



ALERT!

SEC Proposes Rules Relating to Audit Committees of Listed Companies

The Securities and Exchange Commission recently proposed new rules implementing Section 301 of the Sarbanes-Oxley Act of 2002 (the "Act"). The proposed rules direct the national securities exchanges (i.e. the NYSE, AMEX and regional stock exchanges) and national securities associations (i.e. NASDAQ) to prohibit the listing of any security of a company that is not in compliance with the audit committee requirements specified in the Act. These requirements relate to: (1) the independence of audit committee members; (2) the audit committee's responsibility to select and oversee the issuer's independent accountant; (3) procedures for handling complaints regarding accounting or auditing matters; (4) the authority of the audit committee to engage advisors; and (5) funding for the outside auditor and any outside advisors engaged by the audit committee.

Audit Committee Member Independence

The proposed rules would require all members of a listed company's audit committee to meet two independence criteria: (1) an audit committee member may not accept directly or indirectly any consulting, advisory or other compensatory fee from the company (other than board and committee fees); and (2) an audit committee member may not be an "affiliated person" of the company or any of its subsidiaries. In addition to these requirements specified in the Act, the SEC notes that the securities exchanges and associations may impose additional independence requirements through their listing rules.

The first criterion would preclude audit committee service if the company made payments of any prohibited fee (discussed in (1) above) directly to the director, or indirectly to spouses or minor children of the director, or payments for services to law firms, accounting firms, consulting firms, investment banks or similar entities in which the director is a partner, principal or holds a similar position. The SEC proposal indicates that independence would not be lost due to ordinary commercial relationships between the company and an entity with which a director has a relationship, although the SEC notes that some of the current or proposed stock exchange listing standards restrict these relationships.

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Under the second independence criterion, the SEC proposes to define the term "affiliate" and "affiliated person" consistent with its other definitions of those terms under the securities laws. An affiliate would include any person that directly or indirectly controls, is controlled by, or is under common control with the company, and would include any person who is a director, executive officer, partner, member, principal or designee of an entity that is an affiliate of the company. A person or entity would be deemed to control the company if it has the direct or indirect power to direct or cause the direction of the management and policies of the company, whether through the ownership of voting securities, by contract, or otherwise.

The determination of control would depend on the facts and circumstances of each case, however, the proposed rules would create a safe harbor under which a person who is not an executive officer, director or beneficial owner of more than 10% of the company would be deemed not to control the company. If a director does not meet the safe harbor, he or she would not automatically be deemed to control the company and could still rely on the particular facts and circumstances to demonstrate that he or she does not have control.

The proposed rules provide that one member of a listed company's audit committee may be exempted from the independence requirements if the committee member sits on the board of directors of both a listed company and its majority-owned subsidiary, so long as the member meets the other independence standards. In addition, one member may be exempted from the independence requirements for a period of 90 days from the date of effectiveness of a registration statement covering an initial public offering, if the listed company was not required to file periodic reports with the SEC immediately prior to the effective date of the registration statement.

A listed company availing itself of one of these exemptions must disclose that fact in its annual report and proxy statement, and provide the company's assessment of how, if at all, such reliance materially adversely affects the ability of the audit committee to act independently and perform its duties.

Responsibilities Regarding Independent Auditors

Under the SEC's proposed rules, a listed company's audit committee would have direct responsibility for the appointment, compensation, retention and oversight of the work of the independent auditor (including resolving disagreements between management and the auditors) and the independent auditor must report directly to the audit committee.

In connection with its oversight responsibilities, the audit committee would be required to have ultimate authority to approve all audit engagement fees and terms, as well as significant non-audit engagements of the independent auditor.

Procedures for Handling Complaints Regarding Accounting Matters

The proposed rules would also require a listed company's audit committee to establish procedures to cultivate open and effective channels of communication. These would include procedures for (1) the receipt, retention and treatment of complaints received by the company

regarding accounting, internal accounting controls or auditing matters, and (2) the confidential, anonymous submission by the company's employees of their concerns regarding questionable accounting or auditing matters. The proposed rules do not mandate specific procedures, and the SEC expects each audit committee to develop and utilize procedures appropriate for their circumstances.

Authority to Engage Advisors and Funding

Under the proposed rules, a listed company's audit committee must have the authority to engage its own independent auditors, counsel and other advisors, as it determines necessary to perform its duties. The company would have to provide their audit committee with appropriate funding, as determined by the committee, to pay the auditors and any advisors.

Request for Comments

The SEC is requesting comments on each of these provisions of the proposed rule. With respect to the independence of audit committee members, the SEC has inquired whether the classes of related persons subject to the compensatory prohibitions should be expanded or narrowed and whether these prohibitions should extend to a look back period before the member was appointed to the audit committee. Under the proposed auditor responsibility requirement, the SEC has inquired whether the audit committee should be directly responsible for the oversight of a company's internal auditors as well as the independent auditors. Lastly, the SEC has inquired whether there should be additional guidance in determining what constitutes an independent advisor and whether there should be a limit on the amount of compensation that could be requested by the audit committee to pay its independent advisors.

Disclosure Requirements

The SEC proposed rules would require a company to identify the members of the audit committee in the company's annual report on Form 10-K as well as the company's proxy statement (although the Form 10-K could incorporate by reference from the proxy statement). Also, listed companies without an audit committee would have to disclose that the entire board of directors is acting as the company's audit committee.

The proposed rules also update the current disclosure requirements regarding the independence of the audit committee members by requiring companies to use the definition of independence under the applicable stock exchange or association listing standards. The SEC's proposal would eliminate the requirement to disclose if the issuer's board of directors has appointed one director to its audit committee due to an exceptional and limited circumstances exception in the applicable listing standards because such an exception would no longer be permissible under the proposed rules.

Timetable

The SEC's proposed rules must be adopted in final format no later than April 26, 2003. The national securities exchanges and national securities associations would have up to one year

from the date the SEC's final rules are published to implement the new requirements for their listed companies. This means the new listing standards would be operative no later than early 2004, in time for the 2004 proxy season for companies with December 31 fiscal years. This would give most companies the opportunity to appoint new directors, if necessary, to satisfy the audit committee membership requirements.

The NYSE and NASDAQ have each submitted to the SEC proposed amendments to their listing standards to reflect the various requirements of the Act. It is likely that further revisions to these proposals will reflect the SEC's rule proposal before new listing standards are published for comment and ultimately approved by the SEC.

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The information in this Alert is intended for general information purposes only and should not be considered legal advice or opinion on any specific facts or circumstances. You are urged to contact a professional advisor concerning any specific question you may have relating to your own situation.

If you would like to discuss the matters presented in this Alert you may contact:



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