

**MEMO# 11539**

January 11, 2000

## **FINAL SEC AND EXCHANGE RULES REGARDING AUDIT COMMITTEES**

1 Securities Exchange Act Release No. 42266 (December 22, 1999), 64 FR 73389 (December 30, 1999) ("Release"). 2 Securities Exchange Act Release No. 42233 (December 14, 1999), 64 FR 71529 (December 21, 1999). 3 Securities Exchange Act Release No. 42231 (December 14, 1999), 64 FR 71523 (December 21, 1999). 4 Securities Exchange Act Release No. 42232 (December 14, 1999), 64 FR 71518 (December 21, 1999). [11539] January 11, 2000 TO: ACCOUNTING/TREASURERS COMMITTEE No. 3-00 CLOSED-END INVESTMENT COMPANY COMMITTEE No. 1-00 SEC RULES COMMITTEE No. 5-00 RE: FINAL SEC AND EXCHANGE RULES REGARDING AUDIT COMMITTEES

The Securities and Exchange Commission ("SEC") has approved new rules and rule amendments related to the functioning of corporate audit committees<sup>1</sup> as well as proposed rule changes related to audit committee requirements filed by the New York Stock Exchange ("NYSE"),<sup>2</sup> the National Association of Securities Dealers ("NASD"),<sup>3</sup> and the American Stock Exchange ("Amex").<sup>4</sup> The new SEC and exchange audit committee rules include closed-end investment companies. The more significant aspects of the new rules and rule amendments are summarized below and the adopting releases are attached. SEC Audit Committee Rules The SEC has adopted new rules and rule amendments to improve disclosure relating to the functioning of corporate audit committees and to enhance the reliability and credibility of financial statements of public companies. The new rules and rule amendments become effective on January 31, 2000. The new SEC rules require companies to include reports of their audit committees in their proxy statements which must state whether the audit committee has: (1) reviewed and discussed the audited financial statements with management; (2) discussed with the independent auditors the matters required to be discussed by Statement on Auditing Standards No. 61; and (3) received from the auditors disclosures regarding the auditors' independence required by Independence Standards Board Standard No. 1, and discussed with the auditors the auditors' independence. In addition, the report must include a statement by the audit committee whether, based on the review and discussions noted above, the audit committee recommended to the board of directors that the audited financial 5 The proposal would have required that the audit committee state whether anything has come to the attention of the members of the audit committee that caused the audit committee to believe that the audited financial statements included in the company's Annual Report on Form 10-K contain an untrue statement of material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading. The SEC determined not to adopt this proposal in response to concerns expressed by commenters regarding increased liability exposure to audit committee members. 2 statements be included in the company's annual report on Form 10-K for the

last fiscal year for filing with the SEC.<sup>5</sup> The Release specifically states that for closed-end investment companies, the required statement by the audit committee applies to financial statements included in a fund's annual report to shareholders. The Release noted that commenters, including the ICI, disagreed about whether closed-end funds should be excluded altogether from the new proxy statement disclosure requirements. The SEC concluded, however, that the application of these requirements to closed-end funds is warranted because of the critical role that the SEC believes audit committees play in overseeing the financial reporting process. Under the SEC rules, companies also will be required to disclose in their proxy statements whether their 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. The SEC stated that it believes that audit committees that have their responsibilities set forth in a written charter are more likely to play an effective role in overseeing the company's financial reports. The amendments, however, will not require companies to adopt audit committee charters, or dictate the content of the charter if one is adopted. The SEC has adopted a requirement that companies whose securities are listed on the NYSE or AMEX or quoted on Nasdaq that have a non-independent audit committee member disclose the nature of the relationship that makes that individual not independent and the reasons for the board's determination to appoint the director to the audit committee. In addition, companies 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. The SEC stated that while companies are required to provide in their proxy statements certain disclosures that relate to the independence of directors, it was important to make the disclosure about all of the audit committee members' independence explicit and clear for shareholders. The amended SEC proxy rules also provide "safe harbors" for the new proxy statement disclosures to protect companies and their directors from certain liabilities under the federal securities laws. Under the safe harbors, the additional disclosure would not be considered "soliciting material," "filed" with the SEC, subject to Regulation 14A or 14C (and, therefore, not subject to the antifraud provisions of Rules 14a-9 or 14c-6) or to the liabilities of Section 18 of the Exchange Act, except to the extent that the company specifically requests that it be treated as soliciting material, or specifically incorporates it by reference into a document filed under the Exchange Act or the Securities Act. The Release notes, however, that the other antifraud provisions of the Exchange Act and Securities Act would continue to apply. Registrants must comply with the new proxy and information disclosure requirements (e.g., the requirement to include a report of their audit committee in their proxy statements, provide disclosures regarding the independence of their audit committee members, and attach a copy of their audit committee's charter) for all proxy and information statements relating to votes of shareholders occurring 6 The NASD's and Amex's rules require that at least one member of the audit committee have past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer, or other senior officer with financial oversight responsibilities. 3 after December 15, 2000. Registrants may voluntarily comply with any of the new requirements prior to the compliance dates. NYSE, NASD, and Amex Audit Committee Rules The SEC has approved proposed rule changes filed by the NYSE, NASD, and Amex relating to their audit committee requirements for listed companies. The rules are substantially similar and therefore are discussed together below. The new rules require that audit committees adopt a formal written charter and review and reassess annually the adequacy of the charter. The charter, among other things, must specify: (1) the scope of the audit committee's responsibilities and how they are being carried out; (2) the ultimate accountability of the outside auditor to the board and audit

committee; and (3) the responsibility of the audit committee and board for selection, evaluation and replacement of the outside auditor. Under the new rules, audit committees are required to have at least three independent directors, as that term is defined under the respective rules. In certain circumstances, however, a non-independent director can serve on the audit committee, provided that the board determines that it is required by the best interests of the corporation and its shareholders, and the board discloses its reasons for the determination in the next annual proxy statement. Each audit committee member must be financially literate, or become financially literate within a reasonable period of time after his or her appointment to the audit committee, as such qualification is interpreted by the company's board in its business judgment. In addition, in order to further enhance the effectiveness of the audit committee, the rule requires at least one member of each audit committee to have accounting or related financial management expertise, as the company's board interprets such qualification in its business judgment.<sup>6</sup> The rules provide issuers eighteen months after the rule change is approved by the SEC to meet the audit committee structure and membership requirements. In addition, issuers are provided six months following the date of SEC approval of the rule change to adopt a formal written audit committee charter in compliance with the new rules' requirements. The NYSE grandfather all public company audit committee members qualified under current NYSE rules until they are re-elected or replaced. The adopting releases noted that several commenters stated that the proposed rule change should not apply to closed-end investment companies because these funds are adequately regulated under the Investment Company Act and that the potential abuses that the proposed rule change is designed to address do not exist with respect to closed-end funds because their assets consist exclusively of investment securities. Therefore, there is no opportunity to "manage" earnings or results through the selective application of accounting policies. The SEC however stated that it concluded that the decision to include investment companies in the proposed rule changes is warranted. The SEC stated that while it recognizes that the opportunity for some types of financial reporting abuses may be limited by the nature of fund assets, it believes that audit committees do play an important role in overseeing the financial reporting process for investment companies. 4Ari Burstein Assistant Counsel Attachments