



U.S. Securities and Exchange Commission

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-3¹ under the Securities Exchange Act of 1934 (the "Exchange Act"),² amendments to Forms 20-F³ and 40-F⁴ and Items 7 and 22 of Schedule 14A⁵ under the Exchange Act, amendments to Item 401⁶ of Regulation S-B⁷ and Item 401⁸ of Regulation S-K⁹ under the Securities Act of 1933 (the "Securities Act")¹⁰ and amendments to Form N-CSR¹¹ under the Exchange Act and the Investment Company Act of 1940 (the "Investment Company Act").¹²

Table of Contents

- I. [Background and Overview of the New Rule and Amendments](#)
- II. [Discussion](#)
 - A. [Audit Committee Member Independence](#)
 1. [Scope of the Requirement](#)
 2. [Advising, Consulting or Compensatory Fees](#)
 3. [Affiliated Person of the Issuer or Any Subsidiary Thereof](#)
 4. [New Issuers](#)
 5. [Overlapping Board Relationships](#)
 6. [Other Requests for Independence Exemptions](#)
 - B. [Responsibilities Relating to Registered Public Accounting Firms](#)
 1. [Scope of the Requirement](#)
 2. [Clarifications Regarding Possible Conflicts with Other Requirements](#)
 3. [Application to Investment Companies](#)
 - C. [Procedures for Handling Complaints](#)
 - D. [Authority to Engage Advisors](#)
 - E. [Funding](#)
 - F. [Application and Implementation of the Standards](#)
 1. [SROs Affected and Implementation Dates](#)
 2. [Securities Affected](#)
 - a. [Multiple Listings](#)
 - b. [Security Futures Products and Standardized Options](#)
 3. [Issuers Affected](#)

- a. [Foreign Issuers](#)
 - b. [Small Businesses](#)
 - c. [Issuers of Asset-Backed Securities and Certain Other Passive Issuers](#)
 - d. [Investment Companies](#)
4. [Determining Compliance with the Standards](#)
 5. [Opportunity to Cure Defects](#)
- G. [Disclosure Changes Regarding Audit Committees](#)
1. [Disclosure Regarding Exemptions](#)
 2. [Identification of the Audit Committee in Annual Reports](#)
 3. [Updates to Existing Audit Committee Disclosure](#)
 4. [Audit Committee Financial Expert Disclosure for Foreign Private Issuers](#)
- H. [Application to the Commission's Auditor Independence Rules](#)
- III. [Paperwork Reduction Act](#)
- IV. [Cost-Benefit Analysis](#)
- V. [Consideration of Burden on Competition and Promotion of Efficiency, Competition and Capital Formation](#)
- VI. [Final Regulatory Flexibility Analysis](#)
- VII. [Effective Date](#)
- VIII. [Statutory Authority and Text of Rule Amendments](#)

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 exchanges¹⁵ and national securities associations¹⁶ (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 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 firm³¹ 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 issuers³² and small business issuers³³ 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"