PILLSBURY WINTHROP LLP

Client Alert

Sarbanes-Oxley Act: Standards Relating to Listed Company Audit Committees

Pillsbury Winthrop LLP **Securities Practice Team** **April 25, 2003**

Pursuant to Section 301 of the Sarbanes-Oxley Act of 2002 (Act), the Securities and Exchange Commission (SEC) on April 1, 2003 adopted new rules to implement the requirements of that section. This Client Alert discusses these new rules and the potential implications for public companies.

Listing Requirements Added to the Securities Exchange Act of 1934

As a preliminary matter, Section 301 of the Act added Section 10A(m) to the Securities Exchange Act of 1934 (Exchange Act). Section 301 directs the SEC 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 new Sections 10A(m)(2) through (6) of the Exchange Act. This directive was implemented through the adoption of new rules that become effective on April 25, 2003. Sections 10A(m)(2) through (6) of the Exchange Act mandate the following:

- each issuer's audit committee shall be directly responsible for the appointment, compensation and oversight of the work of any registered public accounting firm employed by the issuer for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the issuer, and that registered public accounting firm shall report directly to the audit committee
- each member of an issuer's audit committee shall also be a member of the issuer's board of directors and shall otherwise be independent, which means that the audit committee member may not accept any consulting, advisory or other compensatory fee from the issuer or be an affiliated person of the issuer or any subsidiary of the issuer
- each audit committee shall establish procedures for (1) the receipt, retention and treatment of complaints received by an issuer regarding accounting, internal accounting controls or auditing matters and (2) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters
- each audit committee shall have the authority to engage independent counsel and other advisers as the audit committee determines necessary to carry out its duties
- each issuer shall provide for appropriate funding, as determined by the audit committee, for payment of (1) compensation to the registered public accounting firm employed by the issuer for the purpose of rendering or issuing an audit report, (2) compensation to any independent counsel and other advisers employed by the audit committee and (3) ordinary administrative expenses of the audit committee that are necessary or appropriate in carrying out its duties

New Rules

The SEC's new rules have been codified as a new Rule 10A-3 under the Exchange Act. Under the new rules, self-regulatory organizations (SROs) such as the New York Stock Exchange (NYSE), American Stock Exchange (AMEX) and The Nasdaq Stock Market (Nasdaq) will be prohibited from listing an issuer's securities if the issuer failed to meet the criteria noted above. SROs will be allowed to adopt requirements that go beyond the criteria noted above.

Application and Implementation of the New Standards

The new rules will apply to both domestic and foreign issuers of any size listed on a national securities exchange or national securities association. The new rules will apply to any listed security, including equity securities, debt securities and derivative securities. The SEC has provided for the following exemptions from these requirements:

- issuers whose securities are traded on the over-the-counter market, such as the OTC Bulletin Board, the Pink Sheets and the Yellow Sheets (because those are not considered listed securities)
- asset-backed issuers
- exchange-traded unit investment trusts (but not closed-end investment companies and exchange-traded open-end investment companies)
- listed security futures products cleared by a clearing agency, and listed standardized options issued by a clearing agency, that are registered under the Exchange Act or exempt from registration under the Exchange Act
- non-equity securities listed 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 new requirements as a result of the listing of a class of its equity securities, but if the subsidiary were to list its own equity securities (other than non-convertible, non-participating preferred securities), the subsidiary would be required to meet the new requirements
- foreign governments

In addition, SROs may exclude 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.

Although the new rules generally only apply to listed companies, the new rules do impact non-listed companies insofar as these companies are subject to the SEC proxy rules and action is to be taken with respect to the election of directors. Specifically, given the current requirement in the proxy rules to disclose whether or not the members of an audit committee are independent, the SEC's new rules direct such a non-listed company to define independence in accordance with the standards of any national securities exchange or national securities association that have been approved by the SEC (these standards include the requirements of these new rules), with that independence standard applied consistently to all audit committee members. Existing requirements for these companies are narrower than the new rules because currently a non-listed company must define independence in accordance with the standards of the NYSE, the AMEX or Nasdaq, whereas the new rules also encompass approved standards of additional national securities exchanges and national securities associations.

Effect of New Standards on Foreign Private Issuers

The SEC has stated that it is unwilling at this time to provide a blanket exemption for foreign issuers from these listing standards. However, the following provisions have been included in the new rules to address the special circumstances of foreign issuers:

- allowing non-management employees to serve as audit committee members of a foreign issuer if the employee is elected or named to the board of directors or audit committee pursuant to home country legal or listing requirements (this is common in Germany)
- allowing shareholders to elect, approve or ratify the selection of auditors where provided by an issuer's governing law or documents or other home country legal or listing requirements (this is common in Europe); note that the audit committee would need to be responsible for any recommendation or nomination of an auditor made to an issuer's shareholders

- allowing alternative structures such as boards of auditors to perform auditor oversight functions where these structures are provided under local law
- allowing one member of the audit committee to be a representative of a foreign government, if the "no compensation" prong of the independence requirements is satisfied and the member is not an executive officer
- allowing one representative of an affiliate of a foreign issuer to sit on an audit committee 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 is not an executive officer
- providing accommodations for dual holding companies, where those companies may designate one audit committee for both companies and the dual holding companies will not be deemed to be affiliates of one another
- exempting listed issuers that are foreign governments

In the case of foreign issuers with two-tiered boards, these requirements apply to the supervisory or non-management board.

Audit Committees

Under the Exchange Act, an audit committee is defined as either a committee established by and among an issuer's board of directors or, if no such committee exists, the entire board of directors. If an issuer chooses not to have a separately designated audit committee, the heightened requirements in these new rules apply to the issuer's board of directors as a whole. Therefore, it will be in the interest of most public companies to have an audit committee constituting a subset of the board of directors. In the case of a listed issuer that is a limited partnership or limited liability company where this 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.

Audit Committee Member Independence

Each member of an issuer's audit committee must be independent. The new requirements enhance audit committee independence by implementing the two basic criteria for determining independence in the Act.

First, "independent" means that an audit committee member is barred from receiving any consulting, advisory or other compensatory fee (whether directly or indirectly) from the issuer other than in the capacity as a member of the board of directors or any board committee. This prohibition would preclude payments to an audit committee member as an officer or employee of the issuer. Prohibited indirect payments would include payments to spouses, minor children or stepchildren or children or stepchildren sharing a home with the member, as well as payments accepted by an entity in which an audit committee 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 that provides accounting, consulting, legal, investment banking or financial advisory services to the issuer or any subsidiary. For example, where a partner of a law firm serves on an issuer's audit committee, that law firm would be unable to represent the issuer, regardless of whether or not the partner on the audit committee is involved directly with the representation of the issuer. Ordinary course commercial business relationships between an issuer and an entity with which a director had a relationship would not be captured by these new rules. There is no de minimis exception for these prohibited fees. Compensatory fees for this purpose 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). If an audit committee member is also a shareholder of the issuer, payments made to all shareholders generally (such as dividends) will not be prohibited.

Second, the new rules also establish that members of an issuer's audit committee may not be affiliated with the issuer or a subsidiary of the

issuer, except by virtue of being a member of the board of directors or a committee of the board. "Affiliated person" and "affiliate" are defined to be consistent with the definition of those terms under the securities laws. In the case of investment companies, the comparable term "interested person" is used as defined in the Investment Company Act of 1940. Although the definition of "affiliated person" for non-investment companies, like the existing definitions of this term for these issuers, would require a factual determination based on a consideration of all relevant facts and circumstances, the SEC recognizes that it can be difficult to determine whether or not someone controls an issuer. Accordingly, the new rules set forth a safe harbor from this aspect of the definition of "affiliated person." Under the safe harbor, a person who is not an executive officer, director who is also an employee, general partner, managing member or 10% shareholder of the issuer will be deemed not to control the issuer. This test is similar to the test used for determining insider status under Section 16 of the Exchange Act. The SEC has made clear in the new rules that a failure to fall within the safe harbor will not be solely determinative whether a particular person is an affiliate based on an evaluation of all facts and circumstances.

The new rules grant the following exemptions from the independence requirements:

- for new issuers, only one member of an issuer's audit committee must be independent on the effective date of the issuer's initial registration statement or a registration statement covering an initial public offering of securities, a majority of the audit committee's members must be independent within 90 days thereafter, and all members of the audit committee must be independent within one year thereafter
- 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 board of directors, the member otherwise meets the independence requirements for each 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 entity (this exemption may be helpful in a holding company structure)

There is no exemption for exceptional and limited circumstances similar to those that exist currently under several SRO rules, and the SEC does not currently expect to entertain exemptions or waivers for particular relationships on a case-by-case basis or through its no-action letter process.

Responsibilities Related to Registered Public Accounting Firms

The audit committee 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 an issuer, and the registered public accounting firm must report directly to the audit committee. These oversight responsibilities include the power to terminate the outside auditor. The audit committee has ultimate authority to approve all audit engagement fees and terms, as well as all significant non-audit engagements of the independent auditor. Audit committees of investment companies are required to select the independent auditor, and the independent directors will be required to ratify the selection.

Procedures for Handling Complaints

The 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 concerns regarding questionable accounting or auditing matters. The SEC has not proposed to mandate specific procedures that the audit committee must establish in this regard.

Authority to Engage Advisors

The audit committee must have the authority to engage independent counsel and other advisors, as it determines necessary to carry out its duties.

Funding

Each issuer must provide appropriate funding for its audit committee, as determined by the

audit committee, for payment of compensation to any registered public accounting firm engaged for the purpose of rendering or issuing an audit report or performing other audit, review or attest services for the issuer and to any advisors employed by the audit committee and for other ordinary administrative expenses of the audit committee.

Disclosure Changes Regarding Audit Committees

The new rules make several updates to the SEC's current disclosure requirements regarding audit committees, including the following:

- disclosure in annual reports, proxy statements or information statements for shareholders' meetings at which election for directors are held of (1) the reliance on any exemptions to the requirements of the new rules and (2) the issuer's assessment of whether or not, 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 the new rules
- identification of the audit committee members in annual reports (or, if no audit committee has been designated, disclosure that the entire board of directors is acting as the audit committee)
- updates to the audit committee independence disclosure in proxy statements to reflect the new SRO rules to be adopted under the new rules
- where, in accordance with the listing standards applicable to the listed issuer, the issuer's board of directors determines to appoint a director to the audit committee who is not independent because of exceptional or limited or similar circumstances, disclosure of the nature of the relationship that makes any individual not independent and the reasons for the board of directors' determination

Compliance

The SEC has directed the SROs to 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 new requirements. The new rules also require the SROs to establish procedures for an issuer to have an opportunity to cure any defects before the SROs prohibit the listing of, or delist, any security of an issuer. These SRO 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 shareholders meeting or one year from the occurrence of the event that caused the member to be no longer independent.

Effective Time

While the new rules became effective on April 25, 2003, the SRO rules implementing these new requirements will not be operative until as late as December 1, 2003, with proposed rules required to be filed by the SROs with the SEC by July 15, 2003. Listed issuers other than foreign private issuers and small business issuers must be in compliance with the new rules by the earlier of their first annual shareholders meeting after January 15, 2004 or October 31, 2004. Thus, most issuers will need to be in compliance with the new rules by the 2004 proxy season. Foreign private issuers and small business issuers must be in compliance with the new rules by July 31, 2005. Issuers must comply with the disclosure changes 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 for the particular issuer.

Companies that are contemplating initial public offerings should be particularly sensitive to this time frame. These companies likely will face genuine difficulties in having their boards of directors completely meet the new audit committee independence requirements, due to concerns that companies and investors (*e.g.*, venture capitalists) have in changing the make-up of boards of directors prior to the completion of an initial public offering. Market pressures already exist for these companies and their investors to put some number of independent members on the boards of directors, but often have not resulted in fully independent boards of

directors. The liability system under the Securities Act of 1933 contributes to the reluctance to change the make-up of boards of directors because of director responsibility under Section 11 of that Act at the time that a registration statement goes effective. The exemption periods of up to one year for new issuers may provide some relief in this regard.

Contact Pillsbury Winthrop For More Details

The Pillsbury Winthrop securities practice team works together with the Pillsbury Winthrop securities litigation team and white collar defense and corporate investigation team to monitor developments in the federal securities laws and at the SEC, the NYSE and Nasdaq.

If you wish either to obtain a more detailed explanation of the new rules and their ramifications or develop a new comprehensive and adaptive strategy to meet the changing landscape, please contact the Pillsbury Winthrop securities attorney with whom you work or one of the co-leaders of the Pillsbury Winthrop practice team, Stanton D. Wong in San Francisco (415-983-1790 or *sdwong@pillsburywinthrop.com*) or Todd W. Eckland in New York (212-858-1440 or *teckland@pillsburywinthrop.com*).