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Final SEC Rules on Audit Committees

Companies will be delisted if they fail to comply with the audit-committee requirements of the Sarbanes-Oxley Act and implementing SEC regulations, according to a recent release that mandates changes in the listing standards.¹ The release contains new audit-committee requirements; conforming provisions by the national securities exchanges and the national securities association must be approved by the SEC by December 1, 2003; and listed issuers other than small-business and foreign-private issuers must be in compliance with the new provisions by the date of their first shareholder's meeting after January 15, 2004, but in any event no later than October 31, 2004. Foreign-private and small-business issuers are given more time.

The exchanges and association will be obligated to delist companies that are not in compliance with several sets of requirements and do not successfully cure violations. The requirements cover audit committees' independence (by far the lengthiest segment of the release); responsibilities with respect to public accounting firms; procedures for handling complaints on auditing, accounting, and control matters; authority to engage independent counsel and other advisors; and funding.

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(1) SEC Release No. 33-8220, Standards Relating to Listed Company Audit Committees, April 9, 2003, available at <http://www.sec.gov/rules/final/33-8220.htm>.

Delisting can also occur for violations of listing standards that go beyond the SEC's audit-committee requirements. The SEC expressed its expectation that listing standards may go beyond the rule's requirements and acknowledged that some already do.

APPLICABILITY

The rules apply to both domestic and foreign private issuers with any security listed on a national exchange or association, regardless of the type of security. However, non-listed issuers are affected by the amended disclosure requirements for audit committees.

Issuers Affected. The rules apply to listed issuers, exchange-traded open-end funds, and closed-end investment companies with securities listed on a national exchange or association. Those exempt are asset-backed and non-U.S. government issuers; unit investment trusts; other open-end investment companies (traditional mutual funds); and listed issuers that are organized as a trust or other unincorporated association, do not have boards of directors or persons acting in a similar capacity, and whose activities are limited to passively owning or holding securities, rights, collateral, or other assets on behalf or for the benefit of holders of the listed securities (e.g., structures such as royalty trusts).

Securities Affected. The rules apply not only to voting equity securities, but to any listed security, regardless of its type, including debt securities, derivative securities, and other types of listed securities. However, additional listings by an issuer are exempt if the issuer is already subject to the rules by virtue of a national listing of any class of securities. *Non-equity* securities of certain subsidiaries of a parent company are exempt if the parent is already subject to the rules by virtue of a national listing of any class of equity securities.

Securities futures products and standardized options are exempt from the rules if the clearing agency is registered under the Exchange Act or exempt from registration.

Key Dates. The national securities exchanges and association must submit their proposed listing requirements to the SEC by July 15, 2003 for approval by December 1, 2003. Listed issuers other than small-business and foreign-private issuers must be in compliance with the new requirements by the earlier of their first annual shareholders meeting after January 15, 2004, or October 31, 2004. Foreign-private and "small-business issuers" must be in compliance with the new listing requirements by July 31, 2005.²

The New York Stock Exchange recently filed proposed corporate-governance standards that would not only comply with the new rules, but also go beyond them in several respects. The proposal contains new responsibilities both for boards of directors and for their audit committees.³

AUDIT COMMITTEE INDEPENDENCE

Audit committee members will be considered independent if they meet two criteria. (1) They have not accepted, either directly or indirectly, any consulting, advisory, or other compensatory fee from the issuer or any of its subsidiaries (apart from fees for board service, including service on a board committee). (2) They are not affiliated persons of the issuer or any of its subsidiaries. These criteria apply going forward from the effective date of the rule and a director's appointment to an audit committee. They do not apply to prior activities and relationships.

Compensatory Fees. Remuneration that is incompatible with independence excludes fixed amounts under a retirement plan for prior services and dividends paid to all shareholders. However, incompatible remuneration does include payments to spouses and other specified family members. It also includes payments to an entity in which the audit-committee member is a partner or officer, or occupies a similar position, if the payment is for accounting, consulting, legal, investment banking, financial, or financial advisory services to the issuer or any of its subsidiaries.

(2) A small-business issuer is a U.S. or Canadian issuer that is not an investment company and has less than \$25 million in revenues and public float (market capitalization minus the value of common equity held by affiliates).

(3) The filing is available at <http://www.sec.gov/rules/sro/34-47672.htm>.

Being a limited partner or non-managing member in such an entity and otherwise having no active role in providing services is compatible with audit-committee independence, as is a role in an entity that provides other commercial or nonadvisory financial services, such as lending, check clearing, and custodial services. However, incompatible remuneration includes payments to service-provider organizations, such as professional organizations, in which the potential audit-committee member's compensation for his or her role with that organization could be directly affected by the payment, even if the person is not the primary service provider.

There is no de minimis exception for remuneration incompatible with independence. Any such exceptions now in listing requirements will be removed.

Affiliation. Control is the key concept in defining an affiliated person. Control is the direct or indirect power to direct or cause the direction of an entity's management and policies whether through the ownership of voting securities, by contract, or otherwise. An affiliated person of a non-investment company or its subsidiary controls the company or is controlled by it, directly or indirectly through an intermediary, or is under common control with the company. Executive officers, general partners, managing members, and directors who are also employees of an affiliated entity are affiliated persons. Outside directors of an affiliate and individuals with passive, non-control, or non-policy-making positions are not ineligible to serve on an audit committee merely as the result of those roles.

According to the release, a party who is neither an executive officer nor a beneficial owner, directly or indirectly, of more than ten percent of any class of voting equity securities is not

considered a controlling party for purposes of the affiliated-person test (a safe harbor). However, a party owning more than ten percent of such securities (that is, outside the safe harbor) is not presumed to be an affiliated person. The release says that when the safe harbor does not apply, the determination depends on an evaluation of all the relevant facts and circumstances.

Audit-committee members of affected investment-company issuers must not be "an interested person" as defined in the Investment Company Act of 1940.



Exemptions. The independence requirements are to be phased in for new listed issuers. One member of the issuer's audit committee must be independent as of the initial listing or the effective date of its initial registration statement, a majority 90 days later, and all members within a year. An audit committee member who sits on the board of an affiliated entity is not considered an affiliated person for purposes of the independence requirements if that member otherwise meets the independence requirements of each entity (this is the so-called "overlapping board relationship").

Several exemptions from the independence requirements and other features of the rule were devised to address the needs of foreign private issuers. They are summarized in the boxed presentation.

INDEPENDENT PUBLIC ACCOUNTING FIRMS

Audit committees must be directly responsible to hire, pay, and, if necessary, dismiss the independent auditor. The committee must oversee the auditor's work, and the auditor must report directly to the audit committee. These responsibilities pertain to the work of any registered public accounting firm engaged to provide an audit or to perform other audit, review, or attest

services. Oversight is defined to include the resolution of disagreements between management and the auditor about financial reporting, and the responsibility to hire and retain the auditor includes approving all audit engagement fees and terms.

The rule states that the audit-committee responsibilities do not affect the application of home-country laws, documents, or listing provisions requiring or permitting shareholder determination of the independent auditor's appointment. However, the rule requires that if the procedure includes a recommendation or nomination to the shareholders, the audit committee (or a body performing similar functions) must be responsible for making the recommendation or nomination.

Separate SEC rules on auditor independence require pre-approval by the audit committee of all audit and non-audit services provided to the issuer and its consolidated subsidiaries by its independent accountant.⁴ The new rule clarifies the pre-approval role of a parent-company audit committee.

When a consolidated subsidiary is also an issuer and has its own audit committee, only one of the audit committees must pre-approve services provided by the auditor. The audit committee in the best position to review the effect of the service on the auditor's independence should perform the pre-approval. For example, the parent-company audit committee might perform the pre-approval function for any consolidated subsidiaries with respect to both the consolidated financial statements and with respect to the financial statements of any entity in the consolidated group that is also an issuer.

PROCEDURES FOR COMPLAINTS

Each audit committee must establish a mechanism to receive, retain, and process complaints on auditing, accounting, and internal control issues. The procedures must encompass the confidential, anonymous submission by employees of concerns on questionable accounting and auditing matters.

The SEC went no further than specifying the basic requirements for the mechanism. Each audit committee is expected to establish a mechanism suitable to the listed issuer's circumstances.

FUNDING

Each listed issuer must provide funding for the audit committee to fulfill its responsibilities. This includes money to pay the independent auditor and hire outside advisors. Funding needs are determined by the audit committee. These arrangements augment the independence requirements by making available without obligation the means for the audit committee to pursue its routine, specified activities and those it determines otherwise necessary to its responsibilities.

REPORTING AND CURING NONCOMPLIANCE

Issuers will be required to report material noncompliance with audit-committee requirements to the relevant national exchange or association. The triggering event is awareness of the condition by an executive officer. Noncompliance must be reported promptly thereafter.

The exchanges and association must establish procedures that permit entities both to report material noncompliance and to apply a remedy in order to prevent delisting. The SEC believes the existing procedures for continued listing generally will suffice. The procedures provide issuers with notice, a hearing and appeal process, and an opportunity to cure defects. The procedures may include a provision allowing a member of an audit committee who ceases to be independent for reasons outside his or her control to continue as an audit committee member until the earlier of the next annual meeting or one year from the event that caused the loss of independence.

DISCLOSURES

With some exceptions, reliance on an exemption must be disclosed along with an assessment of whether and (if so) how reliance on the exemption would materially adversely affect the

⁽⁴⁾ SEC Release No. 33-8183, *Strengthening the Commission's Requirements Regarding Auditor Independence*, January 28, 2003.

Provisions for Foreign Private Issuers

Several exemptions to the rule's independence requirements apply to foreign private issuers. These provisions allow:

- Non-executive-officer employees (based on the Exchange Act's definition of "executive officer") to serve as audit-committee members consistent with the issuer's governing law or documents, a collective bargaining or similar agreement, or another home-country legal or listing requirement.
- An audit committee member to be an affiliate of a foreign private issuer, or a representative of such an affiliate, if the requirement on incompatible remuneration is met, the member has observer status only (is neither a voting member nor chair), and the member is not an executive officer of the issuer. This exemption recognizes the fact that controlling shareholders or shareholder groups are more prevalent among foreign private issuers, and these controlling shareholders have traditionally played a prominent role in corporate governance.
- An audit committee member to be a representative of a non-U.S. government or governmental entity that is an affiliate of the foreign private issuer if the requirement on incompatible remuneration is met and the representative is not an executive officer of the issuer.
- Two holding companies that are both foreign private issuers, are organized in different national jurisdictions, and collectively own and supervise the management of one or more businesses conducted as a single enterprise (dual holding companies) are not considered affiliates of each other for purposes of the rule if the holding companies do not conduct any business other than collectively owning and supervising such business. If a listed issuer is one of two dual holding companies, they may designate one audit committee for both companies, provided each member of the

audit committee is a member of the board of directors of at least one of the holding companies and the audit committee members otherwise meet the independence requirements for the overall group.

Foreign private issuers with two-tier boards should treat the supervisory or non-management board as the body best equipped to comply with the rule, that is, as the "board of directors."

In addition to the exemptions above, the release's commentary notes that several non-U.S. jurisdictions require or provide for auditor oversight through a board of auditors or similar body, or groups of statutory auditors ("Board of Auditors"). The rules exempt from the audit committee independence and auditor oversight requirements foreign-private issuers with a Board of Auditors established pursuant to home-country legal or listing provisions expressly requiring or permitting the Board of Auditors if the Board is: (1) required to be either separate from the board of directors or composed of both directors of the issuer and non-directors; (2) not elected by the issuer's management and no executive officer of the issuer is a member of the Board of Auditors; (3) subject to independence standards established by home-country legal or listing provisions; (4) responsible, to the extent permitted by law and in accordance with any applicable home-country legal or listing standards or the issuer's governing documents, to appoint, retain, and oversee the work of any independent auditor engaged (including, to the extent permitted by law, the resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or performing other audit, review, or attest services for the issuer; and (5) subject to the remaining requirements in the final rule; such as the complaint procedures, ability to hire advisors, and funding requirements, to the extent permitted by law.

audit committee's ability to act independently and to comply with the rule's other requirements. This disclosure does not apply, for example, to exclusions for multiple listings, asset-backed and other passive issuers, securities futures products, and standardized options.

The reliance-on-exemption disclosure should be presented in annual reports filed with the Commission or be incorporated by reference in those reports. It should also be included in proxy statements or information statements for shareholders' meetings at which directors are to be elected.

A listed issuer that has no separate audit committee must disclose in its annual report that the entire board of directors is acting as its audit committee. The annual reports of issuers that have audit committees should disclose the members or incorporate the information by reference.

Non-listed issuers that are subject to the proxy rules, and therefore must disclose whether their audit-committee members are independent, may apply the SEC-approved definition of independence of any national exchange or association. The definition must be disclosed and consistently applied.



Issuers must comply with the new disclosure requirements 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. Unlisted issuers should use the date that would apply if they were listed.

Each listed foreign private issuer that has an audit-committee financial expert must disclose whether that person is independent. The definition of independence for this purpose should be the one in the listing requirements of the relevant national exchange or association. Non-listed foreign private issuers can choose any SEC-approved definition of independence adopted by a national exchange or association, provided the definition is disclosed and consistently applied. These disclosure requirements become effective July 31, 2005.



The final rules create new conditions for audit committees. This phase of the transforming process set in motion by the Sarbanes-Oxley Act has reached a conclusion. The next phase will be determined by participants in the new institutional relationships as much or more than by the requirements themselves.

Companies and their audit committees should not treat the descriptive and summary statements in this presentation as a substitute for the actual rules or listing requirements. They should consult the text of the rules, the relevant listing requirements, and their accounting and legal advisors. Listing requirements can go beyond the obligations established in Release No. 33-8220.

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