existing definitions of this term for these issuers, requires a factual determination based on a consideration of all relevant facts and circumstances. To facilitate the analysis on facts and circumstances where we are presumptively comfortable, we are adopting a safe harbor for that aspect of the definition of ''affiliated person,'' with minor modifications from the original proposal.[68] Under the safe harbor as adopted, a person who is not an executive officer or a shareholder owning 10% or more of any class of voting equity securities of a specified person will be deemed not to control such specified person.[69] Many commenters supported the safe harbor and the certainty it will provide to non-affiliates.[70] We have clarified in the final rule, in response to several commenter suggestions, that the ownership prong should be based on ownership of any class of voting equity securities, instead of any class of equity securities.

The Proposing Release specified that those that cannot rely on the safe harbor would not be deemed to be or presumed to be affiliates. Those persons would need to conduct a facts and circumstances analysis of control. Nevertheless, some commenters and others reporting on the proposals were concerned that the 10% shareholder prong in the safe harbor somehow is, is implied to be, or would become viewed as an upper ownership limit for non-affiliate status.[71] We have no intention of this being the case. While SROs in their listing rules could establish an upper ownership limit that would preclude independence, the safe harbor in Exchange Act Rule 10A–3 does not establish such a limit. The safe harbor is designed to identify a group of those that are *not* affiliates so as to provide comfort to those individuals or entities that no additional facts and circumstances analysis is necessary. It only creates a safe harbor position for non-affiliate status. Failing to meet the 10% ownership threshold has no bearing on whether a particular person is an affiliate based on an evaluation of all facts and circumstances. A director who is not an executive officer but beneficially owns more than 10% of the issuer's voting equity could be determined to be not an affiliate under a facts and circumstances analysis of control.

We continue to believe that a 10% ownership limit is an appropriate threshold to presume (along with the other aspects of the safe harbor) that a person is *not* an affiliate. Accordingly, we are not changing that threshold. However, the safe harbor does not in any way specify or imply that a certain level of share ownership automatically presumes that a person is an affiliate. To prevent further misconceptions, we have added an explicit paragraph to the final rule to reinforce these points.

We received several comments regarding how beneficial ownership is to be determined for purposes of the safe harbor, as well as for other aspects of the rule, such as the multiple listing exception. Accordingly, we have included an instruction to the final rule to clarify that calculations of beneficial ownership are to be made consistent with Exchange Act rule 13d–3.[72]

The proposed rules would have deemed a director, executive officer, partner, member, principal or designee of an affiliate to be an affiliate. While some commenters expressed specific

[60] *See, e.g.*, the Letters of AICPA; America's Community Bankers; American Bankers Association; American Stock Exchange, Inc. (''Amex''); Cleary; Cravath; Ford Motor Company; NYCBA; PwC; S&C.

[61] 17 CFR 240.12b–2.

[62] 17 CFR 230.144.

[63] Exchange Act section 3(a)(19), in defining several terms in relation to investment companies, includes a definition of ''affiliated person'' by reference to the Investment Company Act. Because that definition is tailored to investment companies, the definition in Exchange Act Rule 10A–3 uses a definition for non-investment companies consistent with our other definitions of ''affiliate'' for non-investment companies.

[64] *See* Exchange Act Rule 10A–3(e)(1)(i).

[65] *See, e.g.*, Exchange Act Rule 12b–2.

[66] *See* Exchange Act Rule 10A–3(e)(4).

[67] *See, e.g.*, the Letters of ABA; Cleary; CSC; Matsushita Electric Industrial Co., Ltd. (''Matsushita''); PwC; Greg Swalwell.

[68] *See* Exchange Act rule 10A–3(e)(1). Note that this safe harbor does not address the question of whether a person ''is controlled by, or is under common control with'' the issuer. We proposed a similar safe harbor from the definition of ''affiliate'' for Securities Act rule 144 in 1997. See Release No. 33–7391 (Feb. 20, 1997) [62 FR 9246].

[69] The Proposing Release also would have included a requirement that the person not be a director. Several commenters pointed out that this requirement is ambiguous because all audit committee members would be directors and the affiliate prohibition would already exclude capacity as a director. Accordingly, that requirement has been removed in the final rule. Also, the final rule clarifies that the safe harbor is available not just for determinations with respect to the issuer, but to any ''specified person.'' Thus, it is also available for determinations with respect to subsidiaries of the issuer, which are also covered by the affiliate prohibition.

[70] *See, e.g.*, the Letters of Cleary; CSC; Matsushita; Nippon Keidanren (Japan Business Federation); PwC; Greg Swalwell.

[71] *See, e.g.*, the Letters of ABA; Cravath; National Venture Capital Association; The News Corporation Limited. See also Roberta S. Karmel, ''Federalization of the Law Regarding Audit Committees,'' *New York Law Journal,* vol. 229, p. 3 (Feb. 20, 2003).

[72] 17 CFR 240.13d–3.

support for this formulation,[73] several others believed the formulation was overly broad and would capture those who may not necessarily control the affiliate, such as outside directors of an affiliate.[74] These commenters raised concerns similar to those raised regarding our proposal to include partners, members and principals in the compensatory fee prohibition. Many also were concerned that including the term ''designee'' could inadvertently mean that where there was a controlling shareholder, all directors that were elected, including those that met the independence requirements, could be considered ''designees'' of an affiliate and disqualified from service because the controlling shareholder had the power to elect all such directors.

After evaluating these comments, we are narrowing the formulation. Under the final rule, only executive officers, directors that are also employees of an affiliate, general partners and managing members of an affiliate will be deemed to be affiliates. The limitation on directors will exclude outside directors of an affiliate from the automatic designation. Also, the reference to executive officers, general partners and managing members of an affiliate includes the positions we intend to cover. This will help clarify that passive, non-control positions, such as limited partners, and those that do not have policy making functions, are not covered. The formulation for being deemed to be an affiliate is narrower than the formulation of covered positions for the indirect acceptance aspect of the ''no compensation'' prong due to their different purposes. We believe a wider formulation is necessary for the ''no compensation'' prong to capture those whose compensation is more directly linked to fees from the prohibited services but who otherwise do not hold executive positions. Finally, we have removed the term ''designee.'' However, consistent with our historical interpretations of the term ''affiliate,'' an affiliate could not evade the prohibitions in the rule simply by designating a third party representative or agent that it directs to act in its place.

For issuers that are investment companies, we are adopting, as proposed, the requirement that a member of the audit committee of an investment company may not be an ''interested person'' of the investment company, as defined in section 2(a)(19)[75] of the Investment Company Act.[76] As described in the Proposing Release, we have substituted the section 2(a)(19) test for the affiliation test applied to operating companies because the section 2(a)(19) test is tailored to capture the broad range of affiliations with investment advisers, principal underwriters, and others that are relevant to ''independence'' in the case of investment companies. Commenters supported this substitution.[77]

4. New Issuers

Under Exchange Act section 10A(m)(3)(C), we have the authority to exempt from the independence requirements particular relationships with respect to audit committee members, if appropriate in light of the circumstances. As discussed in the Proposing Release, companies coming to market for the first time may face particular difficulty in recruiting members that meet the independence requirements. Before completion of a company's initial public offering, the board of directors often will consist primarily, if not exclusively, of representatives of venture capital investors and insiders. Such representation is entirely consistent with the desire of these parties to have representation in their private venture. The difficulty of recruiting independent directors before an initial public offering, coupled with the uncertainty of whether the initial public offering will be completed, may discourage companies from accessing the public markets to grow their business and provide liquidity, as well as from achieving the other benefits of being a public company, if all of their audit committee members must be independent at the time of the initial public offering. Further, the audit committee of some new public companies may function more effectively if it can maintain historical knowledge and experience during the transition to public company status.

As a result, we proposed an exemption for one member of a non-investment company issuer's audit committee from the independence requirements for 90 days from the effective date of an issuer's initial registration statement under section 12 of the Exchange Act or a registration statement under the Securities Act covering an initial public offering of securities of the issuer. We requested comment on whether this exemption should be extended. While not all agreed,[78] the overwhelming majority of commenters believed the proposed exemption was too restrictive to address the potential problems new issuers may face.[79] Particularly given the increased focus on board service in general, and audit committee service in particular, commenters argued that additional accommodations in both the length of the exemption and the number of members covered are necessary to not overly burden access to the capital markets.

While we recognize these potential difficulties, we continue to believe that it is important to have at least some independent representation on the audit committee at the time of an initial listing, and that a majority of the committee and the full committee should reach the independence requirements as soon as practicable. Accordingly, to balance the concerns between the need for independence and the ability to recruit qualified candidates, we are adopting a revised exception for non-investment company issuers that requires at least one fully independent member at the time of an issuer's initial listing, a majority of independent members within 90 days, and a fully independent committee within one year.

5. Overlapping Board Relationships

As discussed in the Proposing Release, many companies, particularly financial institutions and other entities with a holding company structure, operate or obtain financing through subsidiaries. For these companies, the composition of the boards of the parent company and the subsidiary are sometimes similar given the control structure between the parent and the subsidiary. If an audit committee member of the parent is otherwise independent, merely serving also on the board of a controlled subsidiary should not adversely affect the board member's independence, assuming that the board member also would be considered independent of the subsidiary except for the member's seat on the parent's board. Accordingly, we proposed an exemption from the ''affiliated person'' requirement for a committee member that sits on the board of directors of both a parent and a direct or indirect consolidated

[73] *See, e.g.*, the Letter of PwC.

[74] *See, e.g.*, the Letters of ABA; Cravath; S&C.

[75] 15 U.S.C. 80a–2(a)(19).

[76] The ''interested person'' test will apply to business development companies, as well as registered investment companies. 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].

[77] *See, e.g.*, the Letters of ABA; Deloitte; the Investment Company Institute (''ICI'').

[78] *See, e.g.*, the Letter of SWIB.

[79] *See, e.g.*, the Letters of ABA; AICPA; Amex; CalSTRS; Cleary; CSC; Deloitte; KPMG LLP; National Venture Capital Association (''NVCA''); NYCBA; NYSE; S&C; Vinson & Elkins L.L.P.

majority-owned subsidiary, if the committee member otherwise meets the independence requirements for both the parent and the subsidiary, including the receipt of only ordinary-course compensation for serving as a member of the board of directors, audit committee or any other board committee of the parent or subsidiary.

Commenters were nearly unanimous in their support for such an exemption.[80] However, many commenters believed the exemption, particularly the requirement that the subsidiary must be both consolidated and majority-owned, was overly restrictive.[81] Some companies may possess the requisite ownership to establish control, but may not consolidate the subsidiary due to particular accounting situations.[82] Others may have the requisite control to consolidate by means other than ownership and therefore may not meet the ownership test. Several commenters were particularly concerned regarding unconsolidated 50% owned joint ventures, arguing that many of the reasons provided by the Commission for the exemption apply as well to such joint ventures where two parents exercise joint control.[83] Other commenters noted that while the Commission's proposal addresses parents and subsidiaries, it did not provide similar accommodations for independent directors that serve on boards of sibling subsidiaries under common control of a parent, if such directors would be independent other than for the fact that the two sibling subsidiaries are affiliated through the parent.

To address these concerns, we are expanding the exemption. Under the final rule, an audit committee member may sit on the board of directors of a listed issuer and any affiliate so long as, except for being a director on each such board of directors, the member otherwise meets the independence requirements for each such entity, including the receipt of only ordinary-course compensation for serving as a member of the board of directors, audit committee or any other board committee of each such entity. Under the revised exemption, audit committee members will still be required to be independent of the issuer and its affiliate, but the exemption will now apply regardless of the source of control.

There are some foreign private issuers that operate under a dual holding company structure.[84] Each holding company is a foreign private issuer organized in a different national jurisdiction. The holding companies together collectively own and supervise the management of one or more businesses conducted as a single economic enterprise. The holding companies do not conduct any business other than collectively owning and supervising such businesses. The boards of directors of these dual holding companies may have all, some or no members in common. The dual holding companies may have established a joint audit committee for the group consisting of directors from each dual holding company. The audit committee members of such entities would otherwise meet the independence requirements for the overall group, but could technically be considered affiliates, or as persons who are not directors, because of the particular structural form of the dual holding companies. We are providing an accommodation for such dual holding companies. First, where a listed issuer is one of two dual holding companies, those companies may designate one audit committee for both companies so long as each member of the audit committee is a member of the board of directors of at least one of such dual holding companies. Second, dual holding companies will not be deemed to be affiliates of each other by virtue of their dual holding company arrangements with each other, including where directors of one dual holding company are also directors of the other dual holding company, or where directors of one or both dual holding companies are also directors of the businesses jointly controlled, directly or indirectly, by the dual holding companies (and in each case receive only ordinary-course compensation for serving as a member of the board of directors, audit committee or any other board committee of the dual holding companies or any entity that is jointly controlled, directly or indirectly, by the dual holding companies).

6. Other Requests for Independence Exemptions

As discussed in section II.G.1 below, issuers availing themselves of exemptions from Exchange Act rule 10A–3 will generally have to disclose that fact. Apart from the two limited exemptions discussed in sections II.B.4 and 5 above and the exemptions for controlling persons, foreign governmental board representatives and non-management employee members of foreign private issuers discussed in section II.F.3.a below, we are not exempting other particular relationships from the independence requirements at this time.

We noted in the Proposing Release that despite the existence of exemptions based on exceptional and limited circumstances in several existing SRO rules,[85] section 10A(m) of the Exchange Act, as enacted by Congress, does not contain any such exemption. Nevertheless, we requested comment as to whether such an exemption would be appropriate. Commenters were split on this point, with the commenters representing investors and investor groups not supporting such an exemption, and the commenters predominantly representing SROs supporting the freedom to provide such exemptions.[86] Some of the commenters that advocated against the exemption were concerned that the existing SRO exceptions have been or could be applied in practice more broadly than intended, though some commenters supporting such an exemption disputed this point. Consistent with our proposal, our final rules do not contain any exemptions based on exceptional and limited circumstances.

We also announced in the Proposing Release that, given the policy and purposes behind the Sarbanes-Oxley Act, as well as to maintain consistency and to ease administration of the requirements by the SROs, we do not intend to entertain exemptions or waivers for particular relationships on a case-by-case basis.[87] We requested comment on whether we should permit companies to request exemptive relief from the Commission or SROs on a case-by-case basis. Commenters also were split on this point, again with the commenters representing predominantly investors and investor groups not supporting case-by-case

[80] *See, e.g.*, America's Community Bankers; American Bankers Association; CalPERS; CSC; Deloitte; NYSE; PwC; Southern Company; Greg Swalwell. But see the Letter of SWIB.

[81] *See, e.g.*, the Letters of Dow Corning Corporation; Michael Groll; Kinder Morgan Energy Partners, L.P.; S&C.

[82] *See, e.g.*, the Letter of Michael Groll.

[83] *See, e.g.*, the Letter of Dow Corning Corporation.

[84] *See, e.g.*, the Letters of Reed Elsevier PLC; Royal Dutch Petroleum Company; Unilever PLC.

[85] See, for example, section 303.01 of the NYSE's listing standards; Rule 4350(d) of the NASD's listing standards and section 121B of the AMEX's listing standards. The rules of the NYSE, NASD and AMEX are available on their Web sites at *http://www.nyse.com, http://www.nasd.com* and *http://www.amex.com,* respectively.

[86] Compare, *e.g.*, the Letters of CalPERS; CII; CSC; Deloitte; PwC; SWIB, with the Letters of AICPA; Amex; The Nasdaq Stock Market, Inc. (''Nasdaq''); NVCA.

[87] Similarly, Commission staff will not entertain no-action letter or exemption requests in this area.

relief.[88] After carefully considering these comments, we still believe that general case-by-case exemptions would be neither appropriate nor consistent with the policies and purposes of the Sarbanes-Oxley Act. However, as requested by many commenters,[89] the Commission has exemptive authority to respond to, and will remain sensitive to, evolving standards of corporate governance, including changes in U.S. or foreign law, to address any new conflicts that cannot be anticipated at this time.

B. Responsibilities Relating to Registered Public Accounting Firms

1. Scope of the Requirement

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.[90] 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 promote auditor independence, 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, we are adopting as proposed the requirement that the audit committee of a listed issuer will need to be directly responsible for the appointment, compensation, retention and oversight of the work of any registered public accounting firm engaged (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the issuer, and the independent auditor will have to report directly to the audit committee.[91] These oversight responsibilities include the authority to retain the outside auditor, which includes the power not to retain (or to terminate) the outside auditor. In addition, in connection with these oversight responsibilities, the audit committee must have ultimate authority to approve all audit engagement fees and terms.[92]

Overall, commenters supported the requirement as proposed, believing additional specificity is not needed and flexibility should be given to the audit committee regarding the execution of these responsibilities, without rigid rules.[93] A few commenters, however, suggested that we should limit the requirement to cover only certain registered public accounting firms that perform audit, review or attest services for the issuer, that we should limit the coverage of services specified by the proposal, or that we should clearly delineate which oversight responsibilities remain with management.[94] We believe these specific decisions regarding the execution of the audit committee's oversight responsibilities, as well as decisions regarding the extent of desired involvement by the audit committee, are best left to the discretion of the audit committee of the individual issuer in assessing the issuer's individual circumstances. Accordingly, we are not limiting the oversight responsibilities provided by the statute and the proposal.

Some commenters requested further clarification regarding the scope of the services included in the requirement, including ''audit, review or attest services.'' We believe these services encompass the same services covered in the ''Audit Fees'' category in an issuer's disclosure of fees paid to its independent public accountants. As discussed in our recent release revising the Commission's auditor independence requirements,[95] this category includes services that normally would be provided by the accountant in connection with statutory and regulatory filings or engagements. In addition to services necessary to perform an audit or review in accordance with Generally Accepted Auditing Standards (''GAAS''),[96] this category also may include services that generally only the independent accountant reasonably can provide, such as comfort letters, statutory audits, attest services, consents and assistance with and review of documents filed with the Commission. This approach does not affect the operation of other Commission rules regarding permissible services or preclude the audit committee from oversight or other involvement in the provision of audit-related or other permissible services.

In the Proposing Release, we requested comment on whether other responsibilities not listed in Exchange Act section 10A(m) should be under the supervision of the audit committee, such as the appointment, compensation, retention and oversight of an issuer's internal auditor. Commenters were split on whether the Commission should mandate oversight responsibility regarding an issuer's internal auditor, with the majority not supporting action by the Commission at this time.[97] Given this split, we are not extending the responsibility requirement to include such oversight.

2. Clarifications Regarding Possible Conflicts With Other Requirements

We proposed adding an instruction to the rule to clarify that the requirements regarding auditor responsibility do not conflict with, and are not affected by, any requirement under an issuer'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 requirements instead relate to the assignment of responsibility to oversee the auditor's work as between the audit committee and management. Commenters welcomed this

[88] Compare, *e.g.*, the Letters of AICPA; CalPERS; CII; CSC; NVCA; the Comptroller of the State of New York; PwC; SWIB, with the Letters of Amex; Deloitte; Ralph S. Saul; S&C.

[89] *See, e.g.*, the Letters of Association of Private French Enterprises—Association of Large French Enterprises (''AFEP–AGREF''); Cleary; Italian Association of Limited Liability Companies (''Assonime''); NYSE.

[90] 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. 78l(b)(1)(J) and 78m(a)(2)]. See also Title II of the Sarbanes-Oxley Act [Pub. L. 107–204, Title II, 116 Stat. 771–75].

[91] In response to several commenters' questions, we have removed the phrase ''or related work'' from the final rule where describing the preparation and issuance of an issuer's audit report. We believe the reference to ''or other audit, review or attest services'' appropriately delineates the intention behind the phrase ''or related work.''

[92] *See* also Release No. 33–8183 (Jan. 28, 2003). In response to several commenters' questions, these responsibilities are provided as examples and are not intended to be an exclusive list of responsibilities.

[93] *See, e.g.*, the Letters of AICPA; CalSTRS; Financial Executives Institute (''FEI'').

[94] *See, e.g.*, the Letters of Deloitte; Ernst & Young LLP (''E&Y''); PwC; State Street.

[95] *See* Release No. 33–8183 (Jan. 28, 2003).

[96] *See* also section 2(a)(2) of the Sarbanes-Oxley Act which defines the term ''audit.''

[97] Compare, *e.g.*, the Letters of Francisco J. Barragan; Melody Boehl; Marcus B. Elliott; Institute of Internal Auditors; and National Association of Corporate Directors with the Letters of ABA; Canadian Bankers Association (''CBA''); CSC; Deloitte; FEI; C.H. Moore, Jr.; Nasdaq; NYSBA; and NYSE.

clarification.[98] However, several commenters recommended extending the instruction to include other requirements in the rule, such as auditor compensation and termination, to address foreign requirements that vest these responsibilities with shareholders.[99] We agree with these commenters that the same reasons that justify the clarification regarding auditor selection justify an extension to these other responsibilities. We also agree with those commenters that noted that the clarification should apply even if shareholders are not required to vote on the responsibilities, but voluntarily elect to do so.[100]

Accordingly, we are expanding the instruction. The revised instruction clarifies that none of the audit committee requirements in the final rule conflicts with, nor do they affect the application of, any requirement or ability under an issuer's governing law or documents or other home country legal or listing provisions that requires or permits shareholders to ultimately vote on, approve or ratify such requirements. In addition, we are adopting as proposed the further clarification that if such responsibilities are vested with shareholders, and the issuer provides a recommendation or nomination regarding such matters to its shareholders, the audit committee of the issuer, or body performing similar functions, must be responsible for making the recommendation or nomination.

The proposed instruction also included a clarification that the requirement that the audit committee select auditors does not conflict with any requirement in a company's home jurisdiction that prohibits the full board of directors from delegating such responsibility to a committee. 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 or proposals to the full board. Several commenters noted that this instruction should be expanded to address other responsibilities in the final rule for the same reasons as those relating to shareholder approval.[101] In some jurisdictions, boards may be prohibited from delegating such responsibilities to a committee, including the ability to submit nominations or recommendations to shareholders as called for in the instruction regarding shareholder approval of such matters.

Accordingly, we are expanding the instruction to cover other situations where the board of directors may be prohibited from delegating responsibility to the audit committee, including the ability to submit nominations or recommendations to shareholders. The revised instruction clarifies that none of the audit committee requirements in the final rule, including the requirement that the audit committee provide recommendations to shareholders where such responsibilities are vested with shareholders, conflicts with any legal or listing requirement in an issuer's home jurisdiction that prohibits the full board of directors from delegating such responsibilities to the audit committee or limits the degree of such delegation. However, we continue to believe that in such an instance, the audit committee, or body performing similar functions, must be granted such responsibilities, which can include advisory powers, with respect to such matters to the extent permitted by law, including submitting nominations or recommendations to the full board of directors.

Finally, some commenters noted that in some jurisdictions, the outside auditor can only be removed by court order upon specified circumstances.[102] Other commenters noted that the government is required to select the outside auditor for some foreign private issuers. Similar to the previous instructions, we are providing an additional instruction to clarify that the requirements in the final rule do not conflict with any legal or listing requirement in an issuer's home jurisdiction vesting such responsibilities with a government entity or tribunal. Similar to the other instructions, in such an instance we believe the audit committee should be granted such responsibilities, which can include advisory powers, with respect to such matters to the extent permitted by law.

Some commenters requested that we provide for these clarifications as explicit exemptions from the final rule. As noted previously, however, we believe that the rule's requirements relate to the assignment of such responsibilities as between the audit committee and management. They do not conflict with, and otherwise have no bearing on, the vesting of such responsibilities in other bodies such as shareholders or government entities. Accordingly, we believe it is more appropriate to clarify what the requirements do not apply to or conflict with in the form of an instruction rather than an exemption.

3. Application to Investment Companies

We proposed to exempt investment companies from the requirement that the audit committee be responsible for the selection of the independent auditor. We proposed the exemption in light of section 32(a) of the Investment Company Act,[103] which requires that independent auditors of registered investment companies be selected by majority vote of the disinterested directors.[104]

On January 28, 2003, we adopted amendments to our existing requirements regarding auditor independence.[105] Those amendments require that the audit committee of a registered investment company pre-approve all audit, review, or attest engagements required under the securities laws, a requirement that was supported by the commenters.[106] In order to conform the rules that we are adopting today to the auditor independence rules, we are removing the proposed exemption for investment companies from the requirements regarding selection of the auditor. As a result, the audit committee will be required to select the independent

[98] *See, e.g.*, the Letters of AICPA; The Treasury of the Government of Australia; CalPERS; Deloitte; Financial Services Agency of Japan (''FSA''); German CFOs; NYSE; PwC; Alexander Schaub; Telekom Austria AG.

[99] *See, e.g.*, the Letters of Assonime; Canadian Bankers Association; Cleary; PwC; S&C.

[100] *See, e.g.*, the Letter of Cleary.

[101] *See, e.g.*, the Letters of Brazilian Securities Commission; Cleary; S&C.

[102] *See, e.g.*, the Letters of Aventis SA; Deloitte; France Telecom SA.

[103] 15 U.S.C. 80a–31(a).

[104] Section 32(a) applies to management investment companies and face-amount certificate companies. It does not apply to unit investment trusts, which do not have boards of directors and which we are excluding entirely from the requirements that we are adopting today. *See* section II.F.3.d. concerning unit investment trusts.

There are three types of investment companies: face-amount certificate companies, unit investment trusts and management companies. *See* section 4 of the Investment Company Act [15 U.S.C. 80a–4]. The Investment Company Act divides management companies into two sub-categories, defining an open-end company as a management company that offers for sale or has outstanding any redeemable securities of which it is the issuer and a closed-end company as any management company other than an open-end company. *See* section 5(a) of the Investment Company Act [15 U.S.C. 80a–5(a)]. A unit investment trust is an investment company that is organized under a trust indenture, contract of custodianship or agency, or similar instrument; does not have a board of directors; and issues only redeemable securities, each of which represents an undivided interest in a unit of specified securities, but does not include a voting trust. *See* section 4(2) of the Investment Company Act of 1940 [15 U.S.C. 80a–4(2)].

[105] *See* Release No. 33–8183 (Jan. 28, 2003).

[106] *See, e.g.*, Letter of Investment Company Institute dated January 13, 2003, in response to Release No. 33–8154 (Dec. 2, 2002) [67 FR 76780], proposing auditor independence rules adopted in Release No. 33–8183 (Jan. 28, 2003).

auditor and, under section 32(a) of the Investment Company Act, the independent directors will be required to ratify the selection.

C. Procedures for Handling Complaints

The audit committee must place some reliance on management for information about the company's financial reporting process. Since the audit committee is dependent to a degree on the information provided to it by management and internal and outside auditors, it is imperative for the committee to cultivate open and effective channels of information. Management may not have the appropriate incentives to self-report all questionable practices. A company employee or other individual may be reticent to report concerns regarding questionable accounting or other matters for fear of management reprisal.[107] The establishment of formal procedures for receiving and handling complaints should serve to facilitate disclosures, encourage proper individual conduct and alert the audit committee to potential problems before they have serious consequences.

Accordingly, under the listing standards called for by our final rules, each audit committee must establish procedures for:[108]

- The receipt, retention and treatment of complaints received by the issuer regarding accounting, internal accounting controls or auditing matters, and
- The confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.

As proposed, we are not mandating specific procedures that the audit committee must establish. Commenters were split over whether specific procedures should be mandated. The minority, representing primarily consultants and other third-party providers of such services, as well as several commenters representing investors, believed the Commission should mandate specific procedures, and many advocated a national ''one-size-fits-all'' approach.[109] A substantial number of commenters, however, supported the Commission's approach of not mandating specific procedures, instead preferring to leave flexibility to the audit committee to develop appropriate procedures in light of a company's individual circumstances, so long as the required parameters are met.[110]

Given the variety of listed issuers in the U.S. capital markets, we believe audit committees should be provided with flexibility to develop and utilize procedures appropriate for their circumstances. The procedures that will be most effective to meet the requirements for a very small listed issuer with few employees could be very different from the processes and systems that would need to be in place for large, multi-national corporations with thousands of employees in many different jurisdictions. We do not believe that in this instance a ''one-size-fits-all'' approach would be appropriate. As noted in the Proposing Release, we expect each audit committee to develop procedures that work best consistent with its company's individual circumstances to meet the requirements in the final rule. Similarly, we are not adopting the suggestion of a few commenters that, despite the statutory language, the requirement should be limited to only employees in the financial reporting area.[111]

While the scope of the requirements generally includes complaints received by a listed issuer regardless of source, Exchange Act section 10A(m)(4)(B) and the relevant portion of the rules referring to confidential, anonymous submission of concerns are directed to employees of the issuer. One commenter noted that investment companies rarely have direct employees.[112] The commenter suggested that, for investment companies, the confidential, anonymous submission requirements should extend to employees of entities engaged by an investment company to prepare or assist in preparing its financial statements. We encourage the SROs to consider the appropriate scope of the requirement with regard to investment companies, taking account of the fact that most services are rendered to an investment company by employees of third parties, such as the investment adviser, rather than by employees of the investment company.[113]

D. Authority to Engage Advisors

To be effective, an audit committee must have the necessary resources and authority to fulfill its function. The audit committee likely is not equipped to self-advise on all accounting, financial reporting or legal matters. To perform its role effectively, therefore, an audit committee may need the authority to engage its own outside advisors, including experts in particular areas of accounting, as it determines necessary apart from counsel or advisors hired by management, especially when potential conflicts of interest with management may be apparent.

The advice of outside advisors may be necessary to identify potential conflicts of interest and assess the company's disclosure and other compliance obligations with an independent and critical eye. Often, outside advisors can draw on their experience and knowledge to identify best practices of other companies that might be appropriate for the issuer. The assistance of outside advisors also may be needed to independently investigate questions that may arise regarding financial reporting and compliance with the securities laws. Accordingly, as proposed, the final rule specifically requires an issuer's audit committee to have the authority to engage outside advisors, including counsel, as it determines necessary to carry out its duties.[114] Commenters supported this requirement as proposed.[115]

E. Funding

An audit committee's effectiveness may be compromised if it is dependent on management's discretion to compensate the independent auditor or the advisors employed by the committee, especially when potential conflicts of interest with management may be apparent. Accordingly, as proposed, the final rule requires the issuer to provide for appropriate funding, as determined by the audit committee, in its capacity as a

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[107] The Sarbanes-Oxley Act provides additional protections for employees who provide evidence of fraud. See, for example, section 806 of the Sarbanes-Oxley Act.

[108] Exchange Act rule 10A–3 is not intended to preempt or supersede any other federal or state requirements relating to receipt and retention of records.

[109] *See, e.g.*, the Letters of AuditConcerns, Inc.; CalPERS; Michael Chenkin; Confidential Communications Services, LLC; David Gold; The HR Hotline, Inc.; SWIB; Teamsters.

[110] *See, e.g.*, the Letters of ABA; AICPA; American Bankers Association; Cleary; CSC; Deloitte; Edison Electric Institute; E&Y; FEI; ICI; Nasdaq; The Network, Inc.; NYCBA; NYSBA; PSEG; PwC; Ralph S. Saul; State Street Corporation.

[111] *See, e.g.*, the Letter of S&C.

[112] *See* the Letter of PwC.

[113] Compare Release No. 33–8185 (Jan. 29, 2003) (attorney employed by an investment adviser who prepares, or assists in preparing, materials for a registered investment company to be submitted to or filed with the Commission by or on behalf of the investment company is appearing and practicing before the Commission); Release No. 34–47262 (Jan. 27, 2003) (disclosure required of code of ethics applicable to the principal executive officer and financial officer of a registered management investment company, or persons performing similar functions, regardless of whether they are employees of the investment company or a third party).

[114] As proposed, the requirement does not preclude access to or advice from the company's internal counsel or regular outside counsel. It also does not require an audit committee to retain independent counsel.

[115] *See, e.g.*, the Letters of AICPA; CSC; Deloitte; FEI; ICI; PwC.

committee of the board of directors, for payment of compensation:

- To any registered public accounting firm engaged for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the listed issuer;[116] and
- To any advisors employed by the audit committee.

This requirement will further the standard relating to the audit committee's responsibility to appoint, compensate, retain and oversee the outside auditor. It also will add meaning to the standard relating to the audit committee's authority to engage independent advisors. Not only could an audit committee be hindered in its ability to perform its duties objectively by not having control over the ability to compensate these advisors, but the role of the advisors also could be compromised if they are required to rely on management for compensation. Thus, absent such a provision, both the audit committee and the advisors could be less willing to address disagreements or other issues with management.

Commenters supported this requirement.[117] We also requested comment on whether there should be limits on the amount of compensation that could be requested by the audit committee. The overwhelming majority of commenters did not support compensation limits, arguing that to do otherwise would subvert the intent of the requirement.[118] These commenters argued that audit committee members' own fiduciary duties to the issuer and natural oversight by the board of directors as a whole over the audit committee would address any concerns over abuse. The final rule does not set funding limits.

Some commenters believed it would be appropriate to supplement the funding requirements.[119] While the Commission's proposal would address the compensation of advisors, it would not provide assurance that the audit committee itself can obtain the funding it needs to carry out its duties. Specifically, these commenters believed the final rule should also state that the issuer must provide appropriate funding for ordinary administrative expenses of the audit committee. We find merit in this suggestion. An audit committee's effectiveness may be compromised if it is dependent on management's discretion to pay for the committee's expenses, especially when potential conflicts of interest with management may be apparent. Accordingly, the final rule provides that, in addition to funding for advisors, the issuer must provide appropriate funding for ordinary administrative expenses of the audit committee that are necessary or appropriate in carrying out its duties.

F. Application and Implementation of the Standards

1. SROs Affected and Implementation Dates

Section 10A(m) of the Exchange Act by its terms applies to all national securities exchanges and national securities associations. These entities, to the extent that their listing standards do not already comply with the final rule, will be required to issue or modify their rules, subject to Commission review, to conform their listing standards.[120] The SROs are not precluded from adopting additional listing standards regarding audit committees, as long as they are consistent with Exchange Act rule 10A–3.

To facilitate timely implementation of the requirements, we proposed compliance dates by when each SRO must provide to the Commission proposed rules and rule amendments to implement Exchange Act rule 10A–3, as well as by when such rules or rule amendments must be approved by the Commission. As proposed, SROs would have had until 60 days after publication of our final rule in the **Federal Register** to provide proposed rules or rule amendments, and until 270 days after publication of our final rule to have such rules or rule amendments approved by the Commission. Commenters generally supported these compliance dates, although several requested additional time to submit the proposed rules and rule amendments.[121]

In response to these comments, the SRO compliance dates we are adopting in the final rule are designed to facilitate timely implementation of the new requirements, while providing additional time for SROs to submit proposed rules or rule amendments. Under the final rule, each SRO must provide to the Commission proposed rules or rule amendments that comply with the requirements no later than July 15, 2003. Final rules or rule amendments must be approved by the Commission no later than December 1, 2003.

Regarding when listed issuers must be in compliance with the new listing rules, we proposed that the new requirements would need to be operative by the SROs no later than the first anniversary of the publication of our final rule in the **Federal Register**. A few commenters believed the proposed implementation dates were adequate for issuers to make the necessary changes to their audit committees, arguing that timely implementation is key to restoring investor confidence and public trust.[122] However, a substantial group of commenters recommended modifications and additional time for issuers to comply, for three primary reasons.

First, commenters noted that the new requirements as proposed would become operative during the 2004 annual shareholder meeting period for most listed issuers.[123] Given the importance of allowing issuers to identify, evaluate and recruit qualified directors, as well as the desirability of avoiding the burden and expense of requiring special shareholder meetings to elect those directors, commenters requested the ability to coordinate compliance with their annual shareholder meeting schedule, such as the first annual shareholders meeting after approval of the SRO implementing rules, which could occur after the original compliance date proposed by the Commission.

Second, several commenters requested additional time for compliance by foreign private issuers.[124] The new SRO rules may represent the first time that some foreign listed issuers will be subject to such requirements. Some were concerned that the pool of candidates available in some countries that would be qualified to perform the functions required of audit committee members may be limited. As such, it may take additional time to locate and attract qualified directors.

Finally, several commenters requested accommodations for smaller listed

[116] Exchange Act section 10A(m)(6)(A) uses the phrase ''rendering or issuing an audit report.'' For consistency, we have conformed the language in the final rule to the language used in the oversight requirement in Exchange Act section 10A(m)(2) which refers to ''preparing or issuing an audit report.'' Similarly, the final rule includes as proposed the phrase ''other audit, review or attest services.'' *See* section II.B.1 regarding a discussion of the scope of this formulation.

[117] *See, e.g.,* the Letters of AICPA; CalPERS; Deloitte; FEI; ICI; PwC.

[118] Compare, *e.g.,* the Letters of ABA; Deloitte; E&Y; FEI; PwC with the letters of Southern Company; CalPERS.

[119] *See, e.g.,* the ABA Letter.

[120] An SRO that wished to do so could satisfy the requirements of the rule by requiring that a listed issuer must comply with the requirements set forth in Exchange Act rule 10A–3.

[121] *See, e.g.*, the Letters of ABA; NYSE.

[122] *See, e.g.*, the Letters of CalPERS; CII; CSC; ICI; PwC.

[123] *See, e.g.*, the Letters of ABA; AFEP–AGREF; AXA SA; Cleary; German CFOs; Nippon Keidanren; JPMorgan Chase Bank; Matsushita.

[124] *See, e.g.*, the Letters of Cleary; Davis Polk & Wardwell; Deloitte; European Federation of Accountants (''FEE''); PwC; Telekom Austria AG.

issuers.[125] These issuers may need additional time to locate a sufficient number of qualified directors to meet the requirements. In addition, small business issuers that are listed on some markets, such as Nasdaq, have previously been exempt from listing requirements that require independence for the entire audit committee.[126] Commenters requested an additional transition period for such companies to alleviate the potential burdens they may face.

In response to these concerns, we are adopting a revised set of implementation dates, with an extended date for foreign private issuers and smaller issuers. We are distinguishing listed issuers that are not foreign private issuers by size based upon whether they are a ''small business issuer,'' as defined in Exchange Act rule 12b–2. A small business issuer is a U.S. or Canadian issuer with less than $25 million in revenues and public float that is not an investment company.[127]

Under the final rule, listed issuers, other than foreign private issuers and small business issuers, must be in compliance with the new listing rules by the earlier of (1) their first annual shareholders meeting after January 15, 2004, or (2) October 31, 2004. Foreign private issuers and small business issuers must be in compliance with the new listing rules by July 31, 2005. We believe these dates strike an appropriate balance between the need for timely implementation of the requirements and the ability of listed issuers to comply with the requirements without an unreasonable burden.

As discussed in the Proposing Release, the OTC Bulletin Board (OTCBB), the Pink Sheets and the Yellow Sheets are not affected by Exchange Act rule 10A–3, and therefore issuers whose securities are quoted on these interdealer quotation systems similarly will not be affected, unless their securities also are listed on an exchange or Nasdaq.[128] Each of these quotation systems does not provide issuers with the ability to list their securities, but is a quotation medium for the over-the-counter securities market that collects and distributes market maker quotes to subscribers. These interdealer quotation systems do not maintain or impose listing standards, nor do they have a listing agreement or arrangement with the issuers whose securities are quoted through them. Although market makers may be required to review and maintain specified information about the issuer and to furnish that information to the interdealer quotation system,[129] the issuers whose securities are quoted on such systems do not have any filing or reporting requirements with the system.[130]

2. Securities Affected

In enacting section 10A(m) of the Exchange Act, Congress made no distinction regarding the type of securities to be covered. Section 10A(m)(1)(A) of the Exchange Act prohibits the listing of ''any security'' of an issuer that does not meet the new standards for audit committees. Accordingly, the final rule applies not just to voting equity securities, but to any listed security, regardless of its type, including debt securities, derivative securities and other types of listed securities. We believe investors in all securities of an issuer, whether common equity or fixed income, will benefit from the increased financial oversight of an issuer that would result from a strong and effective audit committee.

Despite the statutory language, a few commenters believed that debt securities and non-convertible preferred securities should be exempted in their entirety.[131] As discussed above, we do not believe such a broad-based exemption is consistent with the language and the intent of section 10A(m). Effective oversight of financial reporting improves the quality and accuracy of such reporting. Quality and accurate financial reporting facilitates the proper pricing and liquidity of all securities on listed markets, regardless of type. While the Sarbanes-Oxley Act made explicit distinctions between debt and equity securities in several different provisions,[132] it made no such distinction in enacting Exchange Act section 10A(m). To avoid undue burden on listed issuers, including debt issuers, we have adopted several exemptions where consistent with the purposes and policies of section 10A(m) and the protection of investors, such as the overlapping board exemption discussed in section II.A.5 and the multiple listing exemption discussed below.

a. Multiple Listings

Many companies today issue multiple classes of securities through various ownership structures on various markets. For example, a company may have a class of common equity securities listed on one market, several classes of debt listed on one or more other markets, and derivative securities listed on yet another market. If an issuer already was subject to the requirements in Exchange Act rule 10A–3 as a result of one listing, there would be little or no additional benefit from having the requirements imposed on the issuer due to an additional listing.

In addition, companies often issue non-equity securities through controlled subsidiaries for various reasons. Requiring these subsidiaries, which often have no purpose other than to issue or guarantee the securities, to be subject to the audit committee requirements would add little additional benefit if the subsidiary is closely controlled or consolidated by a parent issuer that is subject to the requirements. Instead, imposing the requirements on these subsidiaries could create an onerous burden on the parent to recruit and maintain an audit committee meeting the requirements for each specific subsidiary.

Accordingly, we are adopting as proposed an exemption from the requirements for listings of additional classes of securities of an issuer at any time the issuer is subject to the requirements as a result of the listing of a class of common equity or similar securities. The additional listings could be on the same market or on different markets. Some commenters questioned conditioning the exemption on the listing of a class of common equity or similar securities.[133] We proposed conditioning this exemption on the listing of a class of common equity or similar securities because these securities will most likely represent the primary public listing of the company and the applicable listing standards, including those required by our rules, would be likely to be the most comprehensive. We are persuaded that this approach is proper in respect of the listing of subsidiaries' securities, but it is not necessary in the case of multiple listings of the issuer itself. Therefore,

[125] *See, e.g.*, the Letters of ABA; Amex; Nasdaq.

[126] *See, e.g.*, rule 4350(d)(2)(C) of the NASD's listing standards.

[127] Public float is the aggregate market value of a company's outstanding voting and non-voting common equity (*i.e.*, market capitalization) minus the value of common equity held by affiliates of the company.

[128] The OTCBB is operated by The Nasdaq Stock Market, Inc., which is owned by the NASD. Information about the OTCBB can be found at *http://www.otcbb.com*. The Pink Sheets and the Yellow Sheets (as well as the corresponding Electronic Quotation Service) are operated by Pink Sheets LLC. Information about the Pink Sheets, the Yellow Sheets and the Electronic Quotation Service can be found at *http://www.pinksheets.com.*

[129] *See* 17 CFR 240.15c2–11.

[130] However, under OTCBB rules, issuers of securities quoted on the OTCBB must be subject to periodic filing requirements with the Commission or other regulatory authority. *See* NASD rule 6530.

[131] *See, e.g.*, the Letters of ABA; NYSE; S&C.

[132] *See, e.g.*, section 501 of the Sarbanes-Oxley Act.

[133] *See, e.g.*, the Letters of ABA; NYSBA.

the exemption for additional classes of a listed issuer will apply if any class of securities of the issuer is listed on a national securities exchange or national securities association subject to these rules.

Of course, just as an SRO may adopt standards for audit committees that are stricter than those provided in Exchange Act rule 10A–3, they also may apply their listing standards, including those implementing Exchange Act rule 10A–3, to classes of securities where Exchange Act rule 10A–3 would not require it. For example, in the case of an issuer with a class of debt securities listed on an SRO subject to these rules, another SRO may condition listing by that issuer of its common equity securities on full compliance with that second SRO's listing standards regarding the requirements in Exchange Act rule 10A–3. Moreover, our rules do not embody a ''first in time'' principle, so that in the above example, once the class of common equity securities was listed on the second SRO subject to our requirements, unless SRO rules provide otherwise, the multiple listing exemption could be applied in respect of the debt securities listed on the first SRO.

Also as proposed, we are extending the exemption to listings of non-equity securities by certain additional subsidiaries of a parent company, if the parent company is subject to the requirements as a result of the listing of a class of equity securities. We proposed having the exemption apply to non-equity listings by direct or indirect consolidated majority-owned subsidiaries of a parent company. While commenters uniformly supported the exemption,[134] some believed that, for many of the same reasons discussed above regarding the independence exemption for overlapping boards of directors, the number of subsidiaries that would be covered by the multiple listing exemption was too restrictive.[135]

In this instance, however, we believe that a greater degree of interest between the parent and the subsidiary is important. The multiple listing exemption will mean that, unless an SRO's rules provide otherwise, a publicly traded entity will not need to have any independent audit committee members or otherwise be subject to the audit committee responsibilities in Exchange Act rule 10A–3. It is more important in this instance to ensure that the parent company's audit committee is in the appropriate position to provide oversight for the financial reporting of the subsidiary. This is most likely to be the case if the parent consolidates the subsidiary into its own financial statements. Nevertheless, we also understand that a parent may possess the requisite ownership threshold, but may not consolidate the subsidiary due to particular accounting situations.[136] Similarly, 50% owned joint ventures may not be consolidated by the two parents that exercise joint control.[137]

To address these concerns, we are expanding the exemption from the proposal to include listings of non-equity securities by a direct or indirect subsidiary that is consolidated or at least 50% beneficially owned by a parent company, if the parent company is subject to the requirements as a result of the listing of a class of its equity securities. However, as proposed, if the subsidiary were to list its own equity securities (other than non-convertible, non-participating preferred securities[138]), the subsidiary will be required to meet the requirements to protect its own public shareholders. The multiple listing exemption is available to U.S. subsidiaries if the parent is a foreign private issuer, even if the foreign parent is relying on one of the special exemptions for foreign private issuers (such as the board of auditors exemption). However, the special exemptions available to the foreign parent are of course not available to its U.S. subsidiary.

b. Security Futures Products and Standardized Options

The enactment of the Commodity Futures Modernization Act of 2000, or CFMA,[139] addressed the regulation of security futures products.[140] It permits national securities exchanges registered under section 6 of the Exchange Act[141] and national securities associations registered under section 15A(a) of the Exchange Act[142] to trade futures on individual securities and on narrow-based security indices (''security futures'') without being subject to the issuer registration requirements of the Securities Act and Exchange Act as long as they are cleared by a clearing agency that is registered under section 17A of the Exchange Act[143] or that is exempt from registration under section 17A(b)(7)(A) of the Exchange Act. In December 2002, we adopted rules to provide comparable regulatory treatment for standardized options.[144]

The role of the clearing agency for security futures products and standardized options is fundamentally different from a conventional issuer of securities. For example, the purchaser of these products does not, except in the most formal sense, make an investment decision regarding the clearing agency. As a result, information about the clearing agency's business, its officers and directors and its financial statements is less relevant to investors in these products than to investors in the underlying security. Similarly, the investment risk in these products is determined by the market performance of the underlying security rather than the performance of the clearing agency. Moreover, the clearing agencies are self-regulatory organizations subject to regulatory oversight. Furthermore, unlike a conventional issuer, the clearing agency does not receive the proceeds from sales of security futures products or standardized options.[145]

Recognizing these fundamental differences, we are adopting as proposed an exemption for the listing of a security futures product cleared by a clearing agency that is registered under section 17A of the Exchange Act or exempt from registration under section 17A(b)(7) of the Exchange Act. We are adopting as proposed a similar exemption for the listing of standardized options issued by a clearing agency registered under section 17A of the Exchange Act.

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[134] *See, e.g.,* the Letters of ABA; CalPERS; CSC; Edison International; Ford Motor Company; General Electric Company; General Motors Acceptance Corporation; NYSE; PSEG; PwC; Transamerica Finance Corporation (''TFC''); Southern Company.

[135] *See, e.g.,* the Letters of ABA; Cingular Wireless; Corning Incorporated; Dow Corning Corporation; FEI; PwC; S&C; TFC.

[136] *See e,g.,* the Letter of Michael Groll.

[137] *See, e.g.,* the Letters of Cingular Wireless; Corning Incorporated; Dow Corning Corporation; FEI; PwC.

[138] Trust-preferred and similar securities also fall within this category.

[139] Pub. L. No. 106–554, 114 Stat. 2763 (2000).

[140] Securities Act section 2(a)(16) [15 U.S.C. 77b(a)(16)], Exchange Act section 3(a)(56) [15 U.S.C. 78c(a)(56)], and Commodities Exchange Act section 1a(32) [7 U.S.C. 1a(32)] define ''security futures product'' as a security future or an option on a security future.

[141] 15 U.S.C. 78f.

[142] 15 U.S.C. 78o–3(A).

[143] 15 U.S.C. 78q–1.

[144] See Release No. 33–8171 (Dec. 23, 2002) [68 FR 188]. In that release, we exempted standardized options issued by registered clearing agencies and traded on a registered national securities exchange or on a registered national securities association from all provisions of the Securities Act, other than the section 17 antifraud provision of the Securities Act, as well as the Exchange Act registration requirements. Standardized options are defined in Exchange Act rule 9b–1(a)(4) [17 CFR 240.9b–1(a)(4)] as option contracts trading on a national securities exchange, an automated quotation system of a registered securities association, or a foreign securities exchange which relate to option classes the terms of which are limited to specific expiration dates and exercise prices, or such other securities as the Commission may, by order, designate.

[145] However, the clearing agency may receive a clearing fee from its members.

3. Issuers Affected

a. Foreign Issuers

As discussed in the Proposing Release, U.S. investors increasingly have been seeking opportunities to invest in a wide range of securities, including the securities of foreign issuers, and foreign issuers have been seeking opportunities to raise capital and effect equity-based acquisitions in the U.S. using their securities as the ''acquisition currency.'' The Commission has responded to these trends by seeking to facilitate the ability of foreign issuers to access U.S. investors through listings and offerings in the U.S. capital markets. We have long recognized the importance of the globalization of the securities markets both for investors who desire increased diversification and international companies that seek capital in new markets.

Section 10A(m) of the Exchange Act makes no distinction between domestic and foreign issuers. With the growing globalization of the capital markets, the importance of maintaining effective oversight over the financial reporting process is relevant for listed securities of any issuer, regardless of its domicile. Many foreign private issuers already maintain audit committees, and the global trend appears to be toward establishing audit committees.[146] Thus, as proposed, the Commission's direction to the SROs will apply to listings by foreign private issuers as well as domestic issuers.

However, as discussed in the Proposing Release, we are aware that the requirements may conflict with legal requirements, corporate governance standards and the methods for providing auditor oversight in the home jurisdictions of some foreign issuers. Even before we published the Proposing Release, several foreign issuers and their representatives had expressed concerns about the possible application of Exchange Act section 10A(m).[147] The Proposing Release prompted many thoughtful comments from dozens of foreign private issuers and their representatives from around the world. These commenters expressed overwhelming support for the Commission's approach of providing tailored exemptions and guidance where the requirements of Exchange Act section 10A(m) could result in a direct conflict with home country requirements. In our final rules, we have attempted to address commenters' concerns regarding the specific areas in which foreign corporate governance arrangements differ significantly from general practices among U.S. corporations. In addition to the clarifications discussed in section II.B., we discuss these matters below.

i. Employee Representation

We understand that some countries, such as Germany, require that non-management employees, who would not be viewed as ''independent'' under the requirements, serve on the supervisory board or audit committee.[148] Having such employees serve on the board or audit committee can provide an independent check on management, which itself is one of the purposes of the independence requirements under the Sarbanes-Oxley Act. Accordingly, we are adopting as proposed a limited exemption from the independence requirements to address this concern, so long as the employees are not executive officers, as defined by Exchange Act rule 3b–7.[149]

Commenters expressed support for this exemption.[150] Some commenters, however, recommended extending the exemption to include also non-executive employees that serve on the supervisory board or audit committee as a result of an issuer's governing law or documents or an employee collective bargaining or similar agreement. Under the final rule, non-executive employees can sit on the audit committee of a foreign private issuer if the employee is elected or named to the board of directors or audit committee of the foreign private issuer pursuant to the issuer's governing law or documents, an employee collective bargaining or similar agreement or other home country legal or listing requirements.

ii. Two-Tier Board Systems

Some foreign private issuers have a two-tier board system, with one tier designated as the management board and the other tier designated as the supervisory or non-management board. In this circumstance, we believe that the supervisory or non-management board is the body within the company best equipped to comply with the requirements. Our final rule clarifies that in the case of foreign private issuers with two-tier board systems, the term ''board of directors'' means the supervisory or non-management board for purposes of Exchange Act rule 10A–3. As such, the supervisory or non-management board can either form a separate audit committee or, if the entire supervisory or non-management board is independent within the provisions and exceptions of the rule, the entire board can be designated as the audit committee.[151] Commenters supported this clarification.[152]

iii. Controlling Shareholder Representation

Controlling shareholders or shareholder groups are more prevalent among foreign issuers than in the U.S., and those controlling shareholders have traditionally played a more prominent role in corporate governance. In jurisdictions providing for audit committees, representation of controlling shareholders on these committees is common. As proposed, we believe that a limited exception from the independence requirements can accommodate this practice without undercutting the fundamental purposes of the rule. We proposed that one member of the audit committee can be a shareholder, or representative of a shareholder or group, owning more than 50% of the voting securities of a foreign private issuer, if the ''no compensation'' prong of the independence requirements is satisfied, the member in question has only observer status on, and is not a voting member or the chair of, the audit committee, and the member in question is not an executive officer of the issuer.

Several commenters requested that the exemption be extended. Some believed the 50% ownership threshold was too high, arguing that a shareholder can exercise control through lower levels of ownership or through non-

[146] *See*, for example, ''Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor's Independence,'' Statement of the IOSCO Technical Committee (Oct. 2002) (available at *http://www.iosco.org*); Egon Zehnder International, Board of Directors Global Study (2000) (available at *http://www.zehnder.com*); and KPMG LLP, Corporate Governance in Europe: KPMG Survey 2001/2002 (2002) (available at *http://www.kpmg.com*).

[147] *See, e.g.*, Petition for Rulemaking submitted by the Organization for International Investment, File No. 4–462 (Aug. 19, 2002).

[148] *See, e.g.*, Co-Determination Act of 1976 (Mitbestimmungsgesetz). The exemptions provided in the final rule are available to any foreign private issuer that meets their individual requirements. Examples provided in this release are meant to be for illustrative purposes only.

[149] Exchange Act rule 3b–7 [17 CFR 240.3b–7] defines the term ''executive officer'' as an issuer's president, any vice president of the registrant in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function or any other person who performs similar policy-making functions for the registrant. Executive officers of subsidiaries may be deemed executive officers of the issuer if they perform such policy-making functions for the issuer.

[150] *See, e.g.*, the Letters of Allianz AG; Deutsches Aktieninstitut; German CFOs; NYSE; Alexander Schaub; Telekom Austria AG.

[151] *See* note above and the accompanying text.

[152] *See, e.g.*, the Letters of AFL–CIO; CalPERS; Deutsches Aktieninstitut; FEE.

ownership means.[153] Others requested the ability to have more than one representative if there is more than one controlling shareholder.[154] A few objected to the observer-only status provided by the proposed exemption.[155]

In response to commenters' concerns, we are making minor modifications to the exemption. We are expanding the types of controlling persons covered by the exemption, but we continue to believe that it is appropriate that such representatives have only observer status on, and not be a voting member or chair of, the audit committee. Under the final rule, an audit committee member can be a representative of an affiliate of the foreign private issuer, if the ''no compensation'' prong of the independence requirements is satisfied, the member in question has only observer status on, and is not a voting member or the chair of, the audit committee, and the member in question is not an executive officer of the issuer. As revised, this limited exception is designed to address foreign practices, assure independent membership and an independent chair of the audit committee and still exclude management from the committee. As the exemption is designed to provide only a limited accommodation for the practices of some foreign private issuers, we are not extending the exemption to domestic issuers, as requested by some commenters.[156]

iv. Foreign Government Representation

Foreign governments may have significant shareholdings in some foreign private issuers or may own special shares that entitle the government to exercise certain rights relating to these issuers. However, due to their shareholdings or other rights, these representatives may not be considered independent under the final rule. To address foreign practices, we believe that foreign governmental representatives should be permitted to sit on audit committees of foreign private issuers. Commenters supported our proposal to exempt one member of the audit committee that is foreign government representative, provided the ''no compensation'' prong of the independence requirements is met and the member in question is not an executive officer of the issuer.[157] As with the exemption for controlling shareholder representatives, this limited exception is designed to address foreign practices and still exclude management from the committee. However, some believed the exemption should not be limited to just one foreign government representative if the representatives are otherwise independent and are not executive officers of the issuer. Under the final rule, any audit committee member can be a representative of a foreign government or foreign governmental entity, if the ''no compensation'' prong of the independence requirement is satisfied and the member in question is not an executive officer of the issuer.

We recognize that foreign governments may have varying arrangements relating to their state holdings. Some governments may hold shares directly, some through various branches or agencies, some through an institution organized under public law, and some by other entities. Several commenters believed the legal form of the entity that holds the governmental shareholdings should not be determinative.[158] We agree. The exemption applies regardless of the manner in which the foreign government owns its interest.

v. Listed Issuers That Are Foreign Governments

Several commenters also requested a specific exemption for listed issuers that are themselves foreign governments, as these issuers most likely would not be able to comply with the requirements. Accordingly, we are exempting in the final rule listed issuers that are foreign governments, as defined in Exchange Act rule 3b–4(a).[159]

vi. Boards of Auditors or Similar Bodies

While as noted above there is a continuing trend toward having audit committees in foreign jurisdictions, several foreign jurisdictions require or provide for auditor oversight through a board of auditors or similar body, or groups of statutory auditors, that are in whole or in part separate from the board of directors.[160] We believe that these boards of auditors or statutory auditors are intended to be independent of management, although their members may not in all cases meet all of the independence requirements set forth in section 10A(m) of the Exchange Act. In addition, while these bodies provide independent oversight of outside auditors, they may not have all of the responsibilities set forth in rule 10A–3. The establishment of an audit committee in addition to these bodies, with duplicative functions, might not only be costly and inefficient, but it also could generate possible conflicts of powers and duties. Accordingly, we proposed an exemption from certain of the requirements for audit committees for boards of auditors or statutory auditors of foreign private issuers that fulfilled the remaining requirements of the rule, if those boards operate under legal or listing provisions intended to provide oversight of outside auditors that is independent of management, membership on the board excludes executive officers of the issuer and certain other requirements were met.

Commenters expressed strong support for the exemption as an appropriate response to address the potential conflicts regarding these alternative structures.[161] However, several suggested refinements to the technical wording in the proposed exemption to ensure that it properly covers the appropriate structures in various jurisdictions.[162] Also, many requested removing the proposed requirement that the issuer must be listed on a market outside the U.S., as the board of auditor requirement often is a home country

[153] *See, e.g.*, the Letters of ABA; Cleary; PwC; S&C.

[154] *See, e.g.*, the Letter of AFEP–AGREF.

[155] *See, e.g.*, the Letters of ABA; S&C.

[156] *See, e.g.*, the Letters of Cleary; Duchossois Industries, Inc.; NYSE.

[157] *See, e.g.*, the Letters of ABA; Compania Cervecerias Unidas S.A. (''CCU''); France Telecom SA.

[158] *See, e.g.*, the Letters of Davis Polk & Wardwell; Telekom Austria AG.

[159] 17 CFR 240.3b–4(a). Under that definition, the term ''foreign government'' means the government of any foreign country or of any political subdivision of a foreign country. The exemption encompasses all registrants that are eligible to register securities under Schedule B of the Securities Act.

[160] For example, under current Japanese law, we understand that large Japanese corporations must maintain a board of corporate statutory auditors, a legally separate and independent body from the corporation's board of directors that is elected by shareholders. *See, e.g.*, Law for Special Exceptions to the Commercial Code Concerning Audits, etc. of Corporations (Law No. 22, 1974, as amended). Further, we understand that effective April 1, 2003, Japanese corporations will have the option to elect either a governance system with a separate board of directors and board of corporate auditors or a system based on nominating, audit and compensation committees under the board of directors. We also understand that the Italian corporate governance regime provides for an independent board of statutory auditors (''Collegio Sindicale'') and the Brazilian corporate governance regime allows a Fiscal Council (''Conselho Fiscal''). *See, e.g.*, the Letters of Assonime; Brazilian Securities Commission. As noted previously, the examples provided in this release are for illustrative purposes only. The exemption provided in the final rule for boards of auditors or similar bodies will be available to any foreign private issuer that meets the exemption's requirements because of the issuer's home country regime.

[161] *See, e.g.*, the Letters of ABA; Assonime; Baker & McKenzie; Brazilian Securities Commission; CalPERS; Cleary; FSA; Japan Corporate Auditors Association; Japanese Ministry of Economy, Trade and Industry; Nippon Keidanren; Matsushita; Nomura Holdings, Inc; NTT DoCoMo, Inc.; NYSE; ORIX Corporation.

[162] *See, e.g.*, the Letters of ABA; Assonime; Baker & McKenzie; Brazilian Securities Commission; Cleary; ORIX Corporation; S&C.

legal requirement and not a listing requirement.[163] Others believed that the exemption as proposed would not cover the unique situations in some countries where the board of auditors or similar body consists of one or more independent members of the board of directors in addition to one or more non-board members.[164] Without a modification, these commenters believed issuers from such jurisdictions could not satisfy the exemption because of the requirement that the board of auditors must be entirely separate from the board of directors. The overwhelming majority of commenters did not believe a sunset provision for the exemption would be appropriate.[165]

Accordingly, we are making several modifications to the exemption as adopted. Under the final rule, the listing of securities of a foreign private issuer will be exempt from all of the audit committee requirements if the issuer meets the following requirements:

- The foreign private issuer has a board of auditors (or similar body), or has statutory auditors (collectively, a ''Board of Auditors''), established and selected pursuant to home country legal or listing provisions expressly requiring or permitting such a board or similar body;
- The Board of Auditors is required to be either separate from the board of directors, or composed of one or more members of the board of directors and one or more members that are not also members of the board of directors;
- The Board of Auditors are not elected by management of the issuer and no executive officer of the issuer is a member of the Board of Auditors;
- Home country legal or listing provisions set forth or provide for standards for the independence of the Board of Auditors from the issuer or the management of the issuer;
- The Board of Auditors, in accordance with any applicable home country legal or listing requirements or the issuer's governing documents, is responsible, to the extent permitted by law, for the appointment, retention and oversight of the work of any registered public accounting firm engaged (including, to the extent permitted by law, the resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the issuer; and
- The remaining requirements in the rule, such as the complaint procedures requirement, advisors requirement and funding requirement, apply to the Board of Auditors, to the extent permitted by law.

This revised formulation is designed to address the jurisdictions that provide for boards of auditors or similar structures. In all instances, the requirements described in the revised exemption are to apply consistent with home country requirements. We recognize that while these bodies are designed to provide independent oversight of outside auditors, they may not meet all of the same requirements or have all of the responsibilities set forth in Exchange Act rule 10A–3. This approach nonetheless is a preferable method of implementing the protections of the Sarbanes-Oxley Act against the backdrop of this particular category of conflicting home country governance framework.

We have eliminated the requirement that the issuer must also be listed on a market outside the U.S. Also, we are not adopting a sunset date for the exemption. Finally, despite some commenters suggestions, we have not extended the relief to foreign private issuers that have audit committees. [166]

vii. Requests for Other Foreign Exemptions

A foreign private issuer availing itself of the exemptions discussed in this section will be subject to specific disclosure requirements discussed in section II.G.1 below. Consistent with our proposal, there will be no other ability for an SRO to exempt or waive foreign issuers from the requirements. In adopting these exemptions, we recognize that some foreign jurisdictions continue to have historical structures that may conflict with maintaining audit committees meeting the requirements of section 10A(m) of the Exchange Act. We encourage foreign issuers that access the U.S. capital markets to continue to move toward internationally accepted best practices in corporate governance.[167] We also understand that corporate governance structures throughout the world will continue to evolve, and that all future conflicts cannot be anticipated at this time. Accordingly, as requested by many commenters,[168] the Commission has the authority to respond to, and will remain sensitive to, the evolving standards of corporate governance throughout the world to address any new conflicts that may arise with foreign corporate governance rules and practices that cannot be anticipated at this time.

b. Small Businesses

Section 10A(m) of the Exchange Act makes no distinction based on an issuer's size. As discussed in the Proposing Release, we think that improvements in the financial reporting process for companies of all sizes are important for promoting investor confidence in our markets. In this regard, because there have been instances of financial fraud at small companies as well as at large companies, we think that improving the effectiveness of audit committees of small and large companies is important.[169] The final rule, therefore, applies to listed issuers of all sizes as proposed.

The majority of commenters generally agreed with this approach and did not support lesser standards for smaller issuers.[170] These commenters did not believe the requirements will impose a disproportionate burden on small issuers. A few commenters, however, were concerned that smaller issuers may have particular difficulty locating qualified audit committee candidates that will meet the independence criteria, especially given the implementation period proposed by the Commission.[171] While these commenters advocated various approaches, such as an exceptional and limited circumstances exemption for smaller issuers or SRO authority to exempt individual small issuers on a case-by-case basis, most agreed that an additional initial implementation period would be appropriate for these issuers.

We recognize that because the final rule applies only to listed issuers, quantitative listing standards applicable to listed securities, such as minimum revenue, market capitalization and

[163] *See, e.g.*, the Letters of ABA, Cleary; Internet Initiative Japan, Inc.; FSA; Japanese Ministry of Economy, Trade and Industry; Nippon Keidanren; Linklaters; NYSE; S&C.

[164] *See, e.g.*, the Letters of Perusahaan Perseroan (Persero) PT Telekomunikasi Indonesia Tbk; S&C.

[165] Compare, *e.g.*, the letters of ABA; FSA; Japanese Ministry of Economy, Trade and Industry; Nippon Keidanren; Japan Corporate Auditors Association; Matsushita; Nomura Holdings, Inc; NTT DoCoMo, Inc.; NYSE; ORIX Corporation with the letters of CalPERS; PwC.

[166] *See, e.g.*, the Letters of FSA; Japanese Ministry of Economy, Trade and Industry; Nippon Keidanren; Matsushita; Nomura Holdings, Inc; PwC; ORIX Corporation; S&C.

[167] See, *e.g.*, IOSCO Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor's Independence (2002); OECD Principles of Corporate Governance (1999).

[168] *See, e.g.*, the Letters of AFEP–AGREF; Assonime; Cleary; NYSE.

[169] *See* Beasley, Carcello and Hermanson, Fraudulent Financial Reporting: 1987–1997, An Analysis of U.S. Public Companies (Mar. 1999) (study commissioned by the Committee of Sponsoring Organizations of the Treadway Commission).

[170] *See, e.g.*, the Letters of CalPERS; CBA; CSC; Deloitte; PwC.

[171] *See, e.g.*, the Letters of ABA; Amex; Nasdaq.

shareholder equity requirements, will limit the size of issuers that will be affected by the requirements.[172] However, we are sensitive to the possible implication for smaller issuers and for SROs that would like to specialize in securities of these issuers. As discussed in section II.F.1, we are providing an extended compliance period for listed issuers that are small business issuers. In addition, the modifications to several of the other exemptions in the final rule, such as the overlapping board exemption and the new issuer exemption, should provide additional flexibility to small and new issuers in meeting the requirements of the rule. Our approach of not mandating specific procedures for the auditor responsibility requirement and the complaint procedures requirement also should provide issuers flexibility in meeting these requirements.

c. Issuers of Asset-Backed Securities and Certain Other Passive Issuers

In several of our releases implementing provisions of the Sarbanes-Oxley Act,[173] we have noted the special nature of asset-backed issuers.[174] Because of the nature of these entities, such issuers are subject to substantially different reporting requirements. Most significantly, asset-backed issuers are generally not required to file the types of financial statements that other companies must file. Also, such entities typically are passive pools of assets, without a board of directors or persons acting in a similar capacity. Accordingly, we are excluding asset-backed issuers from the requirements as proposed. Commenters supported this exclusion.[175]

Several commenters advocated similar relief for additional types of securities that are issued by trusts where the trust's activities are limited to passively owning or holding (as well as administering and distributing amounts in respect of) securities, rights, collateral or other assets on behalf of or for the benefit of the holders of the listed securities.[176] For example, issuers of royalty trust securities and trust issued receipts often meet such criteria. Structures such as royalty trusts act as mere conduits though which proceeds on the underlying assets are distributed to securityholders.[177] For securities such as trust issued receipts, the receipts represent undivided beneficial ownership of the specified underlying securities that are held in the trust.[178] Because such structures are similar to asset-backed issuers in that they do not have a board of directors or comparable persons from which to form an audit committee, the same policy reasons that exempt asset-backed issuers generally apply to such structures as well.

We recognize that we cannot anticipate all of the various types of these entities that may seek a listing on a national securities exchange or national securities association. Under the final rule, SROs may exclude from Exchange Act Rule 10A–3's requirements issuers that are organized as trusts or other unincorporated associations that do not have a board of directors or persons acting in a similar capacity and whose activities are limited to passively owning or holding (as well as administering and distributing amounts in respect of) securities, rights, collateral or other assets on behalf of or for the benefit of the holders of the listed securities.

d. Investment Companies

We proposed that the rule cover closed-end investment companies and so-called ''exchange-traded funds'' (''ETFs'') structured as open-end investment companies.[179] We proposed to exclude ETFs structured as unit investment trusts (''UITs''). Two commenters argued that open-end ETFs should also be excluded from the rule.[180] The commenters stated that the rule would impose unjustified competitive burdens on open-end ETFs in relation to both open-end investment companies that are not exchange-traded and ETFs structured as UITs.

However, Exchange Act section 10A(m)(1) requires us to direct the SROs to prohibit the listing of any security of an issuer that is not in compliance with the enumerated audit committee standards. Thus, the statute is specifically addressed to issuers listed for trading on SROs, and, as a result, we believe that it would be inconsistent with the statute to exclude open-end ETFs from the rule. With regard to the exclusion for UIT ETFs, we note that UITs, like asset-backed issuers and unlike open-end ETFs, are not actively managed and do not have boards of directors from which audit committee members could be drawn.

4. Determining Compliance With Proposed Standards

Apart from the general requirement to prohibit the listing of a security not in compliance with the enumerated standards, section 10A(m) of the Exchange Act does not establish specific mechanisms for a national securities exchange or a national securities association to ensure that issuers comply with the standards on an ongoing basis. SROs are required to comply with statutory provisions and Commission rules pertaining to SROs and to enforce their own rules, including rules that govern listing requirements and affect their listed issuers.

To further the purposes of section 10A(m), we proposed that SROs, as part of their implementing rules, must require a listed issuer to notify the applicable SRO promptly after an executive officer of an issuer becomes aware of any material noncompliance by the listed issuer with the requirements.[181] The overwhelming majority of commenters supported this proposal.[182] Accordingly, the final rule includes this requirement as proposed.

We also requested comment on whether listed issuers should be required to disclose periodically to the

[172] Examples of the types of quantitative standards necessary for initial and continued listings on the NYSE, Nasdaq and AMEX are available on their respective Web sites.

[173] *See* note above.

[174] The term ''Asset-Backed Issuer'' is defined in 17 CFR 240.13a–14(g) and 240.15d–14(g).

[175] *See, e.g.,* the Letters of CSC; Deloitte; NYSE.

[176] *See, e.g.,* the Letters of ABA; Nasdaq; NYSE.

[177] For a more detailed description of royalty trusts, see Staff Accounting Bulletin No. 47. Of course, the exemption we are establishing will not extend to structures that hold, in addition to the royalty interest, an interest in the operating company that actually owns the oil and gas properties, such as structures commonly known as Canadian income trusts. In these situations, the trustee often also delegates significant management decisions to an operating company, which in turn may delegate those decisions to a manager. The operating company often has a board of directors that is appointed by both the manager and the trust unit holders. We believe such structures should be treated in a manner similar to limited partnerships.

[178] For a further description of trust issued receipts, see, for example, rule 1200 of the AMEX's listing standards, rule 1200 of the NYSE's listing standards, and HOLDRs, SEC No-Action Letter (Sep. 3, 1999) (the staff agreed not to recommend enforcement action to the Commission if, among other things, the trust did not register as an investment company under the Investment Company Act).

[179] Business development companies are covered by the final rules.

Investment companies may avail themselves of the general exemptions in Exchange Act Rule 10A–3(c) [17 CFR 240.10A–3(c)], if applicable. The independence exemptions of Exchange Act rule 10A–3(b)(1)(iv)(A)–(E) [17 CFR 240.10A–3(b)(1)(iv)(A)–(E)] will not apply to investment companies.

[180] *See* the Letters of Amex; Barclays Global Investors, N.A.

[181] We encourage the SROs to impose a similar requirement for noncompliance with other SRO listing standards that pertain to corporate governance standards apart from the audit committee requirements in Exchange Act Rule 10A–3, to the extent SROs do not already provide for such a notice requirement. Commenters also expressed strong support for such a requirement.

[182] *See, e.g.,* the Letters of Amex; CalPERS; CII; CSC; Matsushita; PwC; Transparency International-USA.

SROs whether they have been in compliance with the standards. Commenters were more mixed on this point. Several commenters supported periodic confirmation of compliance to SROs.[183] Others believed it would be redundant to require periodic confirmations in addition to notice of actual breaches, and believed it should be left to the SROs to decide whether periodic confirmations should be included as part of their compliance monitoring procedures.[184] Two national securities exchanges indicated they already require or intend to require such confirmations.[185] We are not adopting a requirement that listed issuers must provide periodic confirmations of compliance to SROs at this time. However, we recognize, as many of the commenters did, that periodic confirmations can be part of an effective overall system for monitoring compliance with listing rules.

5. Opportunity To Cure Defects

Section 10A(m)(1)(B) of the Exchange Act specifies that our rules must provide for appropriate procedures for an issuer to have an opportunity to cure any defects that would be the basis for a prohibition of the issuer's securities as a result of its failure to meet section 10A(m)'s audit committee standards, before imposition of such a prohibition. To effectuate this mandate, our final rule requires SROs to establish such procedures before they prohibit the listing of or delist any security of an issuer.[186] As discussed in the Proposing Release, we believe that existing continued listing or maintenance standards and delisting procedures of the SROs generally will suffice as procedures for an issuer to have an opportunity to cure any defects on an ongoing basis. These procedures already provide issuers with notice and opportunity for a hearing, an opportunity for an appeal and an opportunity to cure any defects before their securities are delisted.[187]

We requested comment as to whether the Commission should specify the maximum time limits for an opportunity to cure defects. Commenters were mixed on this point. Some supported having the Commission mandate specific time periods for the SROs, such as 30 days or 90 days.[188] Others did not support specific time periods, again believing that it should be left to the individual SROs to decide the appropriate time periods given the differences of each market.[189] We are not mandating specific time periods in the final rule. However, as mentioned in the Proposing Release, we expect that the rules of each SRO will provide for definite procedures and time periods for compliance to the extent they do not already do so.

Several commenters expressed concern regarding rare situations that may occur where an audit committee member ceases to be independent for reasons outside the member's reasonable control. For example, an audit committee member could be a partner in a law firm that provides no services to the listed issuer on which the member sits, but the listed issuer could acquire another company that is one of the law firm's clients. Without an opportunity to cure such a defect, the audit committee member would cease to be independent. Additional time may be necessary to cure such defects, such as ceasing the issuer's relationship with the audit committee member's firm or replacing the audit committee member. Accordingly, under our final rule, SRO implementing rules may provide that if a member of an audit committee ceases to be independent for reasons outside the member's reasonable control, that person, with notice by the issuer to the applicable national securities exchange or national securities association, may remain an audit committee member of the listed issuer until the earlier of the next annual meeting of the listed issuer or one year from the occurrence of the event that caused the member to be no longer independent.

G. Disclosure Changes Regarding Audit Committees

1. Disclosure Regarding Exemptions

Exchange Act rule 10A–3 provides for certain exemptions. Because these exemptions will distinguish certain issuers from most other listed issuers, we believe that it is important for investors to know if an issuer is availing itself of one of these exemptions. Accordingly, we are adopting as proposed a requirement that these issuers must disclose their reliance on an exemption and their assessment of whether, and if so, how, such reliance will materially adversely affect the ability of their audit committee to act independently and to satisfy the other requirements of Exchange Act rule 10A–3. Such disclosure will need to appear in, or be incorporated by reference into, annual reports filed with the Commission.[190] The disclosure also will need to appear in proxy statements or information statements of issuers subject to our proxy rules for shareholders' meetings at which elections for directors are held.

While two commenters[191] did not believe the proposed disclosure would result in meaningful disclosure to investors, and several others did not support the assessment disclosure,[192] commenters representing investors and investor groups and others uniformly believed the disclosure, including the assessment disclosure, would provide meaningful information to investors.[193] The purpose of the disclosure is not to single out particular issuers or to imply that a particular listed issuer's home country regime is somehow less effective. Instead, the disclosure is designed to provide additional transparency to investors regarding the listed issuer's audit committee arrangements and the issuer's assessment of the effectiveness of those arrangements.

We proposed that foreign private issuers availing themselves of the exemption for boards of auditors and similar structures would be required to file an exhibit to their annual reports stating that they are doing so. This exhibit would have been in addition to the disclosure required in the body of the report regarding the issuer's use of that exemption. Several commenters did not support the exhibit requirement, arguing that it would be unnecessarily

[183] *See, e.g.*, the Letters of CalPERS; CII; PwC; Transparency International-USA.

[184] *See, e.g.*, the Letters of CSC; Nasdaq.

[185] *See* the Letters of Amex; NYSE.

[186] These procedures, of course, cannot include an extended exemption or waiver of the requirements apart from those provided for in Exchange Act Rule 10A–3.

[187] *See, e.g.*, NASD rule 4800 Series and NYSE Listed Company Manual section 804.

[188] *See, e.g.*, the Letters of CalPERS; CSC; PwC.

[189] *See, e.g.*, the Letters of ABA; NYSE.

[190] This disclosure is to be included in Part III of annual reports on Form 10–K [17 CFR 249.310] and 10–KSB (through an addition to Item 401 of Regulations S–K and S–B). Consequently, companies subject to the proxy rules will be able to incorporate the required disclosure from a proxy or information statement that involves the election of directors into the annual report, if the issuer filed such proxy or information statement within 120 days after the end of the fiscal year covered by the report. See General Instruction G.(3) of Form 10–K and General Instruction E.3. of Form 10–KSB.

For foreign private issuers that file their annual reports on Form 20–F, the disclosure requirement will appear in new Item 16D.

For foreign private issuers that file their annual reports on Form 40–F, the disclosure requirement will appear in paragraph (14) to General Instruction B.

For registered investment companies, the disclosure will appear in Item 5(b) of Form N–CSR and Item 22(b)(14) of Schedule 14A.

[191] *See, e.g.*, the Letters of ABA; S&C.

[192] *See, e.g.*, the Letters of Cravath; Nippon Keidanren; Matsushita; NTT DoCoMo, Inc.

[193] *See, e.g.*, the Letters of CalPERS; CII; CSC; Deloitte; E&Y; PwC; Teachers Insurance and Annuity Association '' College Retirement Equities Fund (''TIAA–CREF''); Transparency International-USA.

redundant of the disclosure in the report.[194] To avoid imposing a duplicative requirement, we are not adopting the exhibit requirement.

We proposed to exclude unit investment trusts from the disclosure requirements relating to their use of the general exemption for UITs. As a passive investment vehicle, a UIT has no board of directors, and there is little reason why investors would expect a UIT to have an audit committee. We also proposed to exclude issuers availing themselves of the multiple listing exemption from the disclosure requirements. These issuers, or their controlling parents, will be required to comply with the audit committee requirements as a result of a separate listing. Accordingly, disclosure of the use of that exemption will not serve the purpose of highlighting for investors those issuers that are different from most other listed issuers. The majority of commenters supported these proposals, and we are adopting them.[195]

We requested comment on whether we should exclude additional issuers from the exemption disclosure requirement. Some commenters recommended excluding disclosure of additional exemptions, such as the exemptions for overlapping boards, security futures products, standardized options, securities issued by foreign governments and securities issued by Asset-Backed Issuers and similar passive issuers.[196] For overlapping boards, issuers relying on that exemption will still be required to have independent directors, so disclosure of the exemption would not serve to highlight those issuers that are different from most issuers. Regarding security futures products, standardized options, foreign governments and Asset-Backed Issuers and similar passive issuers, like UITs, there would be little reason to believe that these issuers would have audit committees. Accordingly, we also are excluding listed issuers that rely on these exemptions from the disclosure requirement.

2. Identification of the Audit Committee in Annual Reports

An issuer subject to the proxy rules of section 14 of the Exchange Act[197] is currently required to disclose in its proxy statement or information statement, if action is to be taken with respect to the election of directors, whether the issuer has a standing audit committee, the names of each committee member, the number of committee meetings held by the audit committee during the last fiscal year and the functions performed by the committee.[198] As discussed in the Proposing Release, we believe it is important for investors to be able to readily determine basic information about the composition of a listed issuer's audit committee. To foster greater availability of this basic information, we are adopting as proposed a requirement that disclosure of the members of the audit committee be included or incorporated by reference in the listed issuer's annual report.[199] Also, because 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, we also are requiring a listed issuer that has not separately designated, or has chosen not to separately designate an audit committee, to disclose that the entire board of directors is acting as the issuer's audit committee.

We are adopting as proposed similar changes for foreign private issuers that file their annual reports on Form 40–F. Foreign private issuers that file their annual reports on Form 20–F already are required to identify the members of their audit committee in their annual reports. For these listed issuers, however, we are adopting the requirement that these issuers must disclose if the entire board of directors is acting as the audit committee.[200] We also are adopting similar changes for registered management investment companies.[201]

Commenters expressed support for these changes.[202] Some commenters, however, recommended that listed issuers that are not required to provide disclosure of their reliance on one of the exemptions to the rule—such as a subsidiary relying on the multiple listing exemption, a foreign government issuer or an Asset-Backed Issuer or similar issuer—also should be excluded from the requirement to disclose whether or not they have a separate audit committee.[203] According to these commenters, because these listed issuers need not disclose they are availing themselves of the exemption to the audit committee requirements, it would be anomalous to require these same listed issuers to disclose whether or not they have an audit committee. We are persuaded by these comments. Accordingly, we are excluding such issuers from this disclosure requirement. We are not making a corresponding change to Form N–CSR for registered management investment companies. We expect that registered management investment companies would only rarely, if at all, rely on the exemptions that trigger a disclosure requirement.[204] We believe that in such an unusual case, it would nonetheless be appropriate for the investment company to disclose whether it has an audit committee.

3. Updates to Existing Audit Committee Disclosure

An issuer subject to the proxy rules is currently required to disclose additional information about its audit committee in its proxy statement or information statement, if action is to be taken with

[194] *See, e.g.*, the Letters of ABA; Cleary; NTT DoCoMo, Inc.; ORIX Corporation.

[195] Compare, *e.g.*, the Letters of ABA; CCU; General Electric Company; General Motors Corporation; General Motors Acceptance Corporation; Nasdaq; PSEG with the Letter of CalPERS.

[196] *See, e.g.*, the ABA Letter.

[197] 15 U.S.C. 78n.

[198] See Item 7(d)(1) of Schedule 14A. Identical information is required with respect to nominating and compensation committees of the board of directors.

[199] Because this information will be included in Part III of annual reports on Forms 10–K and 10–KSB, companies subject to the proxy rules will be able to incorporate the required disclosure from a proxy or information statement that involves the election of directors, where it is already required to appear, into their annual reports. Information regarding the number of meetings of the audit committee and the basic functions performed by the audit committee, as well as the information regarding nominating and compensation committees, will continue to be required only in proxy or information statements that involve the election of directors.

[200] In addition, we have added an instruction to Item 6.C. in Form 20–F that if the company is relying on the exemption in Exchange Act rule 10A–3(c)(3) because it has a board of auditors or similar body, the disclosure required by that Item with regard to the company's audit committee can be provided with respect to the company's board of auditors, or similar body.

[201] Item 22(b)(14) of Schedule 14A and Item 5 of Form N–CSR. Form N–CSR is used by registered management investment companies to file certified shareholder reports with the Commission under the Sarbanes-Oxley Act. See Investment Company Act Release No. 25914 (Jan. 27, 2003) [68 FR 5348].

[202] *See, e.g.*, the Letters of ABA; CalPERS; CSC; PwC; Transparency International-USA.

[203] *See, e.g.*, the Letters of Edison International; General Electric Company; TFC.

Unit investment trusts are not required to provide disclosure of their use of the exemption under Exchange Act rule 10A–3(c)(6)(ii). See Exchange Act rule 10A–3(d). As proposed, UITs were not subject to any requirement that they disclose whether or not they have a separate audit committee, since UITs do not file proxy or information statements where action is to be taken with respect to election of directors, or Form N–CSR, where such disclosure would be made.

[204] These exemptions include those for listing certain securities of subsidiaries of a parent whose listed securities are subject to Exchange Act rule 10A–3, security futures products, standardized options, securities issued by asset-backed issuers, foreign governments and passive issuers. Exchange Act rule 10A–3(c)(2), (4)–(7) [17 CFR 240.10A–3(c)(2), (4)–(7)].

respect to the election of directors.[205] First, the audit committee must provide a report disclosing whether the audit committee has reviewed and discussed the audited financial statements with management and discussed certain matters with the independent auditors.[206] Second, issuers must disclose whether the audit committee is governed by a charter, and if so, include a copy of the charter as an appendix to the proxy statement at least once every three years.[207] Finally, the issuer must disclose whether the members of the audit committee are independent. Under the existing requirements, issuers whose securities are listed on the NYSE or AMEX or quoted on Nasdaq must disclose whether the audit committee members are independent, as defined in the applicable listing standards.[208] These issuers also must disclose if its board of directors has determined to appoint one director to its audit committee due to an exceptional and limited circumstances exception in the applicable listing standards.[209] Issuers whose securities are not listed on the NYSE or AMEX or quoted on Nasdaq also are required to disclose whether their audit committee members are independent. These issuers may choose which definition of independence to use from any of the NYSE, AMEX or Nasdaq listing standards.[210]

Regarding the independence disclosure, all national securities exchanges and national securities associations under our final rule will need to have independence standards for audit committee members, not just the NYSE, AMEX and Nasdaq. The specification in the existing requirements to listings on these three markets is therefore no longer necessary.

Accordingly, as proposed, we are updating the disclosure requirements regarding the independence of audit committee members to reflect the new SROs rules to be adopted under Exchange Act rule 10A–3. Commenters supported these updates.[211] If the registrant is a listed issuer, it will still be required to disclose whether the members of its audit committee are independent. The listed issuer must use the definition of independence for audit committee members included in the listing standards applicable to the listed issuer. Further, because 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, we are clarifying in the rules that if the registrant does not have a separately designated audit committee, or committee performing similar functions, the registrant must provide the disclosure with respect to all members of its board of directors.

Non-listed issuers that have separately designated audit committees will still be required to disclose whether their audit committee members are independent. In determining whether a member is independent, these registrants will be allowed to choose any definition for audit committee member independence of a national securities exchange or national securities association that has been approved by the Commission.[212]

In the Proposing Release, we proposed eliminating disclosure by listed issuers of use of an exceptional and limited circumstances exception in existing SRO listing standards. We did so because our rules do not provide a similar exception to the independence requirements mandated by Exchange Act rule 10A–3. However, it is conceivable that some SROs may retain an exceptional and limited circumstances exception for SRO independence requirements apart from those in Exchange Act rule 10A–3. We are therefore retaining disclosure of the use of such an exemption for standards apart from the requirements in Exchange Act rule 10A–3. We also are eliminating the exclusion of small business issuers from this disclosure requirement, as it is conceivable that such an exception could extend to these issuers as well.

Issuers must comply with the new disclosure changes regarding use of exemptions, identification of the audit committee in annual reports and the independence disclosure updates beginning with reports covering periods ending on or after (or proxy or information statements for actions occurring on or after) the compliance date for the listing standards applicable to the particular issuer. If the issuer is not a listed-issuer, it should use the date that would apply as if it was a listed issuer. Until such dates, issuers should continue to comply with existing Items 7(d)(3)(iv) and 22(b)(14) in their proxy and information statements, if applicable.

Several commenters advocated additional disclosure regarding a board's determination of an audit committee member's independence apart from that currently required.[213] Several of the additional SRO listing standards currently under consideration by the Commission would require such disclosure by listed issuers.[214] We intend to analyze these proposals and the SRO rules implementing Exchange Act 10A–3 to determine if any additional disclosure in this area would be appropriate.

4. Audit Committee Financial Expert Disclosure for Foreign Private Issuers

In our release adopting the disclosure requirements for audit committee financial experts, we expressed our intention to revisit the disclosure requirements regarding the independence of audit committee financial experts of foreign private issuers.[215] Specifically, we noted that in conjunction with the adoption of rules implementing Exchange Act section 10A(m), we would revise the audit committee financial expert disclosure requirements that apply to foreign private issuers such that the concept of ''independence'' under the section 10A(m) rules would be consistent with the concept of ''independence'' under the audit committee financial expert disclosure requirements. Therefore, we are now adopting amendments to the audit committee financial expert disclosure provisions as they apply to foreign private issuers. If the foreign private issuer is a listed issuer, the amendments require the foreign private issuer to disclose whether its audit committee financial expert is independent, as that term is defined by the SRO listing standards applicable to that issuer.[216] If a foreign private issuer is not a listed issuer, it must choose one of the SRO definitions of audit committee member independence that have been approved by the Commission

[205] *See* Item 7(d)(3) of Schedule 14A. These disclosure requirements were adopted in Release No. 34–42266 (Dec. 22, 1999).

[206] *See* Item 7(d)(3)(i) of Schedule 14A. The requirements for the audit committee report are specified in Items 306 of Regulations S–B [17 CFR 228.306] and S–K [17 CFR 229.306]. Under the existing requirements, if the company does not have an audit committee, the board committee tasked with similar responsibilities, or the full board of directors, is responsible for the disclosure.

[207] *See* Items 7(d)(3)(ii) and (iii) of Schedule 14A.

[208] *See* Item 7(d)(3)(iv)(A)(1) of Schedule 14A.

[209] *See* Item 7(d)(3)(iv)(A)(2) of Schedule 14A.

[210] *See* Item 7(d)(3)(iv)(B) of Schedule 14A. Whichever definition is chosen must be applied consistently to all members of the audit committee.

[211] *See, e.g.*, the Letters of ABA; CalPERS; CSC; PwC.

[212] Such definition must include the requirements of Exchange Act section 10A–3. These issuers will still be required to state which definition was used. Further, the requirement that the same definition must be applied consistently to all members of the audit committee will be retained.

[213] *See, e.g.*, the Letters of AFL–CIO; AICPA; Amex; Deloitte; PwC; Transparency International-USA. However, for commenters that did not support such expanded disclosure, *see, e.g.*, the Letters of ABA; Southern Company.

[214] *See* note 27 above.

[215] *See* Release No. 33–8177 (Jan. 23, 2003).

[216] *See* revised Item 16A of Form 20–F and revised paragraph 8 to General Instruction B of Form 40–F.

in determining whether its audit committee financial expert, if it has one, is independent. It must also disclose which definition was used. Foreign private issuers need not comply with these disclosure requirements until July 31, 2005.

Also in that release, we noted our intention to address the treatment of a foreign private issuer with a board of auditors or statutory auditors under home country legal or listing provisions. Specifically, we requested comment as to whether and, if so, how foreign private issuers with boards of auditors or similar bodies or statutory auditors should comply with the audit committee financial expert disclosure requirements. We received several comments both supporting and opposing application of such disclosure requirements to issuers with such bodies. One commenter suggested that the audit committee financial expert's expertise should be related to home country generally accepted accounting principles (''GAAP''), even if the issuer's primary financial statements are filed with the Commission in conformity with U.S. GAAP. We believe that the intent of section 407 of Sarbanes-Oxley Act is to strengthen audit committee oversight of the preparation and audit of financial statements that are presented to U.S. investors, and thus we continue to believe that the audit committee financial expert's expertise should be related to the body of generally accepted accounting principles used in the issuer's primary financial statements filed with the Commission. We do, however, acknowledge the differing regulatory structures of foreign jurisdictions. Therefore, we have added a sentence to the instructions to the audit committee financial expert disclosure provisions to clarify that, for purposes of those provisions, the term ''audit committee'' means the board of auditors or similar bodies or statutory auditors, if the issuer meets the criteria specified in new rule 10A–3(c)(3).[217]

H. Application to the Commission's Auditor Independence Rules

Similar to the issues addressed by the multiple listing exception discussed in section II.F.2.a, some commenters raised an issue with respect to the audit committee pre-approval requirements contained in the Commission's auditor independence rules.[218] Those rules require that the issuer's audit committee pre-approve audit and non-audit services provided to the issuer and its consolidated subsidiaries [219] by the independent accountant. However, to the extent that a consolidated entity contains more than one issuer, some have indicated that it is not clear whether the parent company audit committee's pre-approval of the services to be provided by the independent accountant would satisfy the pre-approval requirements for the separately-issued financial statements of a subsidiary which also is an issuer.[220]

The Commission believes that the audit committee of the parent company that controls another entity within the consolidated group can perform the pre-approval function for the parent company and any consolidated subsidiaries both with respect to the consolidated financial statements and with respect to the financial statements of any consolidated subsidiary that also is an issuer. However, the Commission also understands that there may be instances where such entities have their own audit committees. In those situations, we would not expect that both audit committees be responsible for pre-approving the services that are provided by the auditor. Rather, the relevant facts and circumstances surrounding the engagement or relationship should be evaluated to determine which audit committee is in the best position to review the impact of the service on the auditor's independence.

As noted at the beginning of section II, the definition of the term ''audit committee'' in Exchange Act section 3(a)(58) provides that an issuer either may have a separately designated audit committee composed of members of its board, or if it chooses to do so or if it fails to form a separate committee, the entire board of directors will constitute the audit committee.[221] Moreover, as discussed in section II.F.3.a.vi, certain foreign jurisdictions permit many of the functions normally performed by audit committees to be performed by a board of auditors or similar body which is separate in whole or in part from the issuer's board of directors.

In either of these situations, commenters have asked how issuers should comply with the audit committee pre-approval requirements established by the Commission in its rules on auditor independence. While the Commission's rules on auditor independence require that the audit committee pre-approve audit and non-audit services provided by the independent accountant, those rules do not require that companies establish separately-designated audit committees. If an issuer chooses to do so or fails to form a separate committee, the entire board of directors will constitute the audit committee and may perform the pre-approval function for the issuer.[222] Furthermore, consistent with the intent of Exchange Act rule 10A–3(c)(3), in situations where the issuer has a board of auditors or similar body as allowed by law or listing requirements of that jurisdiction, such board or body may perform the audit committee pre-approval function required by the Commission's rules on auditor independence.

The Commission also reminds registrants and their auditors that the Commission's rules require that auditors communicate certain information to the audit committee.[223] The same body responsible for pre-approval of audit and non-audit services also should be the body to whom these required communications are made by the issuer's auditor.

III. Paperwork Reduction Act

A. Background

The amendments described in this document contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995 (''PRA'').[224] We published a notice requesting comment on the collection of information requirements in the Proposing Release, and we submitted these requirements to the Office of Management and Budget (''OMB'') for review in accordance with the PRA.[225] As discussed in Part II

[217] *See* revised Instruction 3 to Item 401(h) of Regulation S–K and revised Instruction 3 to Item 16A of Form 20–F.

[218] *See* Release No. 33–8183 (Jan. 28, 2003).

[219] In accordance with the Commission's rules on auditor independence, the issuer's audit committee is required to pre-approve audit and non-audit services for the issuer and all of its consolidated subsidiaries whether those subsidiaries are separate issuers or not.

[220] For example, some entities may be issuers as a result of registered debt outstanding.

[221] *See* note above and the accompanying text.

[222] However, as previously discussed, if the issuer is a listed issuer and its entire board constitutes the audit committee, the new SRO rules adopted under Exchange Act Rule 10A–3, including the independence requirements, will apply to the issuer's board as a whole. See note 34 above and the accompanying text.

[223] Auditors are required to communicate the following information to the issuer's audit committee: (1) All critical accounting policies and practices used by the issuer, (2) all alternative accounting treatments of financial information within GAAP related to material items that have been discussed with management, including the ramifications of the use of such alternative treatments and disclosures and the treatment preferred by the accounting firm, and (3) other material written communications between the accounting firm and management of the issuer. See Rule 2–07 of Regulation S–X [17 CFR 210.2–07].

[224] 44 U.S.C. 3501 *et seq.*

[225] 44 U.S.C. 3507(d) and 5 CFR 1320.11.

above, we received several comment letters on the proposals. We have made several changes to the proposals in response to these comments which will reduce the incremental burden associated with the final rule and rule amendments. Accordingly, we are revising our previous burden estimates.

The titles for the collections of information are:

(1) ''Proxy Statements—Regulation 14A (Commission Rules 14a–1 through 14a–15 and Schedule 14A)'' (OMB Control No. 3235–0059);

(2) ''Information Statements—Regulation 14C (Commission Rules 14c–1 through 14c–7 and Schedule 14C)'' (OMB Control No. 3235–0057);

(3) ''Form 10–K'' (OMB Control No. 3235–0063);

(4) ''Form 10–KSB'' (OMB Control No. 3235–0420);

(5) ''Form 20–F'' (OMB Control No. 3235–0288);

(6) ''Form 40–F'' (OMB Control No. 3235–0381);

(7) ''Regulation S–K'' (OMB Control No. 3235–0071);

(8) ''Regulation S–B'' (OMB Control No. 3235–0417); and

(9) ''Form N–CSR'' (OMB Control No. 3235–0570).

These regulations and forms were adopted pursuant to the Securities Act, the Exchange Act and the Investment Company Act and set forth the disclosure requirements for periodic reports, registration statements and proxy and information statements filed by companies to ensure that investors are informed. The hours and costs associated with preparing, filing and sending these forms constitute reporting and cost burdens imposed by each collection of information. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

B. Summary of Amendments

Under our amendments, we would direct SROs to prohibit the listing of any security of an issuer that is not in compliance with several enumerated standards relating to the issuer's audit committee. We are making these changes pursuant to the legislative mandate in section 10A(m) of the Exchange Act, as added by section 301 of the Sarbanes-Oxley Act. As part of our amendments, we are adopting several limited exemptions from the requirements to address the special circumstances of particular issuers. If an issuer were to avail itself of one of these exemptions, it would need to disclose this fact and its assessment of whether, and if so, how, such reliance will materially adversely affect the ability of the audit committee to act independently and to satisfy the other requirements of the final rule. Such disclosure will need to appear in its proxy or information statement for shareholders' meetings at which elections for directors are held. The disclosure also will need to appear in, or be incorporated by reference into, the annual reports of these companies filed with the Commission. We are excluding issuers from these disclosure requirements for reliance on certain exemptions, such as the overlapping board exemption, the multiple listing exemption and the exemption for exchange-traded UITs, foreign government issuers and Asset-Backed Issuers and similar issuers. Collectively, we call these changes the ''Exemption Disclosure.''

Under our amendments, listed issuers also will be required to disclose the names of the members of their audit committee, or that their entire board of directors is acting as their audit committee, in their annual reports. Listed issuers that will be excluded from the Exemption Disclosure will also be excluded from this disclosure, except for issuers relying on the overlapping board exemption. We call these changes the ''Identification Disclosure.''

Finally, we are adopting several updates to existing disclosure requirements regarding audit committees to reflect our amendments and changes made by the Sarbanes-Oxley Act. We call these changes the ''Disclosure Updates.''

These disclosure changes are designed to alert investors of basic information about an issuer's audit committee, including the identity of the issuer's audit committee, whether the issuer is availing itself of an exemption and whether the members of the audit committee are independent. Compliance with the revised disclosure requirements is mandatory. There will be no mandatory retention period for the information disclosed, and responses to the disclosure requirements will not be kept confidential. We do not believe that the imposition of these disclosure changes will alter significantly the number of respondents that file on the affected forms.

In addition to the above, our final rule adopts, as proposed, a requirement that SROs must require a listed issuer to notify the applicable SRO promptly after an executive officer of an issuer becomes aware of any material noncompliance by the listed issuer with the proposed requirements. We believe that any burden imposed by this collection of information will be minimal. For the most part, we believe that listed issuers are already required to make the type of disclosure contemplated by this requirement, either pursuant to existing SRO rules or as a requirement of existing listing agreements. We therefore believe that any reporting and recordkeeping requirements imposed by this aspect of the requirements are ''usual and customary'' activities for listed issuers.[226]

C. Summary of Comment Letters and Revisions to Proposals

We requested comment on the PRA analysis contained in the Proposing Release. We received no comments in response to this request. While we have adopted the disclosure amendments substantially as proposed, some of the changes we have made in the final rules will reduce the number of listed issuers that will be required to make the required disclosure. For example, we have excluded additional issuers from the Exemption Disclosure. These changes will reduce the burden on these registrants. Accordingly, we are revising our PRA reporting and cost burden estimates.

D. Revisions to PRA Reporting and Cost Burden Estimates

As a result of the changes described above, the reporting and cost burden estimates for the collections of information have changed. For purposes of the PRA, we now estimate that the annual incremental paperwork burden for all companies to prepare the disclosure that will be required under our amendments will be approximately 401 hours of personnel time and a cost of approximately $62,400 for the services of outside professionals. We derived these estimates first by estimating the total amount of time it will take for a company to prepare the required disclosure. The Disclosure Updates simply update the disclosure requirements to reflect our amendments and changes to terminology made by the Sarbanes-Oxley Act. We do not believe these changes will change the burden required by this disclosure. The Exemption Disclosure will require only a minimal additional statement by issuers that avail themselves of one of the exemptions in Exchange Act rule 10A–3. We estimated that the Exemption Disclosure will add 0.25 hours per affected filing. The Identification Disclosure will require a company to disclose either the members

[226] *See* 5 CFR 1320.3(b)(2).

of its audit committee, or a brief statement that the board of directors of the issuer is acting as the audit committee. We estimated that the Identification Disclosure will add 0.25 hours per affected filing.

The Exemption Disclosure and Identification Disclosure apply only to listed issuers. Accordingly, not all issuers will be required to make the disclosure. We estimate that there are approximately 7,250 issuers that are listed on a national securities exchange or traded on the Nasdaq National Market or the Nasdaq Smallcap Market.[227] Each of these listed issuers, except for certain issuers relying on exemptions, will be required to at least provide the basic Identification Disclosure in their annual report. Some of these listed issuers also will need to make the Exemption Disclosure.[228] We have increased the number of issuers that will not need to make the Exemption Disclosure.

Further, since the disclosure in the annual report may be incorporated by reference from an issuer's proxy or information statement, we assume that the disclosure will appear in a maximum of one report per affected issuer. As the information will appear in part III of an issuer's Form 10–K or 10–KSB (which can be incorporated by reference from the issuer's proxy statement if directors are to be elected), or in item 5 of Form N–CSR, which may also be incorporated by reference, we assume that affected issuers will follow the general practice of most issuers of including the disclosure in their proxy or information statement where directors are elected and incorporating by reference the disclosure into their annual report. Accordingly, we reduced the number of affected reports on Forms 10–K, 10–KSB and N–CSR to account for this assumption.[229] Further, we assume that the Identification Disclosure is already provided in these proxy or information statements,[230] and the burden hours for this disclosure by these filers therefore has already been assigned to Schedules 14A and 14C. Accordingly, we estimated that the Identification Disclosure will not affect the burden for Schedules 14A and 14C.

The tables below illustrate the revised incremental annual compliance burdens of the collections of information in hours and in cost for annual reports and proxy and information statements under the Exchange Act. The burden was calculated by multiplying the estimated number of affected responses by the estimated average number of hours each entity spends preparing the disclosure. We have based our estimates of the number of affected responses on the actual number of filers during the 2002 fiscal year and our estimates of the number of listed issuers that may be affected by the disclosure changes.[231] For Exchange Act annual reports and proxy and information statements, we estimate that 75% of the burden of preparation is carried by the company internally and that 25% of the burden of preparation is carried by outside professionals retained by the company at an average cost of $300 per hour.[232] The portion of the burden carried by outside professionals is reflected as a cost, while the portion of the burden carried by the company internally is reflected in hours.

CALCULATION OF THE INCREMENTAL BURDEN OF THE EXEMPTION DISCLOSURE [233]

	Affected responses (A)	Incremental hours/form (B)	Total incremental burden (C)=(A)×(B)	75% company (D)=(C)×0.75	25% professional (E)=(C)×0.25	$300 professional cost (F)=(E)×300
20–F	292 [234]	0.25	73	18	55	$16,500.00
40–F	7 [235]	0.25	2	1	2	$600.00
10–K	54 [236]	0.25	14	11	4	$1,200.00
10–KSB	22 [237]	0.25	6	5	2	$600.00
14A	271 [238]	0.25	68	51	17	$5,100.00
14C	17 [239]	0.25	4	3	1	$300.00
Total			167	89	81	$24,300.00

CALCULATION OF THE INCREMENTAL BURDEN OF THE IDENTIFICATION DISCLOSURE

	Affected responses (A)	Incremental hours/form (B)	Total incremental burden (C)=(A)×(B)	75% company (D)=(C)×0.75	25% professional (E)=(C)×0.25	$300 professional cost (F)=(E)×300
20–F	0 [240]	0.25	0	0	0	$0.00
40–F	134 [241]	0.25	34	9	26	$7,800.00
10–K	1,073 [242]	0.25	268	201	67	$20,100.00
10–KSB	430 [243]	0.25	108	81	27	$8,100.00
N–CSR	113 [244]	0.25	28	21	7	$2,100.00

[227] We derived this estimate from 2002 data from the Standard & Poors Research Insight Compustat Database and the Commission's 2001 annual report.

[228] With respect to investment companies, the independence exemptions will not be available. A general exemption will be applicable to UITs, but UITs are excluded from Exemption Disclosure requirements. We anticipate that only a negligible number of investment companies will fall under the other general exemptions. Accordingly, we anticipate that the reporting burden imposed by the Exemption Disclosure requirements on listed investment companies will be negligible.

[229] Foreign private issuers are exempt from the requirements to provide proxy materials, so we assume no adjustment to the number of affected annual reports on Forms 20–F and 40–F.

[230] *See* Item 7(d)(1) of Schedule 14A.

[231] We estimate that 5% of listed issuers will be required to provide disclosure regarding the new issuer exemption in Exchange Act Rule 10A–3(b)(iv)(A). This is based on a weighted average of the number of listed companies that went public over the last three years.

[232] This allocation of the burden is consistent with our recent PRA submissions for Exchange Act periodic reports and proxy and information statements. See, *e.g.*, Release No. 33–8144 (Nov. 4, 2002). Traditionally, we have estimated that the company carried 25% of the burden internally and 75% of the burden of preparation was carried by outside professionals retained by the company. We believe that the new allocation more accurately reflects current practice for annual reports and proxy and information statements. We estimate, however, that the traditional 25% company and 75% outside professional allocation remains applicable for Forms 20–F and 40–F because those forms are prepared by foreign private issuers who rely more heavily on outside counsel for their preparation.

CALCULATION OF THE INCREMENTAL BURDEN OF THE IDENTIFICATION DISCLOSURE—Continued

	Affected responses	Incremental hours/form	Total incremental burden	75% company	25% professional	$300 professional cost
	(A)	(B)	(C)=(A)×(B)	(D)=(C)×0.75	(E)=(C)×0.25	(F)=(E)×300
14A	0[245]	0.25	0	0	0	$0.00
14C	0[246]	0.25	0	0	0	$0.00
Total	.....	.....	438	312	127	$38,100.00

Regulation S–K includes the requirements that a registrant must provide in filings under both the Securities Act and the Exchange Act. Regulation S–B includes the requirements that a small business issuer must provide in filings under the Securities Act and the Exchange Act. The disclosure changes will include changes to items under Regulation S–K and Regulation S–B. However, the filing requirements themselves are included in Form 10–K, Form 10–KSB, Form 20–F, Form 40–F, Schedule 14A and Schedule 14C. We have reflected the burden for the new requirements in the burden estimates for those firms. The items in Regulation S–K and Regulation S–B do not impose any separate burden. We previously have assigned one burden hour each to Regulations S–B and S–K for administrative convenience to reflect the fact that these regulations do not impose any direct burden on companies.

IV. Cost-Benefit Analysis

The amendments represent the implementation of a Congressional mandate. We recognize that implementation of the Sarbanes-Oxley Act will likely create costs and benefits to the economy. We are sensitive to the costs and benefits imposed by our rules, and we have identified certain costs and benefits of our amendments.

A. Background

Section 10A(m)(1) of the Exchange Act, as added by section 301 of the Sarbanes-Oxley Act, requires us to direct, by rule, the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with several enumerated standards regarding issuer audit committees. The new rule must become effective by April 26, 2003, which is 270 days after the date of enactment of the Sarbanes-Oxley Act and section 10A(m) of the Exchange Act.

In general, according to the standards listed in section 10A(m) of the Exchange Act, SROs will be prohibited from listing any security of an issuer that is not in compliance with the following standards:

- Each member of the audit committee of the issuer must be independent according to specified criteria;
- The audit committee of each issuer must be directly responsible for the appointment, compensation, retention and oversight of the work of any registered public accounting firm engaged for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the listed issuer, and each such registered public accounting firm must report directly to the audit committee;
- Each audit committee must 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 by employees of the issuer of concerns regarding questionable accounting or auditing matters;
- Each audit committee must have the authority to engage independent counsel and other advisors, as it determines necessary to carry out its duties; and
- Each issuer must provide appropriate funding for the audit committee.

The amendments described in this document respond directly to the requirements in section 10A(m) of the Exchange Act. In addition, our amendments include several additional provisions, such as:

- Revising existing disclosure requirements regarding the composition of audit committees by also requiring this disclosure in annual reports of listed issuers filed with the Commission;
- Requiring a company availing itself of one of the exemptions from the requirements to disclose that it is doing so;
- Updating existing disclosure requirements regarding audit committees to reflect changes made by the amendments and the Sarbanes-Oxley Act; and
- Revising the disclosure requirements regarding the independence of audit committee financial experts for foreign private issuers.

B. Benefits

One of the main goals of the Sarbanes-Oxley Act is to improve investor confidence in the financial markets. The amendments in this document are among many required by the Sarbanes-

[233] For convenience, the estimated PRA hour burdens have been rounded to the nearest whole number, and the estimated PRA cost burdens have been rounded to the nearest $100. As a result of rounding, the sum of the entries in columns (D) and (E) of the tables may not exactly equal the corresponding entry in column (C).

[234] This figure is based on our estimate of the total number of affected responses by listed issuers.

[235] This figure is based on our estimate of the total number of affected responses by listed issuers.

[236] This figure is based on our estimate of the total number of affected responses by listed issuers, as adjusted for the number of responses where Part III information would be incorporated by reference from a proxy or information statement.

[237] This figure is based on our estimate of the total number of affected responses by listed issuers, as adjusted for the number of responses where Part III information would be incorporated by reference from a proxy or information statement.

[238] This figure is based on our estimate of the total number of affected responses by listed issuers.

[239] This figure is based on our estimate of the total number of affected responses by listed issuers.

[240] Issuers that file their annual report on Form 20–F are already required to identify the members of their audit committee.

[241] This figure is based on our estimate of the total number of affected responses by listed issuers.

[242] This figure is based on our estimate of the total number of affected responses by listed issuers, as adjusted for the number of responses where Part III information would be incorporated by reference from a proxy or information statement.

[243] This figure is based on our estimate of the total number of affected responses by listed issuers, as adjusted for the number of responses where Part III information would be incorporated by reference from a proxy or information statement.

[244] This figure is based on our estimate of the total number of affected responses by listed issuers, as adjusted for the number of responses where Item 5 information would be incorporated by reference from a proxy or information statement.

[245] We estimate that proxy statements on Schedule 14A are already required to identify the members of their audit committee.

[246] We estimate that information statements on Schedule 14C are already required to identify the members of their audit committee.

Oxley Act.[247] They seek to help achieve the Act's goals by promoting strong, effective audit committees to perform their oversight role. By increasing the competence of audit committees, the amendments are designed to further greater accountability and to improve the quality of financial disclosure and oversight of the process by qualified and independent audit committees. Vigilant and informed oversight by a strong, effective and independent audit committee could help to counterbalance pressures to misreport results and 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 imply increased market efficiency due to improved information and investor confidence in the reliability of a company's financial disclosure and system of internal controls. These benefits are not readily quantifiable. Commenters overwhelmingly supported the benefits of the amendments and the importance of audit committees to the financial reporting process. Further, as the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees summarized regarding its own recommendations for audit committees:

> Improving oversight of the financial reporting process necessarily involves the imposition of certain burdens and costs on public companies. Despite these costs, the Committee believes that a more transparent and reliable financial reporting process ultimately results in a more efficient allocation of and lower cost of capital. To the extent that instances of outright fraud, as well as other practices that result in lower quality financial reporting, are reduced with improved oversight, the benefits clearly justify these expenditures of resources.[248]

In addition, we are requiring basic information about the composition of an issuer's audit committee in a listed issuer's annual report. The disclosure is currently only required in proxy or information statements where directors are being elected, and not all listed issuers are subject to the proxy rules or elect directors each year. Also, because 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, we are requiring a listed issuer that has not or has chosen not to separately designate an audit committee to disclose that the entire board of directors is acting as the issuer's audit committee. Also, if a company relies on one of the exemptions to the requirements, some minimal additional disclosure will be required. In our final rules, we are excluding certain issuers from these disclosure requirements to reduce overall burdens consistent with investor protection. We also are making several updates to existing disclosure requirements regarding audit committees and audit committee financial experts to reflect the final rule and changes made by the Sarbanes-Oxley Act.

As a result of these disclosure changes, investors will receive more detailed information on a consistent basis about the basic composition of an issuer's audit committee. These disclosures will afford investors greater visibility about the issuer's audit committee. Providing this information on a more widespread basis also may allow investors to ask more direct and useful questions of management and directors regarding the composition and role of the audit committee. The overwhelming majority of commenters, including many representing investor groups, expressed strong support for the changes, believing they provide important information for investors.

C. Costs

SROs not in compliance with the standards will need to spend additional time and incur additional costs in modifying their rules to comply. There also may be ongoing costs in monitoring compliance with the standards and taking appropriate remedial steps. If the standards have the effect of causing companies to delist or forego listing of their securities, SROs will lose trading volume. The standards could have the effect of discouraging the formation of trading markets that specialize in particular types of issuers (*i.e.*, small issuers or foreign issuers), if those issuers found the requirements too burdensome to seek a listing on those markets. The possibility of these effects and their magnitude if they were to occur are difficult to quantify.

Issuers will need to comply with the audit committee standards if they wish to have their securities listed on a national securities exchange or national securities association. This may require one-time costs by companies to spend additional time and incur additional costs in establishing or modifying their audit committees (or full boards if they do not have a separate audit committee) to comply with the standards. There may be search costs involved in locating independent directors willing to serve on a company's audit committee, including the costs of preparing proxy statements and holding shareholder meetings to elect those directors. If the requirements reduce the pool of candidates that will be willing to serve on an issuer's audit committee, these search costs may increase. Convincing directors to serve on an audit committee may require additional compensation or increased liability insurance coverage due to the new requirements imposed on audit committees. Companies may decide to increase the size of their boards to accommodate new directors meeting the new requirements. If additional independent directors were added to the board, or if existing non-independent directors are replaced, this may increase the percentage of the board that is independent from management. If a company had previously received services from an audit committee member of the type that will be prohibited under the final rule, the company may incur costs in locating an alternative provider for these services.

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 incurs expenses or engages independent counsel or other advisors where it could not do so previously, there will be additional costs for the payment for such expenses and advisors. Companies also may incur additional ongoing expenses if they decide to increase the size of their boards in response to the requirements. In addition, the incremental cost of future director searches to replace an audit committee member may likely be higher as a result of the additional independence requirements.

We believe that as a result of many current SRO listing standards,[249] the Commission's audit committee disclosure requirements adopted in 1999,[250] the prior disclosures related to the involvement of the audit committee in recommending or approving changes in auditors and the resolution of disagreements between management and the auditors,[251] and professional standards that require communications between the auditor and audit committees on auditor independence issues,[252] many companies currently

[247] *See* note above.

[248] See note above.

[249] *See* note 24 above.

[250] *See* note 25 above.

[251] *See, e.g.*, Item 4 of Form 8–K [17 CFR 249.308] and Item 304 of Regulation S–K [17 CFR 229.304].

[252] *See, e.g.*, AICPA, ''Communications with Audit Committees,'' Statements of Auditing Standards (''SAS'') 61, as amended by SAS 89 and

Continued

have audit committees. However, these audit committees may not meet all of the requirements of the final rule. Smaller companies may constitute a larger representative share of issuers that do not meet the requirements, particularly the independence requirements. However, we recognize that because the requirements 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. Nevertheless, we are providing an additional transition period for smaller issuers to alleviate some of the potential burdens they may face. We are also providing an additional transition period for foreign issuers. Companies that do not currently meet the requirements will face all of the costs described above. However, these entities, because they currently lack the protections provided by the standards, may bear a disproportionately greater risk of fraudulent financial reporting, and thus may reap proportionately greater benefits.

We also are adopting limited exemptions to the requirements, such as an exemption for multiple listings, a limited exemption for new public companies and exemptions for certain foreign issuers, to alleviate some of the burdens companies may face where consistent with investor protection. Commenters expressed overwhelming support for these exemptions which will alleviate unnecessary costs and burdens companies may face without any attendant loss in investor protection. Companies that perceive the requirements as too onerous could be dissuaded from seeking or maintaining a listing for their securities, which could impact capital formation and negatively impact the transparency and liquidity of its securities.

We requested comment on the type, amount and duration of these costs. We received no specific data in response to our request. We have no reliable basis for estimating the actual number of companies that will face increased costs as a result of Exchange Act Section 10A(m) or the amount of such costs.

With respect to the disclosure changes regarding audit committees, issuers subject to the proxy rules are already required to compile most of this information for proxy or information statements where directors are being elected. Foreign private issuers that file their annual reports on Form 20-F also are already required to identify the members of their audit committee. The disclosure regarding if a listed issuer is availing itself of an exemption to the requirements should result in minimal additional disclosure. Using estimates derived from our Paperwork Reduction Act analysis, we estimated that the incremental impact of our disclosure changes will result in a total cost of $112,525 for all affected companies.[253]

In formulating the final amendments, we considered several regulatory alternatives that would be consistent with the specific mandate required by section 10A(m) of the Exchange Act. For example, we considered the propriety of excluding all foreign issuers, issuers of a particular size or additional classes of securities, but we determined that such an exclusion would not be appropriate or consistent with the policies underlying the Sarbanes-Oxley Act. The overwhelming majority of commenters agreed with this approach. We think that improvements in the financial reporting process for all listed issuers are important for promoting investor confidence in our markets.

We also considered whether we should provide objective guidance for determining who is an ''affiliated person'' for purposes of the independence requirement. While the majority of commenters supported a safe harbor, some did not want a safe harbor for fear any thresholds in the safe harbor would be viewed as a ceiling that would disqualify a director from serving on the audit committee. In considering the uncertainty that may arise in determining whether a person is an ''affiliated person,'' we have adopted a safe harbor from the definition of affiliate for non-investment companies. However, to add clarity we have added explicit language specifying that the thresholds in the safe harbor are not designed to be viewed as an upper limit on permissible levels.

We have also adopted other limited exemptions to alleviate some of the burdens companies may face where consistent with the Sarbanes-Oxley Act and investor protection. We have expanded these exemptions in a number of instances, where consistent with the Sarbanes-Oxley Act and investor protection, to alleviate unnecessary burdens and expenses. We believe the final rule reflects an appropriate balance between investors and investor groups who advocated more stringent requirements and issuers and their representatives who requested a much larger expansion of the exemptions.

V. Consideration of Burden on Competition and Promotion of Efficiency, Competition and Capital Formation

Section 23(a)(2) of the Exchange Act[254] requires us, when adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition. In addition, section 23(a)(2) prohibits us from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

The amendments represent the implementation of a Congressional mandate. They are intended to increase the independence and effectiveness of listed company audit committees. We anticipate these requirements will enhance the proper functioning of the capital markets by increasing the quality and accountability of financial reporting and restoring investor confidence. This increases the competitiveness of companies participating in the U.S. capital markets. However, the requirements relate only to companies listed on a national securities exchange or national securities association. Competitors not subject to the standards specified in section 10A(m) of the Exchange Act may be subject to fewer corporate governance burdens. Similarly, to the extent foreign exchanges or other markets do not impose these standards, competitors could, all things being equal, migrate to those markets to avoid compliance. This could cause U.S. exchanges and securities associations to lose trading volume and investors to lose liquidity or the benefits of trading in a U.S. market. Competitors and markets not subject to the standard, however, also may suffer from decreased investor confidence compared to those that do comply with the new standards.

Section 2(b) of the Securities Act,[255] section 3(f) of the Exchange Act[256] and section 2(c) of the Investment Company

90; AICPA, Codification of Statements on Auditing Standards (''AU'') § 380; Independence Standards Board, ''Independence Discussion with Audit Committees,'' Independence Standard No. 1 (Jan. 1999).

[253] The estimate is based on the burden hour estimates calculated under the Paperwork Reduction Act. For purposes of the Paperwork Reduction Act, we estimate that the additional disclosure will result in 401 internal burden hours and $62,400 in external costs. Assuming a cost of $125/hour for in-house professional staff, the total cost for the internal burden hours would be $50,125. Hence the aggregate cost estimate is $112,525 ($50,125 + 62,400). The $125/hour cost estimate is based on data obtained from *The SIA Report on Management and Professional Earnings in the Securities Industry (Oct. 2001).*

[254] 15 U.S.C. 78w(a)(2).

[255] 17 U.S.C. 77b(b).

[256] 15 U.S.C. 78c(f).

Act [257] require us, when engaging in rulemaking where we are required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. The amendments are designed to enhance the quality and accountability of the financial reporting process and may help increase investor confidence, which implies increased efficiency and competitiveness of the U.S. capital markets. Increased market efficiency and investor confidence also may encourage more efficient capital formation. As noted above, however, the requirements could have certain indirect negative effects, such as inconsistent application across all competitors. In addition, the requirements, while providing great flexibility for implementation, do remove a certain amount of individual control over the corporate governance process, which could have the possible effect of stifling more efficient approaches from being implemented if they were to develop.

If a company found the requirements too onerous, it could be dissuaded from accessing the U.S. public capital markets, which could impact capital formation. The possibility of these effects and their magnitude if they were to occur are difficult to quantify. We are adopting several limited exemptions from the requirements to alleviate some of the burdens companies may face where consistent with investor protection. For example, the limited exemption for new public companies is intended to counteract any disincentive the requirements may have on a company's willingness to access the public capital markets.

We requested comments on these analyses in the Proposing Release. We received no comments in response to these requests.

VI. Final Regulatory Flexibility Analysis

This Final Regulatory Flexibility Analysis, or FRFA, has been prepared in accordance with the Regulatory Flexibility Act.[258] This FRFA involves new rules and amendments to direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with several enumerated standards relating to the issuer's audit committee. An Initial Regulatory Flexibility Analysis (''IRFA'') was prepared in accordance with the Regulatory Flexibility Act [259] in conjunction with the Proposing Release. The Proposing Release included the IRFA and solicited comments on it.

A. Need for the Amendments

We are adopting new Exchange Act rule 10A–3 to comply with the mandate of the Sarbanes-Oxley Act and new section 10A(m)(1) of the Exchange Act. The amendments 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, the amendments change current disclosure requirements regarding audit committees to increase the transparency of these committees. We believe that these amendments will help to improve the quality and accountability of financial disclosure and oversight of the process by qualified and independent audit committees.

B. Significant Issues Raised by Public Comment

We received no comments in response to the IRFA.

C. Small Entities Subject to the Amendments

The amendments 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)[260] 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.[261] The amendments also will directly affect national securities associations. No affected national securities association is a small entity, as defined by 13 CFR 121.201.

The amendments 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.[262] 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.[263] We estimate that less than 225, or approximately 3%, of the issuers that are not investment companies,[264] and less than 25, or approximately 4% of the issuers that are investment companies,[265] are ''small entities'' for purposes of the Regulatory Flexibility Act that possibly could be affected by the amendments.

D. Reporting, Recordkeeping, and Other Compliance Requirements

Under the amendments, 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 will need to comply with these standards if they wish to have their securities listed on a national securities exchange or a national securities association. The rules will 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.[266] However, not all of the audit committees of these small entities may comply with the new requirements. A small entity whose board or audit committee does not comply with the new requirements will

[257] 15 U.S.C. 80a–2(c).

[258] 5 U.S.C. 601.

[259] 5 U.S.C. 603.

[260] 17 CFR 240.0–10(e).

[261] 17 CFR 240.11Aa3–1.

[262] *See* Exchange Act rule 0–10(a).

[263] *See* note above.

[264] We derived this estimate from the Standard & Poors Research Insight Compustat Database.

[265] We derived this estimate from information compiled by Commission staff.

[266] *See, e.g.*, NACD, *2001–2002 Public Company Governance Survey* (Nov. 2001).

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.

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 incurs expenses or engages independent counsel or other advisors where it could not do so previously, there will be additional costs for the payment of these expenses and 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 rules. Small entities subject to the proxy rules are already required to disclose most of the information affected by our amendments 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 final rules and amendments or how much it would cost to comply. We recognize that because the amendments 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 and number of issuers that will be affected by the requirements.

E. Agency Action To Minimize Effect on Small Entities

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish our stated objectives, while minimizing any significant adverse impact on small entities. In connection with the amendments, we considered the following alternatives:

- Establishing different compliance or reporting requirements or timetables that take into account the resources available to small entities;
- Clarifying, consolidating or simplifying compliance and reporting requirements under the rules for small entities;
- Using performance rather than design standards; and
- Exempting small entities from all or part of the requirements.

The coverage of section 10A(m) of the Exchange Act, as added by Congress in section 301 of the Sarbanes-Oxley Act, makes no distinction based on an issuer's size. We think that improvements in the financial reporting process for listed issuers of all sizes are important for promoting investor confidence in our markets. For example, a 1999 report commissioned by the organizations that sponsored the Treadway Commission found that the incidence of financial fraud was greater in small companies.[267] However, we are sensitive to the costs and burdens that will be faced by small entities. We have endeavored through the amendments to alleviate the regulatory burden on all listed issuers, including the small proportion of small entities that will be affected, while meeting our regulatory objectives.

We believe that a blanket exemption for small entities from coverage of the requirements is not appropriate and inconsistent with the policies underlying the Sarbanes-Oxley Act. Similarly, we believe that different compliance requirements for small entities also would interfere with achieving the primary goal of the amendments to increase the competency and effectiveness of audit committees for all companies with listed securities. The majority of commenters generally agreed with this approach and did not support lesser standards for smaller issuers overall. These commenters did not believe the requirements will impose a disproportionate burden on small issuers. We recognize that because the requirements apply only to listed issuers, the quantitative listing standards applicable to listed securities, such as minimum revenue, market capitalization and shareholder equity requirements, already serve somewhat as a limit on the size of issuers that will be affected by the requirements.

Other commenters, however, were concerned that smaller issuers may have particular difficulty locating qualified audit committee candidates that will meet the independence criteria, especially given the implementation period proposed by the Commission. While these commenters advocated various approaches, such as an exceptional and limited circumstances exemption for smaller issuers or SRO authority to exempt individual small issuers on a case-by-case basis, most agreed that an additional implementation period would be appropriate for these issuers. We are sensitive to the possible implication for smaller issuers and for SROs that would like to specialize in securities of these issuers. The final rule provides an extended compliance period for listed issuers that are small business issuers. In addition, the modifications to several of the other exemptions in the final rule, such as the overlapping board exemption and the new issuer exemption, should provide additional flexibility to small and new issuers in meeting the requirements of the rule. Our approach of not mandating specific procedures for the auditor responsibility requirement and the complaint procedures requirement should give issuers additional flexibility in meeting these requirements. Given the fact that the requirements will impact such a small number of small entities, we are not aware of how to further clarify, consolidate or simplify these amendments for small entities.

The amendments use performance standards in a number of respects. As noted above, we are not specifying the specific procedures or arrangements an issuer or audit committee must develop to comply with the standards. We do provide design standards regarding audit committee member independence, as these are the standards we are directed to implement by Congress. Accordingly, we believe that design standards are necessary to achieve the objectives of the statutory mandate. We do have the authority under section 10A(m)(3)(C) to exempt particular relationships with respect to audit committee members, although, for the reasons discussed above, we are not using that authority at this time for small entities.

VII. Effective Date

The final rules and amendments are effective on April 25, 2003. The Administrative Procedure Act, or APA, generally requires that an agency publish an adopted rule in the **Federal Register** 30 days before it becomes effective.[268] This requirement, however, does not apply if the agency finds good cause for making the rule effective sooner.[269] The Commission believes that it is appropriate to waive the full 30-day advance publication of the new rule and amendments. The Sarbanes-Oxley Act requires the rules to be

[267] *See* note above.

[268] 5 U.S.C. 553(d).

[269] *Id.*

effective by April 26, 2003. We have been working with the SROs to implement the statutory requirement in an orderly fashion. However, because of the extended compliance dates, a notice period of less than 30 days should not prejudice anyone. Under the final rule and amendments, SROs are not required to submit proposals implementing the directive in Exchange Act rule 10A–3 until July 15, 2003. The rules based on those proposals must be approved by the Commission by December 1, 2003. Listed issuers do not have to comply with the new listing rules until their first annual shareholders meeting after January 15, 2004, at the earliest, and small business issuers and foreign private issuers will have additional time to comply. Issuers need not comply with the disclosure changes until reports covering periods ending on or after (or proxy or information statements for actions occurring on or after) the compliance date for the listing standards applicable to the listed issuer. Because of this delay before any action is required as a result of the rules, the Commission finds good cause to make the new rules and amendments effective on April 25, 2003.

VIII. Statutory Authority and Text of Rule Amendments

The amendments contained in this document are being adopted under the authority set forth in sections 2,[270] 6,[271] 7,[272] 8,[273] 10,[274] 17[275] and 19[276] of the Securities Act, sections 3(b), 10A, 12, 13, 14, 15, 23 and 36[277] of the Exchange Act, sections 8,[278] 20,[279] 24(a),[280] 30[281] and 38[282] of the Investment Company Act of 1940 and sections 3 and 301 of the Sarbanes-Oxley Act.

Text of Amendments

List of Subjects

17 CFR Parts 228, 229, 240 and 249

Reporting and recordkeeping requirements, Securities.

17 CFR Part 274

Reporting and recordkeeping requirements, Securities, Investment Companies.

[270] 15 U.S.C. 77b.
[271] 15 U.S.C. 77f.
[272] 15 U.S.C. 77g.
[273] 15 U.S.C. 77h.
[274] 15 U.S.C. 77j.
[275] 15 U.S.C. 77q.
[276] 15 U.S.C. 77s.
[277] 17 U.S.C. 78mm.
[278] 15 U.S.C. 80a-8.
[279] 15 U.S.C. 80a-20.
[280] 15 U.S.C. 80a-24(a).
[281] 15 U.S.C. 80a-29.
[282] 15 U.S.C. 80a-37.

■ In accordance with the foregoing, Title 17, Chapter II of the Code of Federal Regulations is amended as follows.

PART 228—INTEGRATED DISCLOSURE SYSTEM FOR SMALL BUSINESS ISSUERS

■ 1. The general authority citation for Part 228 is revised to read as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z–2, 77z–3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77jjj, 77nnn, 77sss, 78l, 78m, 78n, 78o, 78u–5, 78w, 78*ll*, 78mm, 80a–8, 80a–29, 80a–30, 80a–37, 80b–11 and 7202.

* * * * *

■ 2. Amend § 228.401 by adding paragraph (f) to read as follows:

§ 228.401 (Item 401) Directors, Executive Officers, Promoters and Control Persons.

* * * * *

(f) *Identification of the audit committee.* (1) If you meet the following requirements, provide the disclosure in paragraph (f)(2) of this section:

(i) You are a listed issuer, as defined in § 240.10A–3 of this chapter;

(ii) You are filing either an annual report on Form 10–KSB (17 CFR 249.310b), or a proxy statement or information statement pursuant to the Exchange Act (15 U.S.C. 78a *et seq.*) if action is to be taken with respect to the election of directors; and

(iii) You are neither:

(A) A subsidiary of another listed issuer that is relying on the exemption in § 240.10A–3(c)(2) of this chapter; nor

(B) Relying on any of the exemptions in § 240.10A–3(c)(4) through (c)(7) of this chapter.

(2)(i) State whether or not the small business issuer has a separately-designated standing audit committee established in accordance with section 3(a)(58)(A) of the Exchange Act (15 U.S.C. 78c(a)(58)(A)), or a committee performing similar functions. If the small business issuer has such a committee, however designated, identify each committee member. If the entire board of directors is acting as the small business issuer's audit committee as specified in section 3(a)(58)(B) of the Exchange Act (15 U.S.C. 78c(a)(58)(B)), so state.

(ii) If applicable, provide the disclosure required by § 240.10A–3(d) of this chapter regarding an exemption from the listing standards for audit committees.

PART 229—STANDARD INSTRUCTIONS FOR FILING FORMS UNDER SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934 AND ENERGY POLICY AND CONSERVATION ACT OF 1975—REGULATION S–K

■ 3. The general authority citation for Part 229 is revised to read as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z–2, 77z–3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77iii, 77jjj, 77nnn, 77sss, 78c, 78i, 78j, 78*l*, 78m, 78n, 78o, 78u–5, 78w, 78*ll*(d), 78mm, 79e, 79n, 79t, 80a–8, 80a–29, 80a–30, 80a–31(c), 80a–37, 80a–38(a), 80b–11, and 7202, unless otherwise noted.

* * * * *

■ 4. Amend § 229.401 by:
■ a. Revising Instruction 3 to paragraph (h); and
■ b. Adding paragraph (i).

The additions and revisions read as follows:

§ 229.401 (Item 401) Directors, executive officers, promoters and control persons.

* * * * *

Instructions to Item 401(h)

* * * * *

3. In the case of a foreign private issuer with a two-tier board of directors, for purposes of this Item 401(h), the term *board of directors* means the supervisory or non-management board. In the case of a foreign private issuer meeting the requirements of § 240.10A–3(c)(3), for purposes of this Item 401(h), the term *board of directors* means the issuer's board of auditors (or similar body) or statutory auditors, as applicable. Also, in the case of a foreign private issuer, the term generally accepted accounting principles in paragraph (h)(2)(i) of this Item means the body of *generally accepted accounting principles* used by that issuer in its primary financial statements filed with the Commission.

* * * * *

(i) *Identification of the audit committee.* (1) If you meet the following requirements, provide the disclosure in paragraph (i)(2) of this section:

(i) You are a listed issuer, as defined in § 240.10A–3 of this chapter;

(ii) You are filing either an annual report on Form 10–K or 10–KSB (17 CFR 249.310 or 17 CFR 249.310b), or a proxy statement or information statement pursuant to the Exchange Act (15 U.S.C. 78a *et seq.*) if action is to be taken with respect to the election of directors; and

(iii)You are neither:

(A) A subsidiary of another listed issuer that is relying on the exemption in § 240.10A–3(c)(2) of this chapter; nor

(B) Relying on any of the exemptions in § 240.10A–3(c)(4) through (c)(7) of this chapter.

(2)(i)State whether or not the registrant has a separately-designated standing audit committee established in accordance with section 3(a)(58)(A) of the Exchange Act (15 U.S.C. 78c(a)(58)(A)), or a committee performing similar functions. If the registrant has such a committee, however designated, identify each committee member. If the entire board of directors is acting as the registrant's audit committee as specified in section 3(a)(58)(B) of the Exchange Act (15 U.S.C. 78c(a)(58)(B)), so state.

(ii) If applicable, provide the disclosure required by § 240.10A–3(d) of this chapter regarding an exemption from the listing standards for audit committees.

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

■ 5. The authority citation for Part 240 is revised to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77z–3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j–1, 78k, 78k–1, 78*l*, 78m, 78n, 78o, 78p, 78q, 78s, 78u–5, 78w, 78x, 78*ll*, 78mm, 79q, 79t, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4, 80b–11, and 7202, unless otherwise noted.

* * * * *

■ 6. Add § 240.10A–3 to read as follows:

§ 240.10A–3 Listing standards relating to audit committees.

(a) Pursuant to section 10A(m) of the Act (15 U.S.C. 78j–1(m)) and section 3 of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7202):

(1) *National securities exchanges.* The rules of each national securities exchange registered pursuant to section 6 of the Act (15 U.S.C. 78f) must, in accordance with the provisions of this section, prohibit the initial or continued listing of any security of an issuer that is not in compliance with the requirements of any portion of paragraph (b) or (c) of this section.

(2) *National securities associations.* The rules of each national securities association registered pursuant to section 15A of the Act (15 U.S.C. 78o–3) must, in accordance with the provisions of this section, prohibit the initial or continued listing in an automated inter-dealer quotation system of any security of an issuer that is not in compliance with the requirements of any portion of paragraph (b) or (c) of this section.

(3) *Opportunity to cure defects.* The rules required by paragraphs (a)(1) and (a)(2) of this section must provide for appropriate procedures for a listed issuer to have an opportunity to cure any defects that would be the basis for a prohibition under paragraph (a) of this section, before the imposition of such prohibition. Such rules also may provide that if a member of an audit committee ceases to be independent in accordance with the requirements of this section for reasons outside the member's reasonable control, that person, with notice by the issuer to the applicable national securities exchange or national securities association, may remain an audit committee member of the listed issuer until the earlier of the next annual shareholders meeting of the listed issuer or one year from the occurrence of the event that caused the member to be no longer independent.

(4) *Notification of noncompliance.* The rules required by paragraphs (a)(1) and (a)(2) of this section must include a requirement that a listed issuer must notify the applicable national securities exchange or national securities association promptly after an executive officer of the listed issuer becomes aware of any material noncompliance by the listed issuer with the requirements of this section.

(5) *Implementation.* (i) The rules of each national securities exchange or national securities association meeting the requirements of this section must be operative, and listed issuers must be in compliance with those rules, by the following dates:

(A) July 31, 2005 for foreign private issuers and small business issuers (as defined in § 240.12b–2); and

(B) For all other listed issuers, the earlier of the listed issuer's first annual shareholders meeting after January 15, 2004, or October 31, 2004.

(ii) Each national securities exchange and national securities association must provide to the Commission, no later than July 15, 2003, proposed rules or rule amendments that comply with this section.

(iii) Each national securities exchange and national securities association must have final rules or rule amendments that comply with this section approved by the Commission no later than December 1, 2003.

(b) *Required standards*—(1) *Independence.* (i) Each member of the audit committee must be a member of the board of directors of the listed issuer, and must otherwise be independent; provided that, where a listed issuer is one of two dual holding companies, those companies may designate one audit committee for both companies so long as each member of the audit committee is a member of the board of directors of at least one of such dual holding companies.

(ii) *Independence requirements for non-investment company issuers.* In order to be considered to be independent for purposes of this paragraph (b)(1), a member of an audit committee of a listed issuer that is not an investment company may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee:

(A) Accept directly or indirectly any consulting, advisory, or other compensatory fee from the issuer or any subsidiary thereof, provided that, unless the rules of the national securities exchange or national securities association provide otherwise, compensatory fees do not include the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the listed issuer (provided that such compensation is not contingent in any way on continued service); or

(B) Be an affiliated person of the issuer or any subsidiary thereof.

(iii) *Independence requirements for investment company issuers.* In order to be considered to be independent for purposes of this paragraph (b)(1), a member of an audit committee of a listed issuer that is an investment company may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee:

(A) Accept directly or indirectly any consulting, advisory, or other compensatory fee from the issuer or any subsidiary thereof, provided that, unless the rules of the national securities exchange or national securities association provide otherwise, compensatory fees do not include the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the listed issuer (provided that such compensation is not contingent in any way on continued service); or

(B) Be an ''interested person'' of the issuer as defined in section 2(a)(19) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(19)).

(iv) *Exemptions from the independence requirements.*

(A) For an issuer listing securities pursuant to a registration statement under section 12 of the Act (15 U.S.C. 78l), or for an issuer that has a registration statement under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*) covering an initial public offering of securities to be listed by the issuer, where in each case the listed issuer was

not, immediately prior to the effective date of such registration statement, required to file reports with the Commission pursuant to section 13(a) or 15(d) of the Act (15 U.S.C. 78m(a) or 78o(d)):

(*1*) All but one of the members of the listed issuer's audit committee may be exempt from the independence requirements of paragraph (b)(1)(ii) of this section for 90 days from the date of effectiveness of such registration statement; and

(*2*) A minority of the members of the listed issuer's audit committee may be exempt from the independence requirements of paragraph (b)(1)(ii) of this section for one year from the date of effectiveness of such registration statement.

(B) An audit committee member that sits on the board of directors of a listed issuer and an affiliate of the listed issuer is exempt from the requirements of paragraph (b)(1)(ii)(B) of this section if the member, except for being a director on each such board of directors, otherwise meets the independence requirements of paragraph (b)(1)(ii) of this section for each such entity, including the receipt of only ordinary-course compensation for serving as a member of the board of directors, audit committee or any other board committee of each such entity.

(C) An employee of a foreign private issuer who is not an executive officer of the foreign private issuer is exempt from the requirements of paragraph (b)(1)(ii) of this section if the employee is elected or named to the board of directors or audit committee of the foreign private issuer pursuant to the issuer's governing law or documents, an employee collective bargaining or similar agreement or other home country legal or listing requirements.

(D) An audit committee member of a foreign private issuer may be exempt from the requirements of paragraph (b)(1)(ii)(B) of this section if that member meets the following requirements:

(*1*) The member is an affiliate of the foreign private issuer or a representative of such an affiliate;

(*2*) The member has only observer status on, and is not a voting member or the chair of, the audit committee; and

(*3*) Neither the member nor the affiliate is an executive officer of the foreign private issuer.

(E) An audit committee member of a foreign private issuer may be exempt from the requirements of paragraph (b)(1)(ii)(B) of this section if that member meets the following requirements:

(*1*) The member is a representative or designee of a foreign government or foreign governmental entity that is an affiliate of the foreign private issuer; and

(*2*) The member is not an executive officer of the foreign private issuer.

(F) In addition to paragraphs (b)(1)(iv)(A) through (E) of this section, the Commission may exempt from the requirements of paragraphs (b)(1)(ii) or (b)(1)(iii) of this section a particular relationship with respect to audit committee members, as the Commission determines appropriate in light of the circumstances.

(2) *Responsibilities relating to registered public accounting firms.* The audit committee of each listed issuer, in its capacity as a committee of the board of directors, must be directly responsible for the appointment, compensation, retention and oversight of the work of any registered public accounting firm engaged (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the listed issuer, and each such registered public accounting firm must report directly to the audit committee.

(3) *Complaints.* Each audit committee must establish procedures for:

(i) The receipt, retention, and treatment of complaints received by the listed issuer regarding accounting, internal accounting controls, or auditing matters; and

(ii) The confidential, anonymous submission by employees of the listed issuer of concerns regarding questionable accounting or auditing matters.

(4) *Authority to engage advisers.* Each audit committee must have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties.

(5) *Funding.* Each listed issuer must provide for appropriate funding, as determined by the audit committee, in its capacity as a committee of the board of directors, for payment of:

(i) Compensation to any registered public accounting firm engaged for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the listed issuer;

(ii) Compensation to any advisers employed by the audit committee under paragraph (b)(4) of this section; and

(iii) Ordinary administrative expenses of the audit committee that are necessary or appropriate in carrying out its duties.

(c) *General exemptions.* (1) At any time when an issuer has a class of securities that is listed on a national securities exchange or national securities association subject to the requirements of this section, the listing of other classes of securities of the listed issuer on a national securities exchange or national securities association is not subject to the requirements of this section.

(2) At any time when an issuer has a class of common equity securities (or similar securities) that is listed on a national securities exchange or national securities association subject to the requirements of this section, the listing of classes of securities of a direct or indirect consolidated subsidiary or an at least 50% beneficially owned subsidiary of the issuer (except classes of equity securities, other than non-convertible, non-participating preferred securities, of such subsidiary) is not subject to the requirements of this section.

(3) The listing of securities of a foreign private issuer is not subject to the requirements of paragraphs (b)(1) through (b)(5) of this section if the foreign private issuer meets the following requirements:

(i) The foreign private issuer has a board of auditors (or similar body), or has statutory auditors, established and selected pursuant to home country legal or listing provisions expressly requiring or permitting such a board or similar body;

(ii) The board or body, or statutory auditors is required under home country legal or listing requirements to be either:

(A) Separate from the board of directors; or

(B) Composed of one or more members of the board of directors and one or more members that are not also members of the board of directors;

(iii) The board or body, or statutory auditors, are not elected by management of such issuer and no executive officer of the foreign private issuer is a member of such board or body, or statutory auditors;

(iv) Home country legal or listing provisions set forth or provide for standards for the independence of such board or body, or statutory auditors, from the foreign private issuer or the management of such issuer;

(v) Such board or body, or statutory auditors, in accordance with any applicable home country legal or listing requirements or the issuer's governing documents, are responsible, to the extent permitted by law, for the appointment, retention and oversight of the work of any registered public accounting firm engaged (including, to the extent permitted by law, the

resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the issuer; and

(vi) The audit committee requirements of paragraphs (b)(3), (b)(4) and (b)(5) of this section apply to such board or body, or statutory auditors, to the extent permitted by law.

(4) The listing of a security futures product cleared by a clearing agency that is registered pursuant to section 17A of the Act (15 U.S.C. 78q–1) or that is exempt from the registration requirements of section 17A pursuant to paragraph (b)(7)(A) of such section is not subject to the requirements of this section.

(5) The listing of a standardized option, as defined in § 240.9b–1(a)(4), issued by a clearing agency that is registered pursuant to section 17A of the Act (15 U.S.C. 78q–1) is not subject to the requirements of this section.

(6) The listing of securities of the following listed issuers are not subject to the requirements of this section:

(i) Asset-Backed Issuers (as defined in § 240.13a–14(g) and § 240.15d–14(g));

(ii) Unit investment trusts (as defined in 15 U.S.C. 80a–4(2)); and

(iii)Foreign governments (as defined in § 240.3b–4(a)).

(7) The listing of securities of a listed issuer is not subject to the requirements of this section if:

(i) The listed issuer, as reflected in the applicable listing application, is organized as a trust or other unincorporated association that does not have a board of directors or persons acting in a similar capacity; and

(ii) The activities of the listed issuer that is described in paragraph (c)(7)(i) of this section are limited to passively owning or holding (as well as administering and distributing amounts in respect of) securities, rights, collateral or other assets on behalf of or for the benefit of the holders of the listed securities.

(d) *Disclosure.* Any listed issuer availing itself of an exemption from the independence standards contained in paragraph (b)(1)(iv) of this section (except paragraph (b)(1)(iv)(B) of this section), the general exemption contained in paragraph (c)(3) of this section or the last sentence of paragraph (a)(3) of this section, must:

(1) Disclose its reliance on the exemption and its assessment of whether, and if so, how, such reliance would materially adversely affect the ability of the audit committee to act independently and to satisfy the other requirements of this section in any proxy or information statement for a meeting of shareholders at which directors are elected that is filed with the Commission pursuant to the requirements of section 14 of the Act (15 U.S.C. 78n); and

(2) Disclose the information specified in paragraph (d)(1) of this section in, or incorporate such information by reference from such proxy or information statement filed with the Commission into, its annual report filed with the Commission pursuant to the requirements of section 13(a) or 15(d) of the Act (15 U.S.C. 78m(a) or 78o(d)).

(e) *Definitions.* Unless the context otherwise requires, all terms used in this section have the same meaning as in the Act. In addition, unless the context otherwise requires, the following definitions apply for purposes of this section:

(1)(i) The term *affiliate* of, or a person *affiliated* with, a specified person, means a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.

(ii)(A) A person will be deemed not to be in control of a specified person for purposes of this section if the person:

(*1*) Is not the beneficial owner, directly or indirectly, of more than 10% of any class of voting equity securities of the specified person; and

(*2*) Is not an executive officer of the specified person.

(B) Paragraph (e)(1)(ii)(A) of this section only creates a safe harbor position that a person does not control a specified person. The existence of the safe harbor does not create a presumption in any way that a person exceeding the ownership requirement in paragraph (e)(1)(ii)(A)(*1*) of this section controls or is otherwise an affiliate of a specified person.

(iii) The following will be deemed to be affiliates:

(A) An executive officer of an affiliate;

(B) A director who also is an employee of an affiliate;

(C) A general partner of an affiliate; and

(D) A managing member of an affiliate.

(iv) For purposes of paragraph (e)(1)(i) of this section, dual holding companies will not be deemed to be affiliates of or persons affiliated with each other by virtue of their dual holding company arrangements with each other, including where directors of one dual holding company are also directors of the other dual holding company, or where directors of one or both dual holding companies are also directors of the businesses jointly controlled, directly or indirectly, by the dual holding companies (and, in each case, receive only ordinary-course compensation for serving as a member of the board of directors, audit committee or any other board committee of the dual holding companies or any entity that is jointly controlled, directly or indirectly, by the dual holding companies).

(2) In the case of foreign private issuers with a two-tier board system, the term *board of directors* means the supervisory or non-management board.

(3) In the case of a listed issuer that is a limited partnership or limited liability company where such entity does not have a board of directors or equivalent body, the term *board of directors* means the board of directors of the managing general partner, managing member or equivalent body.

(4) The term *control* (including the terms *controlling, controlled by* and under *common control with*) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.

(5) The term *dual holding companies* means two foreign private issuers that:

(i) Are organized in different national jurisdictions;

(ii) Collectively own and supervise the management of one or more businesses which are conducted as a single economic enterprise; and

(iii) Do not conduct any business other than collectively owning and supervising such businesses and activities reasonably incidental thereto.

(6) The term *executive officer* has the meaning set forth in § 240.3b–7.

(7) The term *foreign private issuer* has the meaning set forth in § 240.3b–4(c).

(8) The term *indirect* acceptance by a member of an audit committee of any consulting, advisory or other compensatory fee includes acceptance of such a fee by a spouse, a minor child or stepchild or a child or stepchild sharing a home with the member or by an entity in which such member is a partner, member, an officer such as a managing director occupying a comparable position or executive officer, or occupies a similar position (except limited partners, non-managing members and those occupying similar positions who, in each case, have no active role in providing services to the entity) and which provides accounting, consulting, legal, investment banking or financial advisory services to the issuer or any subsidiary of the issuer.

(9) The terms *listed* and *listing* refer to securities listed on a national securities exchange or listed in an

automated inter-dealer quotation system of a national securities association or to issuers of such securities.

Instructions to § 240.10A–3

1. The requirements in paragraphs (b)(2) through (b)(5), (c)(3)(v) and (c)(3)(vi) of this section do not conflict with, and do not affect the application of, any requirement or ability under a listed issuer's governing law or documents or other home country legal or listing provisions that requires or permits shareholders to ultimately vote on, approve or ratify such requirements. The requirements instead relate to the assignment of responsibility as between the audit committee and management. In such an instance, however, if the listed issuer provides a recommendation or nomination regarding such responsibilities to shareholders, the audit committee of the listed issuer, or body performing similar functions, must be responsible for making the recommendation or nomination.

2. The requirements in paragraphs (b)(2) through (b)(5), (c)(3)(v), (c)(3)(vi) and Instruction 1 of this section do not conflict with any legal or listing requirement in a listed issuer's home jurisdiction that prohibits the full board of directors from delegating such responsibilities to the listed issuer's audit committee or limits the degree of such delegation. In that case, the audit committee, or body performing similar functions, must be granted such responsibilities, which can include advisory powers, with respect to such matters to the extent permitted by law, including submitting nominations or recommendations to the full board.

3. The requirements in paragraphs (b)(2) through (b)(5), (c)(3)(v) and (c)(3)(vi) of this section do not conflict with any legal or listing requirement in a listed issuer's home jurisdiction that vests such responsibilities with a government entity or tribunal. In that case, the audit committee, or body performing similar functions, must be granted such responsibilities, which can include advisory powers, with respect to such matters to the extent permitted by law.

4. For purposes of this section, the determination of a person's beneficial ownership must be made in accordance with § 240.13d–3.

■ 7. Amend § 240.14a–101 by:

■ a. Adding a sentence to the end of paragraph (d)(1) of Item 7;

■ b. Revising paragraph (d)(3)(iv) of Item 7; and

■ c. Revising the introductory text of paragraph (b)(14) of Item 22.

The additions and revisions read as follows:

§ 240.14a–101 Schedule 14A. Information required in proxy statement.

Schedule 14A Information

* * * * *

Item 7. Directors and executive officers.
* * *

(d)(1) * * * Such disclosure need not be provided to the extent it is duplicative of disclosure provided in accordance with Item 401(i) of Regulation S–K (§ 229.401(i) of this chapter).

* * * * *

(3) * * *

(iv)(A) If the registrant is a listed issuer, as defined in § 240.10A–3:

(*1*) Disclose whether the members of the audit committee are independent, as independence for audit committee members is defined in the listing standards applicable to the listed issuer. If the registrant does not have a separately designated audit committee, or committee performing similar functions, the registrant must provide the disclosure with respect to all members of its board of directors.

(*2*) If the listed issuer's board of directors determines, in accordance with the listing standards applicable to the listed issuer, to appoint a director to the audit committee who is not independent (apart from the requirements in § 240.10A–3) because of exceptional or limited or similar circumstances, disclose the nature of the relationship that makes that individual not independent and the reasons for the board of directors' determination.

(B) If the registrant, including a small business issuer, is not a listed issuer, disclose whether the registrant has an audit committee established in accordance with section 3(a)(58)(A) of the Act (15 U.S.C. 78c(a)(58)(A)) and, if so, whether the members of the committee are independent. In determining whether a member is independent, the registrant must use a definition for audit committee member independence of a national securities exchange registered pursuant to section 6(a) of the Act (15 U.S.C. 78f(a)) or a national securities association registered pursuant to section 15A(a) of the Act (15 U.S.C. 78o–3(a)) that has been approved by the Commission (as such definition may be modified or supplemented), and state which definition was used. Whichever definition is chosen must be applied consistently to all members of the audit committee.

* * * * *

Item 22. Information required in investment company proxy statement.
* * *

(b) * * *

(14) State whether or not the Fund has a separately designated audit committee established in accordance with section 3(a)(58)(A) of the Act (15 U.S.C. 78c(a)(58)(A)). If the entire board of directors is acting as the Fund's audit committee as specified in section 3(a)(58)(B) of the Act (15 U.S.C. 78c(a)(58)(B)), so state. If applicable, provide the disclosure required by § 240.10A–3(d) regarding an exemption from the listing standards for audit committees. Identify the other standing committees of the Fund's board of directors, and provide the following information about each committee, including any separately designated audit committee:

* * * * *

PART 249—FORMS, SECURITIES EXCHANGE ACT OF 1934

■ 8. The general authority citation for Part 249 is revised to read as follows:

Authority: 15 U.S.C. 78a, *et seq.*, and 7202, unless otherwise noted.

* * * * *

■ 9. Amend Form 20–F (referenced in § 249.220f) by:

■ a. Revising the Instruction to Item 6.C;

■ b. Revising paragraph (a)(2) of Item 16A;

■ c. Revising instruction 3 to Item 16A; and

■ d. Adding Item 16D.

The additions and revisions read as follows:

Note: The text of Form 20–F does not, and this amendment will not, appear in the Code of Federal Regulations.

Form 20–F

* * * * *

Item 6. Directors, Senior Management and Employees

* * * * *

Instructions to Item 6.C

1. The term ''plan'' is used very broadly and includes any type of arrangement for compensation, even if the terms of the plan are not contained in a formal document.

2. If the company is a listed issuer as defined in Exchange Act Rule 10A–3 (17 CFR 240.10A–3) and its entire board of directors is acting as the company's audit committee as specified in section 3(a)(58)(B) of the Exchange Act (15 U.S.C. 78c(a)(58)(B)), so state.

3. If the company has a board of auditors or similar body, as described in Exchange Act Rule 10A–3(c)(3) (17 CFR 240.10A–3(c)(3)), the disclosure required by this Item 6.C. with regard to the company's audit committee can be provided with respect to the company's board of auditors, or similar body.

* * * * *

Item 16A. Audit Committee Financial Expert

* * * * *

(a)(1) * * *

(2) If the registrant provides the disclosure required by paragraph (a)(1)(i) of this Item, it must disclose the name of the audit committee financial expert and whether that person is *independent*, as that term is defined in the listing standards applicable to the registrant if the registrant is a listed issuer, as defined in 17 CFR 240.10A–3. If the registrant is not a listed issuer, it must use a definition of audit committee member independence of a national securities exchange registered pursuant to section 6(a) of the Exchange Act (15 U.S.C. 78f(a)) or a national securities association registered pursuant to section 15A(a) of the Exchange Act (15 U.S.C. 78o–3(a)) that has been approved by the Commission (as such definition may be modified or supplemented) in determining whether its audit committee financial expert is independent, and state which definition was used.

* * * * *

Instructions to Item 16A

* * * * *

3. In the case of a foreign private issuer with a two-tier board of directors, for purposes of this Item 16A, the term *board of directors* means the supervisory or non-management board. In the case of a foreign private issuer meeting the requirements of 17 CFR 240.10A–3(c)(3), for purposes of this Item 16A, the term *board of directors* means the issuer's board of auditors (or similar body) or statutory auditors, as applicable. Also, in the case of a foreign private issuer, the term *generally accepted accounting principles* in paragraph (b)(1) of this Item means the body of generally accepted accounting principles used by that issuer in its primary financial statements filed with the Commission.

* * * * *

Item 16D. Exemptions From the Listing Standards for Audit Committees

If applicable, provide the disclosure required by Exchange Act rule 10A–3(d) (17 CFR 240.10A–3(d)) regarding an exemption from the listing standards for audit committees. You do not need to provide the information called for by this Item 16D unless you are using this form as an annual report.

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■ 10. Amend Form 40–F (referenced in § 249.240f) by:

■ a. Revising paragraph (8)(a)(2) of General Instruction B; and

■ b. Adding paragraph (14) to General Instruction B.

The additions and revisions read as follows:

Note: The text of Form 40–F does not, and this amendment will not, appear in the Code of Federal Regulations.

Form 40–F

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General Instructions

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B. Information To Be Filed on This Form

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(8)(a)(1) * * *

(2) If the registrant provides the disclosure required by paragraph (8)(a)(1)(i) of this General Instruction B, it must disclose the name of the audit committee financial expert and whether that person is *independent*, as that term is defined in the listing standards applicable to the registrant if the registrant is a listed issuer, as defined in 17 CFR 240.10A–3. If the registrant is not a listed issuer, it must use a definition of audit committee member independence of a national securities exchange registered pursuant to section 6(a) of the Exchange Act (15 U.S.C. 78f(a)) or a national securities association registered pursuant to section 15A(a) of the Exchange Act (15 U.S.C. 78o–3(a)) that has been approved by the Commission (as such definition may be modified or supplemented) in determining whether its audit committee financial expert is independent, and state which definition was used.

* * * * *

(14) Identification of the Audit Committee. (a) If you meet the following requirements, provide the disclosure in paragraph (b) of this section:

(1) You are a listed issuer, as defined in Exchange Act Rule 10A–3 (17 CFR 240.10A–3) of this chapter;

(2) You are using this form as an annual report; and

(3) You are neither:

(i) A subsidiary of another listed issuer that is relying on the exemption in Exchange Act Rule 10A–3(c)(2) (17 CFR 240.10A–3(c)(2)); nor

(ii) Relying on any of the exemptions in Exchange Act Rule 10A–3(c)(4) through (c)(7) (17 CFR 240.10A–3(c)(4) through (c)(7)).

(b)(1) State whether or not the registrant has a separately-designated standing audit committee established in accordance with section 3(a)(58)(A) of the Exchange Act (15 U.S.C. 78c(a)(58)(A)), or a committee performing similar functions. If the registrant has such a committee, however designated, identify each committee member. If the entire board of directors is acting as the registrant's audit committee as specified in section 3(a)(58)(B) of the Exchange Act (15 U.S.C. 78c(a)(58)(B)), so state.

(2) If applicable, provide the disclosure required by Exchange Act Rule 10A–3(d) (17 CFR 240.10A–3(d)) regarding an exemption from the listing standards for audit committees.

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PART 274—FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940

■ 11. The authority citation for Part 274 continues to read, in part, as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78*l*, 78m, 78n, 78o(d), 80a–8, 80a–24, 80a–26, and 80a–29, unless otherwise noted.

* * * * *

■ 12. Form N–CSR (referenced in §§ 249.331 and 274.128) is amended by:

■ a. Removing the phrase ''Items 4 and 10(a)'' from General Instruction D and in its place adding ''Items 4, 5 and 10(a)'';

■ b. Removing the phrase ''The information required by Item 4'' from General Instruction D and in its place adding ''The information required by Items 4 and 5''; and

■ c. Adding Item 5 to read as follows.

Note: The text of Form N–CSR does not, and this amendment will not, appear in the Code of Federal Regulations.

Form N–CSR

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Item 5. Audit Committee of Listed Registrants

(a) If the registrant is a listed issuer as defined in rule 10A–3 under the Exchange Act (17 CFR 240.10A–3), state whether or not the registrant has a separately-designated standing audit committee established in accordance with section 3(a)(58)(A) of the Exchange Act (15 U.S.C. 78c(a)(58)(A)). If the registrant has such a committee, however designated, identify each committee member. If the entire board of directors is acting as the registrant's audit committee as specified in section 3(a)(58)(B) of the Exchange Act (15 U.S.C. 78c(a)(58)(B)), so state.

(b) If applicable, provide the disclosure required by rule 10A–3(d) under the Exchange Act (17 CFR 240.10A–3(d)) regarding an exemption from the listing standards for audit committees.

Instruction. The information required by this Item is only required in an annual report on this Form N–CSR.

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By the Commission.

Dated: April 9, 2003.

Margaret H. McFarland,

Deputy Secretary.

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