

**MEMO# 15543**

January 14, 2003

## **SEC PROPOSAL REGARDING LISTED COMPANY AUDIT COMMITTEE STANDARDS**

[15543] January 14, 2003 TO: ACCOUNTING/TREASURERS COMMITTEE No. 3-03 CLOSED-END INVESTMENT COMPANY COMMITTEE No. 5-03 SEC RULES COMMITTEE No. 6-03 RE: SEC PROPOSAL REGARDING LISTED COMPANY AUDIT COMMITTEE STANDARDS The Securities and Exchange Commission has proposed a new rule, Rule 10A-3, under the Securities Exchange Act of 1934.\* As proposed, Rule 10A-3 would 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 in Rule 10A-3(b) and (c). These requirements would apply to most listed issuers, including closed-end investment companies and exchange-traded open-end investment companies. Rule 10A-3's requirements relate to: the independence of audit committee members; the audit committee's responsibility to select and oversee the issuer's independent accountant; the procedures for handling complaints regarding the issuer's accounting practices; the authority of the audit committee to engage advisors; and the funding for the independent auditor and any other advisors engaged by the audit committee. The proposals are intended to enhance investor confidence in the securities markets by increasing the effectiveness of listed company audit committees. Under the Sarbanes-Oxley Act, the SEC's rule must become effective by April 26, 2003. Under the SEC's proposals, the new requirements would need to be operative by the national securities exchanges and national securities associations no later than the first anniversary of the publication of the SEC's final rule in the Federal Register. The proposed delayed implementation date is intended to give companies time to conform to the new standards. Further, as proposed, the exchanges and associations would be required to submit to the Commission, no later than 60 days after publication of a final Rule 10A-3, proposals that comply with that rule. Comments on the proposal are due to the SEC 30 days after publication in the Federal Register. We have scheduled a conference call to discuss the proposal on Tuesday, January 21, \* SEC Release Nos. 33-8173, 34-47137, IC-25885 (January 8, 2003) ("Release"). A copy of the Release is available on the SEC's website at <http://www.sec.gov/rules/proposed/34-47137.htm>. 2 2003 at 2:00 (Eastern Standard Time). Please contact me as soon as possible by phone (202/218-3563), e-mail ([ddonohue@ici.org](mailto:ddonohue@ici.org)), or fax (202/326-5827) if you plan on participating on the call. Set forth below is a summary of the significant aspects of the proposal. I. Audit Committee Member Independence Proposed Rule 10A-3 would prohibit audit committee members of any listed issuer from accepting any consulting, advisory or other compensatory fee from the issuer or an affiliate of the issuer, other than in the member's capacity as a member of the board of directors. The Commission also has proposed prohibiting any indirect payments to audit committee members, which would include,

among other things, payments to a law firm in which an audit committee member is a partner and which provides legal services to the issuer. In addition, under the proposal, a member of an investment company's audit committee could not be an "interested person" of the investment company, as defined in Section 2(a)(19) of the Investment Company Act of 1940. The Release notes that the Commission has the authority to exempt from the independence requirements particular relationships with respect to audit committee members. Based on this authority, the Commission has proposed to exempt 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. The Release further notes that the Commission does not propose to consider exemptions for particular relationships on a case-by-case basis. The Release requests comment on several aspects of the independence requirement including: whether there should be a de minimis exception from the prohibition on advisory or other compensatory fees; whether the board should be required to determine whether an audit committee member is independent; whether the prohibition should extend to a "look back" period before the appointment of the member to the audit committee; whether additional relationships should be exempted from the independence requirements; whether the proposed exemption for new public companies should apply to investment companies; whether there should be an exception to the independence requirement based on exceptional and limited circumstances; whether companies should be allowed to request exemptive relief on a case-by-case basis; and whether there should be any modifications to the consulting, advisory or other compensatory fee prohibition for investment companies.

**II. Responsibilities Relating to Registered Public Accounting Firms** Under the proposal, an issuer's audit committee would be responsible for the appointment, compensation, retention, termination, and oversight of the independent auditor engaged for the purpose of preparing an audit report. The Commission has proposed exempting investment companies that fall within the scope of the proposed rule from the requirement that the audit committee be responsible for the selection of the independent auditor, recognizing that Section 32(a) of the Investment Company Act requires a majority of disinterested directors to select independent auditors. The Release specifically notes, however, that investment companies would remain subject to the proposed requirements regarding audit committee responsibility in all other areas.

**3 The Release seeks comment on several aspects of the proposed audit committee responsibilities including:** whether the Commission should exempt investment companies from the requirements relating to independent auditor selection in Section 32(a) of the Investment Company Act and instead require that their independent auditors be selected by the audit committee; whether the Commission should require investment companies to comply with the requirements of both Section 32(a) and the proposed rule (i.e., the audit committee would nominate the independent auditor and the majority of disinterested directors would approve the independent auditor); and how the Commission should reconcile Rule 10A-3, the auditor independence proposal, and Section 32(a).

**III. Procedures for Handling Complaints** The Commission has proposed requiring each audit committee to establish procedures for 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 matters. The proposal does not mandate specific procedures. The Release requests comment on several aspects of the proposed requirements with respect to complaints including: whether issuers should be required to disclose the procedures that have been established and, if so, where such disclosure should appear; and whether the Commission should prescribe specific procedures.

**IV. Authority to Engage Advisors** The Commission has proposed requiring an issuer's audit committee to have the authority to engage outside advisors, including counsel, as it determines necessary to carry out its

duties. The Release notes that the proposed requirement would not preclude the audit committee from seeking advice from the company's internal counsel or regular outside counsel. It also would not require an audit committee to retain independent counsel. The Release requests comment on whether the Commission should define what constitutes an "independent advisor." V. Funding Under the proposal, issuers would be required to provide for appropriate funding, as determined by the audit committee, for payment of compensation to any registered public accounting firm engaged for the purpose of issuing an audit report or performing other audit services for the issuer and to any advisors employed by the audit committee. The Release requests comment on, among other things, whether there should be a limit on the amount of compensation that could be requested by the audit committee. VI. Exemptions for Certain Securities According to the Release, several classes of securities would be exempt from the proposed requirements, including listed security futures products, listed standardized options, asset backed issuers, and, notably, exchange-traded unit investment trusts ("UITs"). The Release requests comment on whether the exclusion for exchange-traded UITs is appropriate; whether a 4 UIT's sponsor, trustee, or depositor should be required to comply with the proposed rule; and whether there are other types of investment companies that should be excluded from the proposed rule. VII. Determining Compliance with the Proposed Standards Proposed Rule 10A-3 would direct the self-regulatory organizations ("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 proposed requirements. According to the Release, the Commission encourages the SROs to impose a similar requirement for noncompliance with other SRO listing standards that relate to corporate governance standards. The Release requests comment on, among other things, whether the proposed triggering event for notification is appropriate and whether a listed issuer should be required to disclose periodically to the SROs whether they have been in compliance with the standards. VIII. Disclosure Regarding Audit Committees The Commission has proposed certain exemptions from proposed Rule 10A-3. The Release explains that because issuers relying on the exemptions would be distinguished from most other listed issuers, the Commission has proposed requiring issuers to disclose their reliance on the exemption and their assessment of whether, and if so, how, such reliance would materially adversely affect the ability of their audit committees to act independently. Such disclosure would need to appear, or be incorporated by reference, in annual reports and proxy statements for shareholder meetings at which directors are to be elected. Significantly, the Commission has proposed exempting exchange-traded UITs from this disclosure requirement. The Release requests comment on whether an exchange-traded UIT should be required to disclose that it is availing itself of the exemption and, if so, where such disclosure should be made. Dorothy M. Donohue Associate Counsel