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Part II

Securities and Exchange Commission

17 CFR Parts 228, et al.
Standards Relating to Listed Company Audit Committees; Proposed Rule

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 228, 229, 240, 249 and 274

[Release Nos. 33–8173; 34–47137; IC–25885; File No. S7–02–03]

RIN 3235–AI75

Standards Relating to Listed Company Audit Committees

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: As directed by the Sarbanes-Oxley Act of 2002, we are proposing a new rule 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 the audit committee requirements established by the Sarbanes-Oxley Act of 2002. These requirements relate to: the independence of audit committee members; the audit committee's responsibility to select and oversee the issuer's independent accountant; procedures for handling complaints regarding the issuer's accounting practices; the authority of the audit committee to engage advisors; and funding for the independent auditor and any outside advisors engaged by the audit committee. The new rule must become effective by April 26, 2003, and under our 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 our final rule in the **Federal Register**. The proposals would implement the requirements of Section 10A(m)(1) of the Securities Exchange Act of 1934, as added by Section 301 of the Sarbanes-Oxley Act of 2002.

DATES: Comments should be received on or before February 18, 2003.

ADDRESSES: To help us process and review your comments more efficiently, comments should be sent by hard copy or e-mail, but not by both methods. Comments sent by hard copy should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609. Comments also may be submitted electronically at the following electronic mail address: *rule-comments@sec.gov*. All comment letters should refer to File No. S7–02–03. This file number should be included in the subject line if electronic mail is used. Comment letters will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549. Electronically submitted comment letters will be posted on the Commission's Internet Web site (*http://www.sec.gov*).[1]

FOR FURTHER INFORMATION CONTACT: Jeffrey J. Minton, Special Counsel, or Elizabeth M. Murphy, Chief, Office of Rulemaking, Division of Corporation Finance, at (202) 942–2910, or, with respect to investment companies, Christopher P. Kaiser, Senior Counsel, Office of Disclosure Regulation, Division of Investment Management, at (202) 942–0724, U.S. Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549.

SUPPLEMENTARY INFORMATION: We are proposing to add new Rule 10A–3[2] under the Securities Exchange Act of 1934 (the ''Exchange Act''),[3] to amend Forms 10–K,[4] 10–KSB,[5] 20–F[6] and 40–F[7] and Items 7 and 22 of Schedule 14A[8] under the Exchange Act, to amend Item 401[9] of Regulation S–B[10] and Items 401[11] and 601[12] of Regulation S–K[13] under the Securities Act of 1933 (the ''Securities Act'')[14] and to amend proposed Form N–CSR[15] under the Exchange Act and the Investment CompanyAct of 1940 (the ''Investment Company Act'').[16]

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I. Background and Overview of the Proposals

Accurate and reliable financial reporting lies at the heart of our disclosure-based system for securities regulation, and is critical to the integrity of the U.S. securities markets. Investors need accurate and reliable financial information to make informed investment decisions. Investor confidence in the reliability of corporate financial information is fundamental to the liquidity and vibrancy of our markets.

Effective oversight of the financial reporting process is fundamental to preserving the integrity of our markets. The board of directors, elected by and accountable to shareholders, is the focal point of the corporate governance system. The audit committee, composed of members of the board of directors, plays a critical role in serving as a check and balance on a company's financial reporting system. The audit committee provides independent review and oversight of a company's financial reporting processes, internal controls and independent auditors. It provides a forum separate from management in which auditors and other interested parties can candidly discuss concerns. By effectively carrying out its functions and responsibilities, the audit committee helps to ensure that management properly develops and adheres to a sound system of internal controls, that procedures are in place to objectively assess management's practices and internal controls, and that the outside auditors, through their own review, objectively assess the company's financial reporting practices.

Since the early 1940s, the Commission, along with the auditing

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[1] We do not edit personal identifying information, such as names or electronic mail addresses, from electronic submissions. You should submit only information that you wish to make available publicly.

[2] 17 CFR 240.10A–3.

[3] 15 U.S.C. 78a *et seq.*

[4] 17 CFR 249.310.

[5] 17 CFR 249.310b.

[6] 17 CFR 249.220f.

[7] 17 CFR 249.240f.

[8] 17 CFR 240.14a–101.

[9] 17 CFR 228.401.

[10] 17 CFR 228.10 *et seq.*

[11] 17 CFR 229.401.

[12] 17 CFR 229.601.

[13] 17 CFR 229.10 *et seq.*

[14] 15 U.S.C. 77a *et seq.*

[15] 17 CFR 249.331 and 17 CFR 274.128.

[16] 15 U.S.C. 80a–1 *et seq.*

and corporate communities, has had a continuing interest in promoting effective and independent audit committees.[17] It was largely with the Commission's encouragement, for instance, that the self-regulatory organizations, or SROs, first adopted audit committee requirements in the 1970s.[18] Over the years, others have expressed support for strong, independent audit committees,[19] including the National Commission on Fraudulent Financial Reporting, also known as the Treadway Commission,[20] and the General Accounting Office.[21]

In 1998, the New York Stock Exchange (the ''NYSE'') and the National Association of Securities Dealers, Inc. (the ''NASD'') sponsored a committee to study the effectiveness of audit committees. This committee became known as the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (the ''Blue Ribbon Committee''). In its 1999 report, the Blue Ribbon Committee recognized the importance of audit committees and issued ten recommendations to improve their effectiveness.[22] In response to these recommendations, the NYSE and the NASD, among others, revised their listing standards relating to audit committees,[23] and we adopted new rules requiring disclosure relating to the functioning, governance and independence of corporate audit committees.[24] Earlier this year, at the Commission's request,[25] the NYSE and the NASD again reviewed their corporate governance standards, including their audit committee rules, in light of several high-profile corporate failures, and have proposed changes to their rules to provide more demanding standards for audit committees.[26]

Recent events involving alleged misdeeds by corporate executives and independent auditors have damaged investor confidence in the financial markets.[27] They have highlighted the need for strong, competent and vigilant audit committees with real authority.[28] In response to the threat to the U.S. financial markets posed by these events, Congress passed, and the President signed into law on July 30, 2002, the Sarbanes-Oxley Act of 2002 (the ''Sarbanes-Oxley Act'').[29] The Sarbanes-Oxley Act mandates sweeping corporate disclosure and financial reporting reform to improve the responsibility of public companies for their financial disclosures. This release is one of several that we are issuing to implement provisions of the Sarbanes-Oxley Act.[30]

In this release, we propose to implement Section 10A(m)(1) of the Exchange Act,[31] as added by Section 301 of the Sarbanes-Oxley Act, which requires us to direct, by rule, the national securities exchanges[32] and national securities associations[33] to prohibit the listing of any security of an issuer that is not in compliance with several enumerated standards regarding issuer audit committees. The new rule must become effective by April 26, 2003, which is 270 days after the date of enactment of the Sarbanes-Oxley Act and Section 10A(m) of the Exchange Act.[34] Under our proposals, the new requirements would need to be operative by the SROs no later than the first anniversary of the publication of our final rule in the **Federal Register**. In addition, our proposals would make

[17] In 1940, the Commission investigated the auditing practices of McKesson & Robbins, Inc., and the Commission's ensuing report prompted action on auditing procedures by the auditing community. *In the Matter of McKesson & Robbins,* Accounting Series Release (ASR) No. 19, Exchange Act Release No. 2707 (Dec. 5, 1940).

[18] For example, in 1972, the Commission recommended that companies establish audit committees composed of outside directors. See ASR 123 (Mar. 23, 1972). In 1974 and 1978, the Commission adopted rules requiring disclosures about audit committees. See Release No. 34–11147 (Dec. 20, 1974) and Release No. 34–15384 (Dec. 6, 1978).

[19] See, *e.g.*, Preliminary Report of the American Bar Association Task Force on Corporate Responsibility (July 16, 2002). The report is available on the American Bar Association's website at www.abanet.org/buslaw/.

[20] The Treadway Commission was sponsored by the American Institute of Certified Public Accountants, the American Accounting Association, the Financial Executives Institute (now Financial Executives International), the Institute of Internal Auditors and the National Association of Accountants. Collectively, these groups were known as the Committee of Sponsoring Organizations, or COSO. The Treadway Commission's report, the Report of the National Commission on Fraudulent Financial Reporting (October 1987), is available at www.coso.org.

[21] GAO, ''CPA Audit Quality: Status of Actions Taken to Improve Auditing and Financial Reporting of Public Companies,'' at 5 (GAO/AFMD–89–38, March 1989).

[22] *See* Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (February 1999). The Blue Ribbon Committee Report is available at www.nyse.com.

[23] *See,* for example, Exchange Act Release No. 42231 (Dec. 14, 1999) [64 FR 71523] (Nasdaq rules) and Exchange Act Release No. 42233 (Dec. 14, 1999) (NYSE rules) [64 FR 71529]. See also Exchange Act Release No. 42232 (Dec. 14, 1999) [64 FR 71518] (American Stock Exchange rules) and Release No. 34–43941 (Feb. 7, 2001) [66 FR 10545] (Pacific Exchange rules).

[24] *See* Exchange Act Release No. 42266 (Dec. 22, 1999) [64 FR 73389].

[25] *See* Press Release No. 2002–23 (Feb. 13, 2002).

[26] See File Nos. SR–NASD–2002–141 and SR–NYSE–2002–33 (pending before the Commission).

[27] See, for example, John Waggoner and Thomas A. Fogarty, ''Scandals Shred Investors' Faith: Because of Enron, Andersen and Rising Gas Prices, the Public is More Wary Than Ever of Corporate America,'' USA Today, May 5, 2002; and Louis Aguilar, ''Scandals Jolting Faith of Investors,'' Denver Post, June 27, 2002.

[28] See, for example, John Good, ''After Enron, Beef Up Those Audit Committees,'' The Commercial Appeal, Apr. 26, 2002; and ''FT Comment After Enron: Giving Meaning to the Codes of Best Practice: Corporate Governance: Companies Need Truly Independent Directors, Strong Audit Committees, an Outlet for Whistleblowers and Tight Controls on Share Options,'' The Financial Times, Feb. 19, 2002.

[29] Pub. L. 107–204, 116 Stat. 745 (2002).

[30] For example, see Release No. 34–46421 (Aug. 27, 2002) [67 FR 56462] (Ownership reports and trading by officers, directors and principal security holders); Release No. 33–8124 (Aug. 28, 2002) [67 FR 57276] (Certification of disclosure in companies' quarterly and annual reports); Release No. 33–46685 (Oct. 18, 2002) [67 FR 65325] (Improper influence on conduct of audits); Release No. 33–8138 (Oct. 22, 2002) [67 FR 66208] (Disclosure regarding internal control reports, audit committee financial experts and company codes of ethics); Release No. 33–8144 (Nov. 4, 2002) [67 FR 68054] (Disclosure about off-balance sheet arrangements, contractual obligations and contingent liabilities and commitments); Release No. 33–8145 (Nov. 4, 2002) [67 FR 68790] (Conditions for use of non-GAAP financial information); Release No. 34–46778 (Nov. 6, 2002) [67 FR 69430] (Insider trades during pension plan blackout periods); Release No. 33–8150 (Nov. 21, 2002) [67 FR 71670] (Implementation of standards of conduct for attorneys); Release No. 33–8151 (Nov. 21, 2002) [67 FR 71018] (Retention of records relevant to audits and reviews); Release No. 33–8154 (Dec. 2, 2002) [67 FR 76780] (Strengthening the Commission's requirements regarding auditor independence); and Release No. 33–8170 (Dec. 20, 2002) [67 FR 79466] (Mandated electronic filing and website posting for Forms 3, 4 and 5).

[31] 15 U.S.C. 78j–1(m)(1).

[32] A ''national securities exchange'' is an exchange registered as such under Section 6 of the Exchange Act (15 U.S.C. 78f). There are currently nine national securities exchanges registered under Section 6(a) of the Exchange Act: American Stock Exchange (AMEX), Boston Stock Exchange, Chicago Board Options Exchange (CBOE), Chicago Stock Exchange, Cincinnati Stock Exchange, International Securities Exchange, New York Stock Exchange (NYSE), Philadelphia Stock Exchange and Pacific Exchange. In addition, an exchange that lists or trades security futures products (as defined in Exchange Act Section 3(a)(56) (15 U.S.C. 78c(56))) may register as a national securities exchange under Section 6(g) of the Exchange Act solely for the purpose of trading security futures products. Regarding security futures products, see Section II.F.2.b.

[33] A ''national securities association'' is an association of brokers and dealers registered as such under Section 15A of the Exchange Act (15 U.S.C. 78o–3). The National Association of Securities Dealers (NASD) is the only national securities association registered with the Commission under Section 15A(a) of the Exchange Act. The NASD partially owns and operates The Nasdaq Stock Market (Nasdaq). Nasdaq has filed an application with the Commission to register as a national securities exchange. In addition, Section 15A(k) of the Exchange Act (15 U.S.C. 78o–3(k)) provides that a futures association registered under Section 17 of the Commodity Exchange Act (7 U.S.C. 21) shall be registered as a national securities association for the limited purpose of regulating the activities of members who are registered as broker-dealers in security futures products pursuant to Section 15(b)(11) of the Exchange Act (15 U.S.C. 78o(b)(11)). Regarding security futures products, see Section II.F.2.b.

[34] See Exchange Act Section 10A(m)(1)(A).

several changes to our current disclosure requirements regarding audit committees.

Under proposed Exchange Act Rule 10A–3,[35] SROs would be prohibited from listing any security of an issuer that is not in compliance with the following standards, as discussed in more detail below:

- Each member of the audit committee of the issuer must be independent according to specified criteria;
- The audit committee of each issuer must be directly responsible for the appointment, compensation, retention and oversight of the work of any registered public accounting firm [36] engaged for the purpose of preparing or issuing an audit report or related work or performing other audit, review or attest services for the issuer, and each such registered public accounting firm must report directly to the audit committee;
- Each 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 the issuer of concerns regarding questionable accounting or auditing matters;
- Each audit committee must have the authority to engage independent counsel and other advisors, as it determines necessary to carry out its duties; and
- Each issuer must provide appropriate funding for the audit committee.

The standards articulated in Section 10A(m) of the Exchange Act will provide a framework in which audit committees can be more effective in protecting shareholder interests and in addressing the risk that management self-interest may diverge from shareholder interest. The audit committee is more likely to be effective in performing its oversight role when it has adequate resources and is empowered to accomplish its responsibilities independently of management, especially when potential conflicts of interests with management may be apparent. Independent audit committee members also are more likely to be objective when evaluating financial disclosure and internal controls. There must also be frank, open and clear channels of communication so that information can reach the audit committee.

II. Proposed Changes

Under Section 3(a)(58) of the Exchange Act,[37] as added by Section 205 of the Sarbanes-Oxley Act, the term audit committee is defined as:

- A committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and
- If no such committee exists with respect to an issuer, the entire board of directors of the issuer.

Accordingly, an issuer either may have a separately designated audit committee composed of members of its board or, if it chooses to do so or if it fails to form a separate committee, the entire board of directors would constitute the audit committee. If the entire board constituted the audit committee, our proposals for the new SRO rules, including the independence requirements, would apply to the issuer's board as a whole.

In addition, because proposed Exchange Act Rule 10A–3 would impose requirements that only would apply to issuers listed on a national securities exchange or listed in an automated inter-dealer quotation system of a national securities association,[38] the requirements of proposed Exchange Act Rule 10A–3 only would apply to issuers that are so listed. None of the requirements of Section 10A(m) of the Exchange Act or proposed Exchange Act Rule 10A–3 apply to other reporting companies under Section 13(a) [39] or 15(d) [40] of the Exchange Act.

A. Audit Committee Member Independence

As early as 1940, the Commission encouraged the use of audit committees composed of independent directors.[41] An audit committee comprised of independent directors is better situated to assess objectively the quality of the issuer's financial disclosure and the adequacy of internal controls than a committee that is affiliated with management. Management may face market pressures for short-term performance and corresponding pressures to satisfy market expectations. These pressures could be exacerbated by the use of compensation or other incentives focused on short-term stock appreciation, which can promote self-interest rather than the promotion of long-term shareholder interest. An independent audit committee with adequate resources helps to overcome this problem and to align corporate interests with those of shareholders. An independent audit committee also would likely be better equipped to satisfy several other new requirements mandated by the Sarbanes-Oxley Act and the Exchange Act, such as overseeing a sound system of internal controls, approving any non-audit services by the outside auditor and enhancing the independence of the audit function.

The proposed requirements would enhance audit committee independence by implementing the two basic criteria for determining independence enumerated in Section 10A(m) of the Exchange Act. First, audit committee members would be barred 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 and any board committee.[42] This prohibition would preclude payments to a member as an officer or employee, as well as other compensatory payments. To prevent evasion of this requirement, disallowed payments to an audit committee member would include payments made either directly or indirectly. We believe that barring indirect as well as direct compensatory payments is necessary to implement the intended purposes of Section 10A(m) of the Exchange Act. For example, payments to spouses of members raise questions regarding independence comparable to those raised by payments to members themselves. In addition, we believe that payments for services to law firms, accounting firms, consulting firms, investment banks or similar entities in which audit committee members are partners or hold similar positions are the kinds of compensatory payments that were intended to be precluded by Exchange Act Section 10A(m). We therefore propose that indirect

[35] Exchange Act Rule 10A–2 (17 CFR 240.10A–2) was proposed in Release No. 33–8154 (Dec. 2, 2002).

[36] The term ''registered public accounting firm'' is defined in Section 2(a)(12) of the Sarbanes-Oxley Act. See 15 U.S.C. 78c(b)(59). Until the Public Company Accounting Oversight Board that is contemplated under the Sarbanes-Oxley Act has established the registration of public accounting firms, the proposed requirement relating to the audit committee's oversight would refer to the public accounting firm employed by the issuer for the purposes indicated.

[37] 15 U.S.C. 78c(a)(58).

[38] In this release, we refer to issuers that are listed on one or more of these markets as ''listed issuers.''

[39] 15 U.S.C. 78m(a).

[40] 15 U.S.C. 78o(d).

[41] See note 17 above.

[42] See Section 10A(m)(3)(B)(i) of the Exchange Act and proposed Exchange Act Rule 10A–3(b)(1)(ii)(A) and (iii)(A). If the committee member is also a shareholder of the issuer, payments made to all shareholders generally, such as dividends, would not be prohibited by this provision.

acceptance of compensatory payments includes 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 or principal or occupies a similar position and which provides accounting, consulting, legal, investment banking, financial or other advisory services or any similar services to the issuer.[43]

In seeking to ensure appropriate levels of independence, we recognize that some SROs currently restrict additional business or personal relationships,[44] and that some SROs are seeking to add to these requirements, in particular in the additional listing standards that are currently under consideration.[45] We support the goals the SROs are trying to achieve through these ongoing efforts, and we are committed to working with the SROs to ensure the success of these proposals. We believe that our mandate under Section 10A(m) of the Exchange Act, where independence is evaluated by reference to payments of compensatory fees, is best fulfilled by our current proposal. Our proposal would not, for example, preclude independence on the basis of ordinary course commercial business relationships between an issuer and an entity with which a director had a relationship. Our proposal also would not extend to the broad categories of family members that may be reached by SRO listing standards. Instead, our proposals build and rely on the SROs standards of independence that cover additional relationships not specified in Exchange Act Section 10A(m). Our proposal would allow the SROs to adopt further requirements of these sorts, but they would do so within the more flexible environment of listing standards. We encourage SROs that do not currently have separate independence requirements to adopt appropriate requirements in connection with their implementation of the standards in Exchange Act Section 10A(m).

As the second basic criterion for determining independence, a member of the audit committee of an issuer that is not an investment company may not be an affiliated person of the issuer or any subsidiary of the issuer apart from his or her capacity as a member of the board and any board committee. We would clarify that a director, executive officer, partner, member, principal or designee of an affiliate would be deemed to be an affiliate. For purposes of the proposed rule, we propose to define the terms ''affiliate'' and ''affiliated person'' consistent with our other definitions of these terms under the securities laws, such as in Exchange Act Rule 12b–2 [46] and Securities Act Rule 144,[47] with an additional safe harbor.[48] We propose to define ''affiliate'' of, or a person ''affiliated'' with, a specified person, to mean ''a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.'' [49] We propose to define the term ''control'' consistent with our other definitions of this term under the Exchange Act [50] as ''the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.'' [51]

Similarly, a member of the audit committee of an issuer that is an investment company could not be an ''interested person'' of the investment company as defined in Section 2(a)(19) [52] of the Investment Company Act.[53] We have substituted the Section 2(a)(19) test for the affiliation test applied to operating companies because the Section 2(a)(19) test is tailored to capture the broad range of affiliations with investment advisers, principal underwriters, and others that are relevant to ''independence'' in the case of investment companies.

Our proposed definition of ''affiliated person'' for non-investment companies, like our existing definitions of this term for these issuers, would require a factual determination based on a consideration of all relevant facts and circumstances. However, because we recognize that it can be difficult to determine whether someone controls an issuer, we are proposing to create a safe harbor from this aspect of the proposed definition of ''affiliated person.'' [54] Under the proposed safe harbor, a person who is not an executive officer, director or 10% shareholder of the issuer would 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.[55]

This safe harbor should cover most non-affiliates without including people who control an issuer. Moreover, our proposal would create only a safe harbor position. Therefore, an audit committee member that would not be eligible to rely on the safe harbor would not be deemed an affiliated person by virtue of those facts. Those who would be ineligible to rely on the safe harbor, but believe that they do not control an issuer, still could rely on a facts and circumstances analysis.

Under Exchange Act Section 10A(m)(3)(C), we have the authority to exempt from the independence requirements particular relationships with respect to audit committee members, if appropriate in light of the circumstances. Companies coming to market for the first time may face particular difficulty in recruiting members that meet the proposed independence requirements. Before a company's initial public offering, the board of directors often will consist primarily, if not exclusively, of representatives of venture capital investors and insiders. Such representation is entirely consistent with the desire of these parties to have representation in their private venture. The difficulty of recruiting independent directors before an initial public offering, coupled with the uncertainty of whether the initial public offering will be completed, may discourage companies from accessing the public markets to grow their business and provide liquidity, as well as from achieving the other benefits of being a public company, if all of their audit committee members must be independent at the time of the initial public offering. Further, the audit committee of some new public companies may function more

[43] See proposed Exchange Act Rule 10A–3(e)(6).

[44] See note 23 above.

[45] See note 26 above.

[46] 17 CFR 240.12b–2.

[47] 17 CFR 230.144.

[48] Exchange Act Section 3(a)(19), in defining several terms in relation to investment companies, includes a definition of ''affiliated person'' by reference to the Investment Company Act. Because that definition is tailored to investment companies, our proposed definition would use a definition for non-investment companies consistent with our other definitions of ''affiliate'' for non-investment companies.

[49] See proposed Exchange Act Rule 10A–3(e)(1).

[50] See, *e.g.*, Exchange Act Rule 12b–2.

[51] See proposed Exchange Act Rule 10A–3(e)(3).

[52] 15 U.S.C. 80a–2(a)(19).

[53] See proposed Exchange Act Rule 10A–3(b)(1)(iii)(B). The ''interested person'' test would apply to business development companies, as well as registered investment companies. See note 95.

[54] See proposed Exchange Act Rule 10A–3(e)(1). Note that this safe harbor does not address the question of whether a person ''is controlled by, or is under common control with'' the issuer. We proposed a similar safe harbor from the definition of ''affiliate'' for Securities Act Rule 144 in 1997. See Release No. 33–7391 (Feb. 20, 1997) [62 FR 9246].

[55] 17 U.S.C. 78p. However, unlike our rules under Section 16, for purposes of determining who is an executive officer and calculating beneficial ownership, we propose to refer to Exchange Act Rule 3b–7 [17 CFR 240.3b–7] for the definition of ''executive officer'' and Exchange Act Rule 13d–3(d)(1) [17 CFR 240.13d–3(d)(1)] for calculating beneficial ownership.

effectively if one director has historical knowledge and experience with the company. Accordingly, we propose 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 under Section 12 of the Exchange Act or a registration statement under the Securities Act covering an initial public offering of securities of the issuer.[56]

Further, many companies, particularly financial institutions and other entities with a holding company structure, operate through subsidiaries. For these companies, the composition of the boards of the parent company and the subsidiary are sometimes similar given the control structure between the parent and the subsidiary. If an audit committee member of the parent is otherwise independent, merely serving also on the board of a controlled subsidiary should not adversely affect the board member's independence, assuming that the board member also would be considered independent of the subsidiary except for the member's seat on the parent's board. Accordingly, we propose to exempt from the ''affiliated person'' requirement a committee member that sits on the board of directors of both a parent and a direct or indirect consolidated majority-owned subsidiary, if the committee member otherwise meets the independence requirements for both the parent and the subsidiary, 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 the parent or subsidiary.[57]

As discussed in Section II.G.1 below, any issuer availing itself of any of these exceptions would have to disclose that fact. Apart from the two limited exemptions discussed above, and the exemptions for controlling shareholders, foreign governmental board representatives and non-management employee members of foreign private issuers discussed in Section II.F.3.a below, we do not propose to exempt any other particular relationships from the independence requirements at this time. In this regard, we note that Section 10A(m) of the Exchange Act does not, and therefore our proposed rule does not, contain any exemptions based on exceptional and limited circumstances similar to those that exist currently under several SRO rules.[58] Also, given the policy and purposes behind the Sarbanes-Oxley Act, as well as to maintain consistency and to ease administration of the requirements by the SROs, we do not currently propose to entertain exemptions or waivers for particular relationships on a case-by-case basis.[59]

Questions regarding the proposed independence requirements:

- Is additional clarification necessary regarding the consulting, advisory or other compensatory fee prohibition? For example, should we clarify whether ''compensatory fees'' would include compensation under a retirement or similar plan in which a former officer or employee of the issuer participates? Should there be an exception for a *de minimis* amount of payments? If so, what amount would be appropriate? How would such an exception be consistent with the purposes of the prohibition?
- Is the proposed extension of the compensatory prohibition to spouses, minor children or stepchildren or children or stepchildren sharing a home with the member appropriate? Should it be expanded or narrowed? For example, should there be an exception for non-executive family members employed by the issuer? Is the extension to payments accepted by an entity in which an audit committee member is a partner, member or principal or occupies a similar position and which provides accounting, consulting, legal, investment banking, financial or other advisory services or any similar services to the issuer appropriate? Should we extend the prohibition further, such as to ordinary course business relationships?
- Is the proposed definition of ''affiliated person'' for non-investment companies appropriate? Is the proposed safe harbor from the definition of affiliated person appropriate? Should it include fewer or more persons? In responding to these questions, please keep in mind that, by its very nature, it would be difficult to create a safe harbor covering all individuals who are non-affiliates without inadvertently covering affiliates as well. The safe harbor would not create a presumption that those outside the safe harbor are affiliates. Rather, the safe harbor is designed to cover only those individuals whom we reasonably believe would not be affiliates. Is this assumption accurate? Can we reliably assume that people who own less than 10% of a company and are not officers or directors are not in control of the company? Should this threshold be higher (*e.g.*, 20%) or lower (*e.g.*, 5%)? Should the exclusion from the definition of affiliate include an express presumption that those persons not so excluded are affiliates, unless rebutted by a majority of independent directors?
- Should we rely exclusively on retaining a subjective test for determining affiliate status, given the varied contractual arrangements with a control feature entered into by issuers, particularly smaller companies? A person might employ specified thresholds to conceal a control relationship. Should a facts and circumstances test be retained in order to reflect the different ways a control relationship can be established with an issuer?
- Should the board of directors be required to determine whether an audit committee member is independent?[60] Should the board be required to disclose this determination? If so, when? If the board should not make the determination, who should?
- The proposed independence requirements relate to current relationships with the audit committee member and related persons. Should the prohibition also extend to a ''look back'' period before the appointment of the member to the audit committee? If so, what period (*e.g.*, three years or five years) would be appropriate? Should there be different look-back periods for different relationships or different parties? If so, which ones?
- Should there be additional criteria for independence apart from the two proposed criteria? For example, in addition to the proposed prohibitions, should there be a prohibition on any transactions or relationships with the audit committee member or an affiliate of the audit committee member apart from the committee member's capacity as a member of the board and any board committee?
- Should additional relationships be exempted from the independence requirements at this time? If so, which relationships should be exempted, why should they be exempted, and how would such an exemption be consistent with maintaining the independence of the audit committee?
- Is the proposed exemption for new public companies appropriate? Should

[56] See proposed Exchange Act Rule 10A–3(b)(1)(iv)(A).

[57] See proposed Exchange Act Rule 10A–3(b)(1)(iv)(B).

[58] See, for example, Section 303.01 of the NYSE's listing standards; Rule 4350(d) of the NASD's listing standards and Section 121B of the AMEX's listing standards. The rules of the NYSE, NASD and AMEX are available on their Web sites at *www.nyse.com, www.nasd.com* and *www.amex.com*, respectively.

[59] Similarly, Commission staff would not entertain no-action letter or exemption requests in this area.

[60] See, *e.g.*, note 26 above.

more than one audit committee member be exempted from the requirements? Should a specific percentage of audit committee members be exempted? Should the exemption be conditioned on there being at least a majority of independent directors on the audit committee? Should the exemption period be longer (*e.g.*, 1 year) or shorter (*e.g.*, 30 days)? We are not proposing to apply this exemption to investment companies. Should this exemption apply to investment companies?

- Is the proposed exemption for independent board members that sit on both a parent's and consolidated majority-owned subsidiary's board of directors appropriate? Is the requirement that the board member also is otherwise independent of the subsidiary necessary? Should the exemption be limited only to wholly owned subsidiaries or other specified level of ownership? Should the exemption be denied if the subsidiary maintains a listing for its own securities? Is there any need for a similar exemption from the ''interested person'' test for investment companies?
- Should there be an exception to the independence requirements based upon exceptional and limited circumstances, if the board determines that membership on the committee by the individual is required by the best interests of the corporation and its shareholders? If so, should the board be required to disclose the nature of the relationship and the reasons for that determination? Should there be a time limit for these appointments?
- Should companies be allowed to request exemptive relief on a case-by-case basis? If so, what procedures should be used for submitting and evaluating applications for exemptive relief? What factors should the Commission consider in considering such requests? How would such a case-by-case process be consistent with the policy and purposes of Section 10A(m)? How would such a process be coordinated between the Commission and the SROs? Should companies be required to disclose publicly any exemption they receive? Should SROs be permitted to grant exemptions within defined parameters? What should those parameters be?
- Are any modifications required to the consulting, advisory or other compensatory fee prohibition for investment companies? Is it appropriate to use the definition of ''interested person'' as set forth in Section 2(a)(19) of the Investment Company Act to test the independence of members of investment company audit committees, as proposed? If not, should the rule apply the affiliation test, which we propose to apply to operating companies, or a different test?

B. Responsibilities Relating to Registered Public Accounting Firms

One of the audit committee's primary functions is to enhance the independence of the audit function, thereby furthering the objectivity of financial reporting. The Commission has long recognized the importance of an auditor's independence in the audit process.[61] The auditing process may be compromised when a company's outside auditors view their main responsibility as serving the company's management rather than its full board of directors or its audit committee. This may occur if the auditor views management as its employer with hiring, firing and compensatory powers. Under these conditions, the auditor may not have the appropriate incentive to raise concerns and conduct an objective review. Further, if the auditor does not appear independent to the public, then investor confidence is undermined and one purpose of the audit is frustrated. One way to help ensure that the auditor is truly independent, then, is for the auditor to be hired, evaluated and, if necessary, terminated by the audit committee. This would help to align the auditor's interests with those of shareholders.

Accordingly, under the proposed rule, an audit committee would have to be directly responsible for the appointment, compensation, retention and oversight of the work of the independent auditor engaged (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work or performing other audit, review or attest services for the issuer,[62] and the independent auditor would have to report directly to the audit committee. We propose to clarify that these oversight responsibilities include the authority to retain the outside auditor, which would include the power not to retain (or to terminate) the outside auditor. In addition, in connection with these oversight responsibilities, the audit committee would need to have ultimate authority to approve all audit engagement fees and terms, as well as all significant non-audit engagements of the independent auditor. In this regard, the proposed requirement would reinforce the new requirement in section 10A(i) of the Exchange Act, as added by section 202 of the Sarbanes-Oxley Act, that auditing and non-auditing services be pre-approved by the audit committee. The proposed requirement, like the other proposed requirements, also would promote compliance with an issuer's internal control requirements.

The proposed requirement does not conflict with, and would not be affected by, any requirement under a company's governing law or documents or other home country requirements that requires shareholders to elect, approve or ratify the selection of the issuer's auditor. The proposed requirement instead relates to the assignment of responsibility to oversee the auditor's work as between the audit committee and management. We propose to add an instruction to the new rule to reflect this intention. In such an instance, however, if the issuer provides a recommendation or nomination of an auditor to its shareholders, the audit committee of the issuer would need to be responsible for making the recommendation or nomination.[63]

In addition, we are proposing to exempt investment companies from the requirement that the audit committee be responsible for the selection of the independent auditor. Section 32(a) of the Investment Company Act,[64] which requires that independent auditors of registered investment companies be selected by majority vote of the disinterested directors, already addresses the concerns behind this requirement. Investment companies

[61] The federal securities laws recognize the importance of independent auditors. See, *e.g.*, Items 25 and 26 of Schedule A of the Securities Act and Sections 12(b)(1)(J) and 13(a)(2) of the Exchange Act [15 U.S.C. 78*l*(b)(1)(J) and 78m(a)(2)]. *See also* Title II of the Sarbanes-Oxley Act.

[62] For a further discussion of the scope of audit, review and attest services, which are broader than those services required to perform an audit pursuant to generally accepted auditing standards, *see* Release No. 33–8154 (Dec. 2, 2002). For example, Section 10A(i)(1)(A) of the Exchange Act [15 U.S.C. 78j–1(i)(1)(A)] identifies services related to the issuance of comfort letters and services related to statutory audits required for insurance companies for purposes of state law as audit services.

[63] Similarly, the proposed requirement does not conflict with any requirement in a company's home jurisdiction that prohibits the full board of directors from delegating the responsibility to select the company's auditor. In that case, the audit committee would need to be granted advisory and other powers with respect to such matters to the extent permitted by law, including submitting nominations to the full board.

[64] 15 U.S.C. 80a–31(a). The exemption would apply to business development companies because they are subject to the requirements of Section 32(a) of the Investment Company Act pursuant to Section 59 of the Investment Company Act [15 U.S.C. 80a–58]. Business development companies are a category of closed-end investment company that are not registered under the Investment Company Act, but are subject to certain provisions of that Act. *See* Sections 2(a)(48) and 54–65 of the Investment Company Act [15 U.S.C. 80a–2(a)(48) and 80a–53–64].

generally would remain subject to the proposed requirements regarding audit committee responsibility in all other areas, including compensation and oversight of the auditors.[65]

Questions regarding the proposed auditor responsibility requirement:

- We request comment on implementation of this proposed requirement. Is additional specificity needed?
- Should the audit committee also be directly responsible for the appointment, compensation, retention and oversight of an issuer's internal auditor? Should other responsibilities be under the supervision of the audit committee?
- Does the proposed instruction that the requirement does not conflict with, and is not affected by, any requirement that requires shareholders to ultimately elect, approve or ratify the selection of the issuer's auditor adequately address the concerns of issuers whose governing law or documents requires shareholder selection of the auditor? Are additional accommodations necessary? Please explain how any accommodation would be consistent with the Sarbanes-Oxley Act.
- Should the requirements relating to independent auditor selection of Section 32(a) of the Investment Company Act be retained with respect to registered investment companies falling within the scope of the proposed rule? If so, why? Should the Commission instead exempt registered investment companies from the requirements relating to independent auditor selection in Section 32(a) of the Investment Company Act, when such investment companies fall within the scope of the proposed rule, and require that their independent auditors be selected by the audit committee? If so, why?
- Should the Commission require registered investment companies to comply with the requirements of both Section 32(a) of the Investment Company Act and the proposed rule with respect to the selection of independent auditors? If so, should we interpret these provisions to require that the audit committee nominate the independent auditor and the majority of disinterested directors approve the independent auditor?
- We note that our recent release regarding auditor independence proposes that the audit committee of a registered investment company separately approve the independent auditor.[66] How should the Commission reconcile proposed Rule 10A–3, the auditor independence proposal, and Section 32(a) of the Investment Company Act?

C. Procedures for Handling Complaints

The audit committee must place some reliance on management for information about the company's financial reporting process. Since the audit committee is dependent to a degree on the information provided to it by management and internal and outside auditors, it is imperative for the committee to cultivate open and effective channels of information. Management may not have the appropriate incentives to self-report all questionable practices. A company employee or other individual may be reticent to report concerns regarding questionable accounting or other matters for fear of management reprisal.[67] The establishment of formal procedures for receiving and handling complaints could serve to facilitate disclosures, encourage proper individual conduct and alert the audit committee to potential problems before they have serious consequences.

Accordingly, under the standards contemplated by the proposals, each audit committee would need to establish procedures for:[68]

- 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 or auditing matters.

We do not propose to mandate specific procedures that the audit committee must establish. Given the variety of listed issuers in the U.S. capital markets, we believe companies should be provided with flexibility to develop and utilize procedures appropriate for their circumstances. We expect each audit committee to develop procedures that work best consistent with its company's individual circumstances.

Questions regarding the proposed complaint procedures requirement:

- Do most listed issuers have procedures for the receipt, retention and treatment of complaints or for the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters? If so, how do these procedures work? Are they effective in their purpose?
- Should the proposed rule require a company to disclose the procedures that have been established or any changes to those procedures? If so, where and how often should the disclosure appear and what should it look like?
- Should specified procedures be prescribed or encouraged? For example, should we specify how long complaints must be retained? Should we specify who could or could not be designated by the audit committee for the receipt and treatment of complaints?

D. Authority To Engage Advisors

To be effective, an audit committee must have the necessary resources and authority to fulfill its function. The audit committee likely is not equipped to self-advise on all accounting, financial reporting or legal matters. To perform its role effectively, therefore, an audit committee may need the authority to engage its own outside advisors, including experts in particular areas of accounting, as it determines necessary apart from counsel or advisors hired by management, especially when potential conflicts of interest with management may be apparent.

The advice of outside advisors may be necessary to identify potential conflicts of interest and assess the company's disclosure and other compliance obligations with an independent and critical eye. Often, outside advisors can draw on their experience and knowledge to identify best practices of other companies that might be appropriate for the issuer. The assistance of outside advisors also may be needed to independently investigate

[65] Section 32(a) applies to management investment companies and face-amount certificate companies. It does not apply to unit investment trusts, which do not have boards of directors and which we propose to exclude entirely from the requirements that we are proposing. *See* Section II.F.3.d. concerning unit investment trusts. There are three types of investment companies: face-amount certificate companies, unit investment trusts and management companies. *See* Section 4 of the Investment Company Act [15 U.S.C. 80a–4]. The Investment Company Act divides management companies into two sub-categories, defining an open-end company as a management company that offers for sale or has outstanding any redeemable securities of which it is the issuer and a closed-end company as any management company other than an open-end company. *See* Section 5(a) of the Investment Company Act [15 U.S.C. 80a–5(a)]. A unit investment trust is an investment company that is organized under a trust indenture, contract of custodianship or agency, or similar instrument; does not have a board of directors; and issues only redeemable securities, each of which represents an undivided interest in a unit of specified securities, but does not include a voting trust. See Section 4(2) of the Investment Company Act of 1940 [15 U.S.C. 80a–4(2)].

[66] *See* Exchange Act Release No. 46934 (Dec. 2, 2002).

[67] The Sarbanes-Oxley Act provides additional protections for employees who provide evidence of fraud. *See,* for example, Section 806 of the Sarbanes-Oxley Act.

[68] The Commission's proposals are not intended to preempt or supersede any other Federal or State requirements relating to receipt and retention of records.

questions that may arise regarding financial reporting and compliance with the securities laws. Accordingly, the proposed rule would specifically require an issuer's audit committee to have the authority to engage outside advisors, including counsel, as it determines necessary to carry out its duties.[69]

Questions regarding the proposed authority to engage advisors requirement:

- Is any additional specificity needed for this requirement? For example, should we define what constitutes an ''independent advisor?'

E. Funding

An audit committee's effectiveness may be compromised if it is dependent on management's discretion to compensate the independent auditor or the advisors employed by the committee, especially when potential conflicts of interest with management may be apparent. Accordingly, the proposed rule would require the issuer to provide for appropriate funding, as determined by the audit committee, in its capacity as a committee of the board of directors, for payment of compensation:

- To any registered public accounting firm engaged for the purpose of rendering or issuing an audit report or related work or performing other audit, review or attest services for the listed issuer; and
- To any advisors employed by the audit committee.

This proposed requirement would further the proposed standard relating to the audit committee's responsibility to appoint, compensate, retain and oversee the outside auditor. It also would add meaning to the proposed standard relating to the audit committee's authority to engage independent advisors. Not only could an audit committee be hindered in its ability to perform objectively its duties by not having control over the ability to compensate these advisors, but the role of the advisors also could be compromised if they are required to rely on management for compensation. Thus, absent such a provision, both the audit committee and the advisors could be less willing to address disagreements or other issues with management.

Questions regarding the proposed funding requirement:

- Is any additional specificity needed for this requirement? For example, should a specific agreement or arrangement be required to provide for the appropriate funding?
- Should there be any limit on the amount of compensation that could be requested by the audit committee? If so, who should set these limits (*e.g.*, the full board)? Should the audit committee's request be limited to ''reasonable'' compensation? Who would determine what is ''reasonable''? How would such limits be consistent with the policy and purposes of the Sarbanes-Oxley Act? Is the fact that the audit committee members ultimately are elected by, and answerable to, shareholders sufficient to address any concern over compensation limits?

F. Application and Implementation of the Proposed Standards

1. SROs Affected

Section 10A(m) of the Exchange Act by its terms applies to all national securities exchanges and national securities associations. These entities, to the extent that their listing standards do not already comply with the proposals, will be required to issue or modify their rules, subject to Commission review, to conform their listing standards.[70] Under our proposals, the new requirements would need to be operative by the SROs no later than the first anniversary of the publication of our final rule in the **Federal Register**. The SROs are not precluded from adopting additional listing standards regarding audit committees, as long as they are consistent with the proposed rule.

To facilitate timely implementation of the proposals, we propose that each SRO must provide to the Commission, no later than 60 days after publication of our final rule in the **Federal Register**, proposed rules or rule amendments that comply with our final rule. Further, each SRO would need to have final rule or rule amendments that comply with our final rule approved by the Commission no later than 270 days after publication of our final rule in the **Federal Register**. We request comment below on the appropriateness of these periods.

The OTC Bulletin Board (OTCBB), the Pink Sheets and the Yellow Sheets would not be affected by the proposed requirements, and therefore issuers whose securities are quoted on these interdealer quotation systems similarly would not be affected, unless their securities also are listed on an exchange or Nasdaq.[71] Each of these quotation systems does not provide issuers with the ability to list their securities, but is a quotation medium for the over-the-counter securities market that collects and distributes market maker quotes to subscribers. These interdealer quotation systems do not maintain or impose listing standards, nor do they have a listing agreement or arrangement with the issuers whose securities are quoted through them. Although market makers may be required to review and maintain specified information about the issuer and to furnish that information to the interdealer quotation system,[72] the issuers whose securities are quoted on such systems do not have any filing or reporting requirements with the system.[73]

Questions regarding the proposed application to SROs

- Do the proposed implementation dates provide sufficient time for SROs to propose and obtain Commission approval for new or amended rules to meet the requirements of the proposals? Is the date by when the standards would need to be operative appropriate? If not, what other dates would be appropriate? What factors should the Commission consider in determining these dates?

2. Securities Affected

In enacting Section 10A(m) of the Exchange Act, Congress made no distinction regarding the type of securities to be covered. Section 10A(m)(1)(A) of the Exchange Act prohibits the listing of ''any security'' of an issuer that does not meet the new standards for audit committees. Accordingly, the proposed rule would apply not just to voting equity securities, but to any listed security, regardless of its type, including debt securities, derivative securities and other types of listed securities. We believe investors in all securities of an issuer, whether common equity or fixed income, would benefit from the increased financial oversight of an issuer that would result from a strong and effective audit committee.

[69] The proposed requirement would not preclude access to or advice from the company's internal counsel or regular outside counsel. It also would not require an audit committee to retain independent counsel.

[70] An SRO that wished to do so could satisfy the requirements of the rule by requiring that a listed issuer must comply with Exchange Act Rule 10A–3.

[71] The OTCBB is operated by The Nasdaq Stock Market, Inc., which is owned by the NASD. Information about the OTCBB can be found at *www.otcbb.com.* The Pink Sheets and the Yellow Sheets (as well as the corresponding Electronic Quotation Service) are operated by Pink Sheets LLC. Information about the Pink Sheets, the Yellow Sheets and the Electronic Quotation Service can be found at *www.pinksheets.com.*

[72] *See* 17 CFR 240.15c2–11.

[73] However, under OTCBB rules, issuers of securities quoted on the OTCBB must be subject to periodic filing requirements with the Commission or other regulatory authority. *See* NASD Rule 6530.

a. Multiple Listings

Many companies today issue multiple classes of securities through various ownership structures on various markets. For example, a company may have a class of common equity securities listed on one market, several classes of debt listed on one or more other markets, and derivative securities listed on yet another market. If a company already was subject to the proposed standards as a result of one listing, there would be little or no additional benefit from having the requirements imposed on the company due to an additional listing. Further, once one national securities exchange or national securities association is responsible for monitoring the compliance of a company with the standards, there would be little or no additional benefit, and much overlap and duplicative effort, from requiring more than one of these SROs to monitor compliance.

In addition, issuers often issue non-equity securities through a wholly owned or majority-owned subsidiary for various reasons. Requiring these subsidiaries, which often have no purpose other than to issue or guarantee the securities, to be subject to the proposed audit committee requirements would add little additional benefit if the subsidiary is closely controlled by a parent issuer that is subject to the proposed requirements. Instead, imposing the requirement on these subsidiaries could create an onerous burden on the parent to recruit and maintain an audit committee meeting the requirements for each specific subsidiary.

Accordingly, we propose an exemption from the proposed requirements for additional listings of securities by a company at any time the company is subject to the proposed requirements as a result of the listing of a class of common equity or similar securities. The additional listings could be on the same market or on different markets. We condition this exemption on the listing of a class of common equity or similar securities because these securities would most likely represent the primary public listing of the company. Companies that do not have a class of common equity or similar securities listed would be subject to the proposed requirements in each affected market where its securities were listed.

We also propose to extend this exemption to listings of non-equity securities by a direct or indirect consolidated majority-owned subsidiary of a parent company, if the parent company is subject to the proposed requirements as a result of the listing of a class of its equity securities. However, if the subsidiary were to list its own equity securities (other than non-convertible, non-participating preferred securities [74]) the subsidiary would be required to meet the proposed requirements to protect its own public shareholders.

b. Security Futures Products and Standardized Options

The enactment of the Commodity Futures Modernization Act of 2000, or CFMA,[75] addressed the regulation of security futures products.[76] It permits national securities exchanges registered under Section 6 of the Exchange Act [77] and national securities associations registered under Section 15A(a) of the Exchange Act [78] to trade futures on individual securities and on narrow-based security indices (''security futures'') without being subject to the issuer registration requirements of the Securities Act and Exchange Act as long as they are cleared by a clearing agency that is registered under Section 17A of the Exchange Act [79] or that is exempt from registration under Section 17A(b)(7)(A) of the Exchange Act. In December 2002, we adopted rules to provide comparable regulatory treatment for standardized options.[80]

The role of the clearing agency for security futures products and standardized options is fundamentally different from a conventional issuer of securities. For example, the purchaser of these products does not, except in the most formal sense, make an investment decision regarding the clearing agency. As a result, information about the clearing agency's business, its officers and directors and its financial statements is less relevant to investors in these products than to investors in the underlying security. Similarly, the investment risk in these products is determined by the market performance of the underlying security rather than the performance of the clearing agency. Moreover, the clearing agencies are self-regulatory organizations subject to regulatory oversight. Furthermore, unlike a conventional issuer, the clearing agency does not receive the proceeds from sales of security futures products or standardized options.[81]

Recognizing these fundamental differences, we propose to exempt from our proposed rule the listing of a security futures product cleared by a clearing agency that is registered under Section 17A of the Exchange Act or exempt from registration under Section 17A(b)(7) of the Exchange Act. We propose a similar exemption for the listing of standardized options issued by a clearing agency registered under Section 17A of the Exchange Act.

Questions regarding proposed application to listed securities:

- Is the proposed exemption for the listings of other classes of securities of an issuer appropriate? Would the benefit of having multiple SROs monitoring compliance outweigh the potential duplicative and administrative burdens that would be imposed on issuers and SROs if there was not such an exemption? Should the exemption be conditioned on having a class of common equity or similar securities listed, or should any class of securities be sufficient?
- Similarly, is the proposed exemption of listings of non-equity securities by consolidated majority-owned subsidiaries appropriate? Instead, should all issuers of securities be required to maintain an audit committee meeting the proposed standards? What would be the burden on companies from mandating such a requirement? Should the exemption be limited to wholly owned subsidiaries or some other specified level of ownership? Is limiting the exemption to non-equity securities (other than non-convertible, non-participating preferred securities) of the subsidiary appropriate?
- Is the exclusion for securities futures products and standardized options appropriate? If not, how should these securities be handled?
- Although we do not propose to exempt other types of securities from

[74] Trust-preferred and similar securities also would fall within this category.

[75] Pub. L. No. 106–554, 114 Stat. 2763 (2000).

[76] Securities Act Section 2(a)(16) [15 U.S.C. 77b(a)(16)], Exchange Act Section 3(a)(56) [15 U.S.C. 78c(a)(56)], and Commodities Exchange Act Section 1a(32) [7 U.S.C. 1a(32)] define ''security futures product'' as a security future or an option on a security future.

[77] 15 U.S.C. 78f.

[78] 15 U.S.C. 78o–3(A).

[79] 15 U.S.C. 78q–1.

[80] *See* Release No. 33–8171 (Dec. 23, 2002) [68 FR 188]. In that release, we exempted standardized options issued by registered clearing agencies and traded on a registered national securities exchange or on a registered national securities association from all provisions of the Securities Act, other than the Section 17 antifraud provision of the Securities Act, as well as the Exchange Act registration requirements. Standardized options are defined in Exchange Act Rule 9b–1(a)(4) [17 CFR 240.9b–1(a)(4)] as option contracts trading on a national securities exchange, an automated quotation system of a registered securities association, or a foreign securities exchange which relate to option classes the terms of which are limited to specific expiration dates and exercise prices, or such other securities as the Commission may, by order, designate.

[81] However, the clearing agency may receive a clearing fee from its members.

coverage of the proposed rule, we request comment on the propriety of either a complete or partial exemption from the requirements for other types of securities? For example, should the rule apply only to classes of voting common equity of an issuer? What would be the basis for such an exclusion, and how would it be consistent with the purposes of the Sarbanes-Oxley Act? In responding to this request, commenters should specifically address how such an exemption would be consistent with investor protection.

3. Issuers Affected

a. Foreign Issuers

For many years, U.S. investors increasingly have been seeking opportunities to invest in a wide range of securities, including the securities of foreign issuers, and foreign issuers have been seeking opportunities to raise capital and effect equity-based acquisitions in the U.S. using securities as the ''acquisition currency.'' The Commission has responded to these trends by seeking to facilitate the ability of foreign issuers to access U.S. investors through listings and offerings in the U.S. capital markets. We have long recognized the importance of the globalization of the securities markets both for investors who desire increased diversification and international companies that seek capital in new markets.

Section 10A(m) of the Exchange Act makes no distinction between domestic and foreign issuers. With the growing globalization of the capital markets, the importance of maintaining effective oversight over the financial reporting process is relevant for listed securities of any issuer, regardless of its domicile. Many foreign private issuers [82] already maintain audit committees, and the global trend appears to be toward establishing audit committees.[83] The proposed rule, therefore, would apply to foreign private issuers as well as domestic issuers.

However, we are aware that the proposed requirements may conflict with legal requirements, corporate governance standards and the methods for providing auditor oversight in the home jurisdictions of some foreign issuers. Several foreign issuers and their representatives have expressed concerns about the possible application of Exchange Act Section 10A(m).[84] In our proposal, we attempt to address these concerns in specific areas in which foreign corporate governance arrangements differ significantly from general practices among U.S. corporations.

For example, we understand that some countries, such as Germany, require that non-management employees, who would not be viewed as ''independent'' under the proposed requirements, serve on the supervisory board or audit committee.[85] Having such employees serve on the board or audit committee can provide an independent check on management, which itself is one of the purposes of the independence requirements under the Sarbanes-Oxley Act. Accordingly, we are proposing a limited exemption from the independence requirements to address this concern. We would provide that non-management employees could sit on the audit committee of a foreign private issuer if the employee is elected or named to the board of directors or audit committee of the foreign private issuer pursuant to home country legal or listing requirements.

We also note that certain foreign private issuers have a two-tier board, with one tier designated as the management board and the other tier designated as the supervisory or non-management board. In this circumstance, we believe that the supervisory or non-management board would be the body within the company best equipped to comply with the proposed requirements. We propose to clarify that in the case of foreign private issuers with two-tier boards of directors, the term ''board of directors'' means the supervisory or non-management board. As such, the supervisory or non-management board could either form a separate audit committee or, if the entire supervisory or non-management board was independent within the provisions and exceptions of the proposed rule, the entire board could be designated as the audit committee.[86]

Controlling shareholders or shareholder groups are more prevalent among foreign issuers than in the United States, and those controlling shareholders have traditionally played a more prominent role in corporate governance. In jurisdictions providing for audit committees, representation of controlling shareholders on these committees is common. We believe that a limited exception from the independence requirements can accommodate this practice without undercutting the fundamental purposes of the proposed rule. In particular, we would propose that one member of the audit committee could be a shareholder, or representative of a shareholder or group, owning more than 50% of the voting securities of a foreign private issuer, 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 in question is not an executive officer of the issuer.[87] This limited exception is designed to accommodate foreign practices, would assure independent membership and an independent chair of the audit committee and would still exclude management from the committee.

Similarly, foreign governments may have significant shareholdings in some foreign private issuers or may own special shares that entitle the government to exercise certain rights relating to these issuers. However, due to their shareholdings or other rights, these representatives may not be considered independent under our proposals. To accommodate foreign practices, we believe that foreign governmental representatives should be permitted to sit on audit committees of foreign private issuers. As a result, we propose a limited exception that one member of the audit committee could be a representative of a foreign government or foreign governmental entity, if the ''no compensation'' prong of the independence requirement is satisfied and the member in question is not an executive officer of the issuer. As with

[82] The term ''foreign private issuer'' is defined in Exchange Act Rule 3b–4(c) [17 CFR 240.3b–4(c)]. A foreign private issuer is a non-government foreign issuer, except for a company that (1) has more than 50% of its outstanding voting securities owned by U.S. investors and (2) has either a majority of its officers and directors residing in or being citizens of the U.S., a majority of its assets located in the U.S., or its business principally administered in the U.S.

[83] See, for example, ''Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor's Independence,'' Statement of the IOSCO Technical Committee (Oct., 2002) (available at www.iosco.org); Egon Zehnder International, Board of Directors Global Study (2000) (available at www.zehnder.com); and KPMG LLP, Corporate Governance in Europe: KPMG Survey 2001/2002 (2002) (available at www.kpmg.com).

[84] See, *e.g.*, Petition for Rulemaking submitted by the Organization for International Investment, File No. 4–462 (Aug. 19, 2002).

[85] See, *e.g.*, Co-Determination Act of 1976 (Mitbestimmungsgesetz).

[86] *See* note 37 above and the accompanying text.

[87] Exchange Act Rule 3b–7 defines the term ''executive officer'' as an issuer's president, any vice president of the registrant in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function or any other person who performs similar policy-making functions for the registrant. Executive officers of subsidiaries may be deemed executive officers of the issuer if they perform such policy-making functions for the issuer.

the proposed exemption for controlling shareholder representatives, this limited exception is designed to accommodate foreign practices and still exclude management from the committee.

Finally, while as noted above there is a trend toward having audit committees in foreign jurisdictions, several foreign jurisdictions require or provide for auditor oversight through a board of auditors or similar body, or groups of statutory auditors, that are separate from the board of directors.[88] We believe that these boards of auditors or statutory auditors are intended to be independent of management, although their members may not in all cases meet all of the independence requirements set forth in Section 10A(m) of the Exchange Act. In addition, while these bodies provide independent oversight of outside auditors, they may not have all of the responsibilities set forth in our proposals.

The establishment of an audit committee in addition to these bodies, with duplicative functions, might not only be costly and inefficient, but it also could generate possible conflicts of powers and duties. Accordingly, we propose an exemption from certain of the requirements for audit committees for boards of auditors or statutory auditors of foreign private issuers that fulfill the remaining requirements of the rule, if those boards operate under legal or listing provisions that are intended to provide oversight of outside auditors that is independent of management, membership on the board excludes executive officers of the issuer and certain other requirements are met. Specifically, foreign private issuers with boards of auditors or similar bodies or statutory auditors meeting these requirements would be exempt from the requirements regarding the independence of audit committee members and the audit committee's responsibility to oversee the work of the outside auditor. The remaining proposed requirements regarding procedures for handling complaints, access to advisors and funding for advisors would apply to these issuers, with the requirements being applicable to the board of auditors or statutory auditors instead of an audit committee. Also, such board or body would need to be, to the extent permitted by law, responsible for the appointment and retention of any registered public accounting firm engaged by the listed issuer.[89]

A foreign private issuer availing itself of any of these exemptions would be subject to specific disclosure requirements discussed in Section II.G.1 below. In proposing these exemptions, we recognize that some foreign jurisdictions continue to have historical structures that may conflict with maintaining audit committees meeting the requirements of Section 10A(m) of the Exchange Act. We encourage foreign issuers that access the U.S. capital markets to continue to move toward internationally accepted best practices in corporate governance.[90]

As mentioned below, we request comment on whether there are other areas, in either one country or in many countries, in which the rules we are proposing are inconsistent or inappropriate in a significant way with foreign corporate governance arrangements. If there are other areas, do those arrangements adequately address the problems to be addressed under Exchange Act Section 10A(m)? As proposed, there would be no other ability for an SRO to exempt or waive foreign issuers from the proposed requirements.

b. Small Businesses

Section 10A(m) of the Exchange Act makes no distinction based on an issuer's size. We think that improvements in the financial reporting process for companies of all sizes are important for promoting investor confidence in our markets. In this regard, because we have seen instances of financial fraud at small companies as well as at large companies, we think that improving the effectiveness of audit committees of small and large companies is important.[91] The proposed rule, therefore, would apply to listed issuers of all sizes.

We recognize that because the proposals apply only to listed issuers, quantitative listing standards applicable to listed securities, such as minimum revenue, market capitalization and shareholder equity requirements, will limit the size of issuers that will be affected by the requirements.[92] However, we are sensitive to the possible implication for smaller issuers and for SROs that would like to specialize in securities of these issuers. We request comment below on these topics.

c. Issuers of Asset-Backed Securities

In several of our releases implementing provisions of the Sarbanes-Oxley Act,[93] we have noted the special nature of asset-backed issuers.[94] Because of the nature of these entities, such issuers are subject to substantially different reporting requirements. Most significantly, asset-backed issuers are generally not required to file the financial statements that other companies must file. Also, such entities typically are passive pools of assets, without an audit committee or board of directors or persons acting in a similar capacity. Accordingly, we propose to exclude asset-backed issuers from the proposed requirements.

d. Investment Companies

There are essentially two categories of investment companies that have shares listed for trading on exchanges: closed-end investment companies and so-called ''exchange-traded funds'' (''ETFs''). Closed-end investment companies are actively managed investment companies, which do not issue redeemable securities. ETFs are investment companies that are registered under the Investment Company Act as open-end investment companies or unit investment trusts (''UITs''). Unlike typical open-end funds or UITs, ETFs do not sell or redeem their individual shares (''ETF shares'') at net asset value (''NAV''). Instead, ETFs sell and redeem ETF shares at NAV only in large blocks (such as 50,000 ETF shares). In addition, national securities exchanges list ETF shares for trading, which allows investors to purchase and sell individual ETF shares among themselves at market prices throughout the day. Unlike open-end ETFs or closed-end investment companies, UITs, including those that operate as ETFs, are

[88] For example, under current Japanese law, we understand that large Japanese corporations must maintain a board of corporate statutory auditors, a legally separate and independent body from the corporation's board of directors that is elected by shareholders. See, *e.g.*, Law for Special Exceptions to the Commercial Code Concerning Audits, etc. of Corporations (Law No. 22, 1974, as amended). Further, we understand that effective April 1, 2003, Japanese corporations will have the option to elect either a governance system with a separate board of directors and board of corporate auditors or a system based on nominating, audit and compensation committees under the board of directors.

[89] Such responsibility could be vested in such board or body, or statutory auditors, in any manner, including without limitation by law or listing requirement or delegation.

[90] *See, e.g.*, IOSCO Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor's Independence (2002); OECD Principles of Corporate Governance (1999).

[91] See Beasley, Carcello and Hermanson, Fraudulent Financial Reporting: 1987–1997, An Analysis of U.S. Public Companies (Mar. 1999) (study commissioned by the Committee of Sponsoring Organizations of the Treadway Commission).

[92] Examples of the types of quantitative standards necessary for initial and continued listings on the NYSE, Nasdaq and AMEX are available on their respective websites.

[93] *See* note 30 above.

[94] The term ''Asset-Backed Issuer'' is defined in 17 CFR 240.13a–14(g) and 240.15d–14(g).

not actively managed and do not have boards of directors from which audit committee members could be drawn. Accordingly, our proposed rules would cover closed-end investment companies and exchange-traded open-end investment companies, but we are proposing to exclude exchange-traded UITs from the proposed requirements.[95]

Questions regarding the proposed application to issuers:

• Although we do not propose a complete exemption for foreign issuers from coverage of the proposed rule, and question whether such an exemption would be consistent with the policies underlying the Sarbanes-Oxley Act, we solicit comment on the propriety of either a complete or broader exemption from the requirements for foreign issuers. Given the exemptions that are proposed, would the proposals conflict with local law or local stock exchange requirements? If so, how? Are the problems that the proposals are intended to address dealt with in alternative ways in other jurisdictions? Would any foreign issuers not consider a listing solely because of these requirements? Would any foreign issuers that currently maintain a U.S. listing seek to delist their securities because of these requirements?

• Is the proposed special accommodation to the independence requirements adequate for issuers in countries with a dual board structure where employee representatives sit on the supervisory board or are required to be on the audit committee? If not, how should we accommodate these issuers, if at all?

• Are the proposed special accommodations for foreign issuers with controlling shareholder or shareholder groups or foreign government representation appropriate? Do the proposed exemptions provide appropriate accommodations for foreign private issuer practices, consistent with the purposes of Section 10A(m) of the Exchange Act and the protection of investors? Are there alternative approaches that would be preferable to address the issue? Should any of the conditions of the proposed exemption be changed? For example, for controlling shareholders, should the level of shareholder ownership proposed be higher (*e.g.*, 80%) or lower (*e.g.*, 10%)? Is the limitation for controlling shareholders to observer status and not being a voting member or chair of the audit committee appropriate?

• Is the proposed special accommodation for issuers from jurisdictions that operate with boards of auditors or similar bodies appropriate? Does the proposed exemption provide appropriate accommodation for these issuers, consistent with the purposes of Section 10A(m) of the Exchange Act and the protection of investors? Are there alternative approaches that would be preferable to address the issue? Should we provide a ''sunset'' date for this provision to allow the Commission to reconsider its effectiveness and to reexamine the trend towards audit committees in other jurisdictions? If so, what date should we use (*e.g.*, December 31, 2005)?

• Is the compliance burden for companies under a certain size disproportionate to the benefits to be obtained from the proposed requirements? Would any smaller issuers not consider a listing solely because of these requirements? Would any smaller issuers that currently maintain a listing seek to delist their securities because of these requirements? How can we minimize the burden consistent with the purposes of the Sarbanes-Oxley Act?

• Should the scope of one or more of the proposed requirements be narrowed to exclude or apply differently to companies under a certain size? If so, which requirements should be changed? How would such accommodations be consistent with the purposes of Section 10A(m) and the protection of investors? Should there be special accommodations for companies considered under our rules to be ''small business issuers'' (companies that have revenues and public float of less than $25 million)?[96] Should there be a higher cutoff, such as $100 million or $200 million public float and/or revenues? If there should be a different standard for determining the level of issuer affected, should it be based on additional or alternative criteria, such as total assets, shareholder equity or reporting history? What alternate means exist that would provide the same protections to shareholders?

• Is the exclusion of asset-backed issuers appropriate? If not, how should these issuers be handled? Are there other types of issuers that should be handled differently?

• Is the exclusion for ETFs that are structured as unit investment trusts appropriate? If not, how should these ETF UITs be handled? Exchange-traded UITs typically provide audited financial information in shareholder reports although these reports are not required by Commission rules. How should this affect whether exchange-traded UITs are covered by the proposed requirements? Should the sponsor, depositor, or trustee of the UIT be required to comply with the proposed rule? Are there other types of investment companies that should be excluded from the proposed rule? If so, why?

• We propose to make the general exemptions of Exchange Act Rule 10A–3(c) available for use by investment companies. Would investment companies ever fall within any of these exemptions? Should some exemptions be available to investment companies and others unavailable? If so, which ones should be available and why?

4. Determining Compliance With Proposed Standards

Apart from the general requirement to prohibit the listing of a security not in compliance with the enumerated standards, Section 10A(m) of the Exchange Act does not establish specific mechanisms for a national securities exchange or a national securities association to ensure that issuers comply with the proposed standards on an ongoing basis. SROs are required to comply with Commission rules pertaining to SROs and to enforce their own rules, including rules that govern listing requirements and affect their listed issuers. To further the purposes of Section 10A(m), we propose to direct 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 proposed requirements.[97]

Questions regarding determining compliance with the proposed standards:

• Should a listed issuer be required to notify the SRO if it has failed to comply with our proposed requirements? Is it sufficient for the notification to be made ''promptly?'' Should the direction to the SROs on this point be more specific

[95] Business development companies would be covered by the proposed rules.

Investment companies may avail themselves of the general exemptions in proposed Exchange Act Rule 10A–3(c) [17 CFR 240.10A–3(c)], if applicable, and, except in the case of reliance on the exemption for UITs contained in paragraph (c)(5)(ii) or the exemption contained in paragraph (c)(1), would have to disclose such use of a general exemption on proposed Form N–CSR and in proxy statements. The independence exemptions of proposed Exchange Act Rule 10A–3(b)(1)(iv)(A)–(E) [17 CFR 240.10A–3(b)(1)(iv)(A)–(E)] would not apply to investment companies.

[96] The term ''small business issuer'' is defined in Exchange Act Rule 12b–2.

[97] We encourage the SROs to impose a similar requirement for noncompliance with other SRO listing standards that pertain to corporate governance standards apart from the audit committee requirements in proposed Exchange Act Rule 10A–3, to the extent SROs do not already provide for such a notice requirement.

(*e.g.*, notification must occur no later than two business days after an executive officer of the issuer becomes aware of any material noncompliance)?

• Is the proposed triggering event for notification (*i.e.*, that an executive officer of the issuer has become aware of any material noncompliance) appropriate? For example, should the standard also include any audit committee member becoming aware of any material noncompliance?

• In addition to, or in lieu of, notification in the event of noncompliance, should a listed issuer be required to disclose periodically to the SROs whether they have been in compliance with the standards? If so, how often?

• Should a listed issuer be required to notify the SRO if it has failed to comply with listing standards apart from our proposed requirements for audit committees? Should this requirement apply only to particular listing standards?

5. Opportunity To Cure Defects

Section 10A(m)(1)(B) of the Exchange Act specifies that our rules must provide for appropriate procedures for an issuer to have an opportunity to cure any defects that would be the basis for a prohibition of the issuer's securities as a result of its failure to meet the proposed audit committee standards, before imposition of such a prohibition. To effectuate this mandate, our proposals would require the SROs to establish such procedures before they prohibit the listing of or delist any security of an issuer.[98] Preliminarily, we believe that existing continued listing or maintenance standards and delisting procedures of the SROs would suffice as procedures for an issuer to have an opportunity to cure any defects on an ongoing basis. These procedures already provide issuers with notice and opportunity for a hearing, an opportunity for an appeal and an opportunity to cure any defects before their securities are delisted.[99] However, we do expect that the rules of each SRO will provide for definite procedures and time periods for compliance with the proposed requirements to the extent they do not already do so.

We also expect that our final rule will have a delayed implementation date before companies would initially be subject to the standards to provide affected companies with time to conform to the new standards. We recognize that companies may need to conduct shareholder elections to elect independent directors for their audit committees. We envision that the standards contemplated by our proposals would need to be operative by the SROs no later than the first anniversary of the publication of our final rule in the **Federal Register**. This should give listed issuers enough time to go through an annual meeting election cycle to elect any new directors that would be necessary to meet the new requirements.

Questions regarding the opportunity to cure defects:

• Should the SROs be required to establish specific procedures for curing defects apart from those proposed? If so, what would these procedures look like? Should there be a specific course for redress other than the delisting process?

• Should our final rule include specific provisions that set maximum time limits for an opportunity to cure defects? If so, what time limits would be appropriate?

• Beyond the limited exemption we propose for the independence requirements, should companies that have just completed their initial public offering be given additional time to comply with the requirements?

• Is the proposed date for when the SROs rules must be operative appropriate for companies that must comply with the new standards? If not, what date would be appropriate and what factors should we consider in setting any such date? Would a period beyond the proposed date be necessary or appropriate for compliance by smaller companies? Are there special considerations that we should take into account for foreign private issuers?

G. Disclosure Changes Regarding Audit Committees

1. Disclosure Regarding Exemptions

Our proposals provide for certain exemptions. Because these exemptions would distinguish certain issuers from most other listed issuers, we believe that it is important for investors to know if an issuer is availing itself of one of these exemptions. Accordingly, we propose that these issuers would need 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 committee to act independently and to satisfy the other requirements of proposed Exchange Act Rule 10A–3. Such disclosure would need to appear in, or be incorporated by reference into, annual reports filed with the Commission.[100] The disclosure also would need to appear in proxy statements or information statements for shareholders' meetings at which elections for directors are held.

Because of the nature of the exemption for boards of auditors or similar structures of foreign private issuers discussed in Section II.F.3.a., we also are proposing that foreign private issuers availing themselves of that exemption be required to file an exhibit to their annual reports stating that they are doing so.[101] Because the presence of exhibits can be easily identified in electronic filings, we believe this requirement will facilitate monitoring of the use of this exemption by investors.

As discussed in Section II.F.3.d., we are proposing a general exemption for unit investment trusts from the requirements of the proposed rule. In addition, we are proposing that UITs be excluded from the disclosure requirements relating to their use of the exemption.[102] As a passive investment vehicle, a UIT has no board of directors, and there is little reason why investors would expect a UIT to have an audit committee. In addition, there is no appropriate disclosure document required by Commission rules where a UIT could include this disclosure.[103]

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[98] These procedures, of course, could not include an extended exemption or waiver of the requirements apart from those proposed.

[99] *See, e.g.*, NASD Rule 4800 Series and NYSE Listed Company Manual Section 804.

[100] This disclosure is proposed to be included in Part III of annual reports on Form 10–K and 10–KSB (through an addition to Item 401 of Regulations S–K and S–B). Consequently, companies subject to the proxy rules would be able to incorporate the required disclosure from a proxy or information statement that involves the election of directors into the annual report, if the issuer filed such proxy or information statement within 120 days after the end of the fiscal year covered by the report. *See* General Instruction G.(3) of Form 10–K and General Instruction E.3. of Form 10–KSB.

For foreign private issuers that file their annual reports on Form 20–F, the disclosure requirement would appear in new paragraph (f) to Item 15. The additions of paragraphs (c)–(e) to Item 15 of Form 20–F were proposed in Release No. 33–8138 (Oct. 22, 2002), Release No. 33–8154 (Dec. 2, 2002), and Release No. 33–8160 (Dec. 10, 2002) [67 FR 77594] (Rule 10b–18 and purchases of certain equity securities by the issuer and others), respectively.

For foreign private issuers that file their annual reports on Form 40–F, the disclosure requirement would appear in paragraph (11) to General Instruction B. The additions of paragraphs (9) and (10) to General Instruction B. of Form 40–F were proposed in Release No. 33–8138 (Oct. 22, 2002) and Release No. 33–8154 (Dec. 2, 2002), respectively.

For registered investment companies, the disclosure would appear in Item 8 of proposed Form N–CSR and Item 22(b)(14) of Schedule 14A.

[101] The exhibit requirement would appear in new paragraph 11 to the Instructions as to Exhibits of Form 20–F. The addition of paragraph 10 to the Instructions as to Exhibits of Form 20–F was proposed in Release No. 33–8138 (Oct. 22, 2002).

[102] See proposed Exchange Act Rule 10A–3(d).

[103] UITs file annual reports with the Commission on Form N–SAR [17 CFR 249.330 and 274.101] under Investment Company Act Rule 30a–1 [17 CFR 270.30a–1]. However, these N–SAR reports are

We also are proposing to exclude issuers availing themselves of the multiple listing exemption from the disclosure requirements relating to their use of that exemption. These issuers, or their controlling parents, would be required to comply with the proposed audit committee requirements as a result of a separate listing. Accordingly, disclosure of the use of that exemption would not serve the purpose of highlighting for investors those issuers that are different from most other listed issuers. However, if such an issuer also was availing itself of another exemption from the proposed requirements (*i.e.*, the temporary exemption from the independence requirements for new listed issuers), disclosure of the use of that exemption would be required.

2. Identification of the Audit Committee in Annual Reports

An issuer subject to the proxy rules of Section 14 of the Exchange Act [104] is currently required to disclose in its proxy statement or information statement, if action is to be taken with respect to the election of directors, whether the issuer has a standing audit committee, the names of each committee member, the number of committee meetings held by the audit committee during the last fiscal year and the functions performed by the committee.[105] We believe it is important for investors to be able to readily determine basic information about the composition of a listed issuer's audit committee. To foster greater availability of this basic information, we are proposing to require disclosure of the members of the audit committee to be included or incorporated by reference in the listed issuer's annual report.[106] Also, because the Exchange Act now provides that in the absence of an audit committee the entire board of directors will be considered to be the audit committee, we propose to require a listed issuer that has not separately designated or has chosen not to separately designate an audit committee to disclose that the entire board of directors is acting as the issuer's audit committee.

We propose similar changes for foreign private issuers that file their annual reports on Form 40–F. Foreign private issuers that file their annual reports on Form 20–F already are required to identify the members of their audit committee in their annual reports. For these listed issuers, however, we do propose that they disclose if the entire board of directors is acting as the audit committee. We also propose similar changes for registered management investment companies.[107]

3. Updates to Existing Audit Committee Disclosure

An issuer subject to the proxy rules is currently required to disclose additional information about its audit committee in its proxy statement or information statement, if action is to be taken with respect to the election of directors.[108] First, the audit committee must provide a report disclosing whether the audit committee has reviewed and discussed the audited financial statements with management and discussed certain matters with the independent auditors.[109] Second, issuers must disclose whether the 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.[110] Finally, the issuer must disclose whether the members of the audit committee are independent. Under the existing requirements, issuers 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.[111] These issuers also must disclose if its board of directors has determined to appoint one director to its audit committee due to an exceptional and limited circumstances exception in the applicable listing standards.[112] Issuers whose securities are not listed on the NYSE or AMEX or quoted on Nasdaq also are required to disclose whether its audit committee members are independent. These issuers may choose which definition of independence to use from any of the NYSE, AMEX or Nasdaq listing standards.[113]

Regarding the independence disclosure, all national securities exchanges and national securities associations under our proposals would need to have independence standards for audit committee members, not just the NYSE, AMEX and Nasdaq. The specification in the existing requirements to listings on these three markets would therefore no longer be necessary. Further, our proposals would not allow for an exception to the independence requirements due to exceptional and limited circumstances. As a result, disclosure regarding use of this exception would be unnecessary.

Accordingly, we propose to update the disclosure requirements regarding the independence of audit committee members to reflect the new SROs rules to be adopted under Exchange Act Rule 10A–3. If the registrant was a listed issuer, it would still be required to disclose whether the members of its audit committee were independent. The listed issuer would need to use the definition of independence for audit committee members included in the listing standards applicable to the listed issuer. Further, because the Exchange Act now provides that in the absence of an audit committee the entire board of directors will be considered to be the audit committee, we propose to clarify that if the registrant does not have a separately designated audit committee, or committee performing similar functions, the registrant must provide the disclosure with respect to all members of its board of directors.

Non-listed issuers that have separately designated audit committees would still be required to disclose whether their audit committee members were independent. In determining whether a member was independent,

regulatory reports to the Commission and are not intended primarily as disclosure documents for investors.

[104] 15 U.S.C. 78n.

[105] See Item 7(d)(1) of Schedule 14A. Identical information is required with respect to nominating and compensation committees of the board of directors.

[106] Because this information is proposed to be included in Part III of annual reports on Forms 10–K and 10–KSB, companies subject to the proxy rules would be able to incorporate the required disclosure from a proxy or information statement that involves the election of directors, where it is already required to appear, into their annual reports. Information regarding the number of meetings of the audit committee and the basic functions performed by the audit committee, as well as the information regarding nominating and compensation committees, would continue to be required only in proxy or information statements that involve the election of directors.

[107] Item 22(b)(14) of Schedule 14A and proposed Item 8 of proposed Form N–CSR. Proposed Form N–CSR would be used by registered management investment companies to file certified shareholder reports with the Commission under the Sarbanes-Oxley Act. See Investment Company Act Release No. 25723 (Aug. 30, 2002) [67 FR 57298]. The Commission proposed amendments to Form N–CSR in Investment Company Act Release No. 25739 (Sep. 20, 2002) [67 FR 60828]; Investment Company Act Release No. 25775 (Oct. 22, 2002) [67 FR 66208]; Investment Company Act Release No. 25838 (Dec. 2, 2002); Investment Company Act Release No. 25845 (Dec. 10, 2002); and Investment Company Act Release No. 25870 (Dec. 18, 2002).

[108] See Item 7(d)(3) of Schedule 14A. These disclosure requirements were adopted in Release No. 34–42266 (Dec. 22, 1999).

[109] See Item 7(d)(3)(i) of Schedule 14A. The requirements for the audit committee report are specified in Items 306 of Regulations S–B [17 CFR 228.306] and S–K [17 CFR 229.306]. Under the existing requirements, if the company does not have an audit committee, the board committee tasked with similar responsibilities, or the full board of directors, is responsible for the disclosure.

[110] See Items 7(d)(3)(ii) and (iii) of Schedule 14A.

[111] See Item 7(d)(3)(iv)(A)(*1*) of Schedule 14A.

[112] See Item 7(d)(3)(iv)(A)(*2*) of Schedule 14A.

[113] See Item 7(d)(3)(iv)(B) of Schedule 14A. Whichever definition is chosen must be applied consistently to all members of the audit committee.

these registrants would be allowed to choose any definition for audit committee member independence of a national securities exchange or national securities association that has been approved by the Commission.[114]

Questions regarding the proposed disclosure changes:

• Should companies be required to disclose publicly if they are taking advantage of an exemption to the proposed SRO requirements? If so, are the proposed locations of this disclosure appropriate? Should we permit incorporation by reference into the company's annual report? Should the disclosure be required as an exhibit to the company's filing? Is the disclosure of the company's assessment of whether and if so, how, such reliance would materially adversely affect the ability of the audit committee to act independently and to satisfy the other proposed requirements appropriate?

• Should foreign private issuers that avail themselves of the exemption for boards of auditors or similar structures be required to file an exhibit to their annual reports stating that they are doing so?

• Should a UIT be required to disclose that it is availing itself of the exemption from the audit committee requirements? If so, where should such disclosure be made? Exchange-traded UITs typically provide audited financial information in shareholder reports although these reports are not required by Commission rules.[115] Should disclosure of the exemption from audit committee requirements be required in these reports?

• Should an issuer relying on the multiple listing exemption be required to disclose that it is availing itself of that exemption? Should the disclosure only be required for subsidiaries relying on the exemption for their own listed securities?

• Should we require disclosure of basic information about an issuer's audit committee in its annual report, or is the current location of this disclosure for issuers subject to the proxy rules sufficient? Would disclosure of whether the entire board is acting as the audit committee be helpful?

• Given the new definition of audit committee in the Exchange Act, is it appropriate to clarify in the current disclosure requirements for audit committees that if the issuer does not have a separately designated audit committee, or committee performing similar functions, the issuer must provide the disclosure with respect to all members of its board of directors? How many issuers will this change affect?

• Are our proposed changes to the disclosure requirements regarding the independence of audit committee members appropriate? Is there a reason to continue to require non-listed issuers to choose from one of the NYSE's, AMEX's or Nasdaq's definitions for audit committee members?

• Listed issuers that are foreign private issuers are generally not subject to the proxy rules. Should we require disclosure regarding the independence of audit committee members for these issuers? If so, where should this disclosure appear?

• Is there any additional disclosure concerning audit committees that would be beneficial to investors? With the new requirements we propose for audit committees, is any existing disclosure we require regarding audit committees no longer needed?

H. General Request for Comment

We request and encourage any interested person to submit comments on the proposals, on any additional or different changes, and on any other matters that might have an impact on the proposals. We request comment from the point of view of national securities exchanges and national securities associations that would be required to comply with the proposals. We also request comment from the point of view of companies that would be subject to the listing requirements that would result from the proposals. We also request comment from the point of view of investors in the securities of these companies on their views of the proposals and any possible changes to the proposals. With regard to any comments, we note that such comments are of greatest assistance to our rulemaking initiative if accompanied by supporting data and analysis of the issues addressed in those comments.

III. Paperwork Reduction Act

A. Background

Our proposals contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995 (''PRA'').[116] We are submitting our proposals to the Office of Management and Budget (''OMB'') for review in accordance with the PRA.[117] The titles for the collection of information are:

(1) ''Proxy Statements—Regulation 14A (Commission Rules 14a–1 through 14a–15 and Schedule 14A)'' (OMB Control No. 3235–0059);

(2) ''Information Statements—Regulation 14C (Commission Rules 14c–1 through 14c–7 and Schedule 14C)'' (OMB Control No. 3235–0057);

(3) ''Form 10–K'' (OMB Control No. 3235–0063);

(4) ''Form 10–KSB'' (OMB Control No. 3235–0420);

(5) ''Form 20–F'' (OMB Control No. 3235–0288);

(6) ''Form 40–F'' (OMB Control No. 3235–0381);

(7) ''Regulation S–K'' (OMB Control No. 3235–0071);

(8) ''Regulation S–B'' (OMB Control No. 3235–0417); and

(9) ''Form N–CSR'' (OMB Control No. 3235–0570).

These regulations and forms were adopted pursuant to the Securities Act, the Exchange Act and the Investment Company Act and set forth the disclosure requirements for periodic reports, registration statements and proxy and information statements filed by companies to ensure that investors are informed. The hours and costs associated with preparing, filing and sending these forms constitute reporting and cost burdens imposed by each collection of information. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

Under our proposals, we would direct SROs to prohibit the listing of any security of an issuer that is not in compliance with several enumerated standards relating to the issuer's audit committee. We are making these proposals pursuant to the legislative mandate in Section 10A(m) of the Exchange Act, as added by Section 301 of the Sarbanes-Oxley Act. As part of our proposals, we are proposing several limited exemptions from the requirements to address the special circumstances of particular issuers. If an issuer was to avail itself of one of these exemptions, we propose that it would need to disclose this fact and its assessment of whether, 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

[114] Such definition would include the requirements of proposed Exchange Act Section 10A–3. These issuers would still be required to state which definition was used. Further, the requirement that the same definition must be applied consistently to all members of the audit committee would be retained.

[115] See, *e.g.*, SPDR Trust, Series 1, Investment Company Act Release Nos. 18959 (Sept. 17, 1992) (notice) and 19055 (Oct. 26, 1992) (order) and Fourth Amended and Restated Application, filed Aug. 7, 1992, File No. 812–7545, at 35.

[116] 44 U.S.C. 3501 *et seq.*

[117] 44 U.S.C. 3507(d) and 5 CFR 1320.11.

proposed requirements. Such disclosure would need to appear in its proxy or information statement for shareholders' meetings at which elections for directors are held. The disclosure also would need to appear in, or be incorporated by reference into, the annual reports of these companies filed with the Commission. In addition, a foreign private issuer that availed itself of the board of auditors exception would need to file a brief exhibit. We have proposed an exemption from these proposed disclosure requirements for exchange-traded UITs and issuers relying on the multiple listing exemption. We call these proposed changes the ''Exemption Disclosure.''

Under our proposals, listed issuers also would be required to disclose the members of their audit committee, or that their entire board of directors is acting as their audit committee, in their annual reports. We call these proposed changes the ''Identification Disclosure.''

Finally, we are proposing several updates to existing disclosure requirements regarding audit committees to reflect our proposals and changes made by the Sarbanes-Oxley Act. We call these proposed changes the ''Disclosure Updates.''

These disclosure changes are designed to alert investors of basic information about an issuer's audit committee, including the identity of the issuer's audit committee, whether the issuer is availing itself of an exemption and whether the members of the audit committee are independent. Compliance with the revised disclosure requirements would be mandatory. There would be no mandatory retention period for the information disclosed, and responses to the disclosure requirements would not be kept confidential. We do not believe that the imposition of these proposed disclosure changes would alter significantly the number of respondents that file on the affected forms.

In addition to the above, we propose to direct 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 proposed requirements. We believe that any burden imposed by this collection of information would be minimal. For the most part, we believe that listed issuers are already required to make the type of disclosure contemplated by the proposal, either pursuant to existing SRO rules or as a requirement of existing listing agreements. We therefore believe that any reporting and recordkeeping requirements imposed by this aspect of the proposals are ''usual and customary'' activities for listed issuers.[118]

B. Revisions to PRA Reporting and Cost Burden Estimates

For purposes of the PRA, we estimate that the annual incremental paperwork burden for all companies to prepare the disclosure that would be required under our proposals would be approximately 685 hours of personnel time and a cost of approximately $99,600 for the services of outside professionals. We derived these estimates first by estimating the total amount of time it would take for a company to prepare the proposed disclosure. The Disclosure Updates simply update the disclosure requirements to reflect our proposals and changes to terminology made by the Sarbanes-Oxley Act. We do not believe these changes would change the burden required by this disclosure. The Exemption Disclosure would require only a minimal additional statement by issuers that avail themselves of one of our proposed exemptions. In addition, foreign private issuers availing themselves of the board of auditors exception would need to file a brief exhibit. We estimate that the Exemption Disclosure would add 0.25 hours per affected filing. The Identification Disclosure would require a company to disclose either the members of its audit committee, or a brief statement that the board of directors of the issuer is acting as the audit committee. We estimate that the Identification Disclosure would add 0.25 hours per affected filing.

The Exemption Disclosure and Identification Disclosure apply only to listed issuers. Accordingly, not all issuers would be required to make the proposed disclosure. We estimate that there are approximately 7,250 issuers that are listed on a national securities exchange or traded on the Nasdaq National Market or the Nasdaq Smallcap Market.[119] Each of these listed companies, except exchange-traded UITs, would be required to at least provide the basic Identification Disclosure in their annual report. Some of these listed issuers also would need to make the Exemption Disclosure.[120]

Further, since the disclosure in the annual report may be incorporated by reference from an issuer's proxy or information statement, we assume that the disclosure would appear in a maximum of one report per affected issuer. As the information would appear in Part III of an issuer's Form 10–K or 10–KSB (which can be incorporated by reference from the issuer's proxy statement if where directors are to be elected), or in Item 8 of Form N–CSR, which may also be incorporated by reference, we assume that affected issuers will follow the general practice of most issuers of including the disclosure in their proxy or information statement where directors are elected and incorporating by reference the disclosure into their annual report. Accordingly, we are reducing the number of affected reports on Forms 10–K, 10–KSB and N–CSR to account for this assumption.[121] Further, we assume that the Identification Disclosure is already required in these proxy or information statements,[122] and the burden hours for this disclosure by these filers therefore has already been assigned to Schedules 14A and 14C. Accordingly, we estimate that the Identification Disclosure will not affect the burden for Schedules 14A and 14C.

The tables below illustrate the incremental annual compliance burdens of the collections of information in hours and in cost for annual reports and proxy and information statements under the Exchange Act. The burden was calculated by multiplying the estimated number of affected responses by the estimated average number of hours each entity spends preparing the proposed disclosure. We have based our estimates on the number of affected responses on the actual number of filers during the 2002 fiscal year and our estimates of the number of listed issuers that may be affected by the disclosure changes.[123] For Exchange Act annual reports and proxy and information statements, we estimate that 75% of the burden of preparation is carried by the company internally and that 25% of the burden of preparation is carried by outside professionals retained by the company

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[118] See 5 CFR 1320.3(b)(2).

[119] We derived this estimate from the Standard & Poors Research Insight Compustat Database and the Commission's annual report.

[120] With respect to investment companies, the independence exemptions would not be available. A general exemption would be applicable to UITs, but UITs would be excluded from Exemption Disclosure requirements. We anticipate that only a negligible number of investment companies would fall under the other general exemptions. Accordingly, we anticipate that the reporting burden imposed by the Exemption Disclosure requirements on listed investment companies would be negligible.

[121] Foreign private issuers are exempt from the requirements to provide proxy materials, so we assume no adjustment to the number of affected annual reports on Forms 20–F and 40–F.

[122] See Item 7(d)(1) of Schedule 14A.

[123] We estimate that 5% of listed issuers would be required to provide disclosure regarding the new issuer exemption in proposed Exchange Act Rule 10A–3(b)(iv)(A) and 20% of listed issuers would be required to provide disclosure regarding use of the holding company exemption in proposed Exchange Act Rule 10A–3(b)(iv)(B).

at an average cost of $300 per hour.[124] The portion of the burden carried by outside professionals is reflected as a cost, while the portion of the burden carried by the company internally is reflected in hours.

CALCULATION OF THE INCREMENTAL BURDEN OF THE EXEMPTION DISCLOSURE [125]

	Affected responses	Incremental hours/form	Total incremental burden	75% Company	25% Professional	$300 professional cost ($)
	(A)	(B)	(C)=(A)*(B)	(D)=(C)*0.75	(E)=(C)*0.25	(F)=(E)*300
20–F	[126] 438	0.25	110	28	83	24,900.00
40–F	[127] 35	0.25	9	2	7	2,100.00
10–K	[128] 269	0.25	67	50	17	5,100.00
10–KSB	[129] 108	0.25	27	20	7	2,100.00
14A	[130] 1,356	0.25	339	254	85	25,000.00
14C	[131] 86	0.25	22	17	6	1,800.00
Total	.....	.....	574	371	205	61,500.00

CALCULATION OF THE INCREMENTAL BURDEN OF THE IDENTIFICATION DISCLOSURE

	Affected responses	Incremental hours/form	Total incremental burden	75% Company	25% Professional	$300 Professional cost ($)
	(A)	(B)	(C)=(A)*(B)	(D)=(C)*0.75	(E)=(C)*0.25	(F)=(E)*300
20–F	[132] 0	0.25	0	0	0	0.00
40–F	[133] 134	0.25	34	9	26	7,800.00
10–K	[134] 1,073	0.25	268	201	67	20,100.00
10–KSB	[135] 430	0.25	108	81	27	8,100.00
N–CSR	[136] 113	0.25	28	21	7	2,100.00
14A	[137] 0	0.25	0	0	0	0.00
14C	[138] 0	0.25	0	0	0	0.00
Total	.....	.....	438	312	127	38,100.00

Regulation S–K includes the requirements that a registrant must provide in filings under both the Securities Act and the Exchange Act. Regulation S–B includes the requirements that a small business issuer must provide in the Securities Act and the Exchange Act. The proposed disclosure changes would include changes to items under Regulation S–K and Regulation S–B. However, the filing requirements themselves are included in Form 10–K, Form 10–KSB, Form 20–F, Form 40–F, Schedule 14A and Schedule 14C. We have reflected the burden for the new requirements in the burden estimates for those firms. The items in Regulation S–K and Regulation S–B do not impose any separate burden. We previously have assigned one burden hour each to Regulations S–B and S–K for administrative convenience to reflect the fact that these regulations do not impose any direct burden on companies.

C. Request for Comment

We request comment in order to (a) evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility; (b) evaluate the accuracy of our estimates of the burden

[124] This allocation of the burden is consistent with our recent PRA submissions for Exchange Act periodic reports and proxy and information statements. See, *e.g.*, Release No. 33–8144 (Nov. 4, 2002). Traditionally, we have estimated that the company carried 25% of the burden internally and 75% of the burden of preparation was carried by outside professionals retained by the company. We believe that the new allocation more accurately reflects current practice for annual reports and proxy and information statements. We estimate, however, that the traditional 25% company and 75% outside professional allocation remains applicable for Forms 20–F and 40–F because those forms are prepared by foreign private issuers who rely more heavily on outside counsel for their preparation.

[125] For convenience, the estimated PRA hour burdens have been rounded to the nearest whole number, and the estimated PRA cost burdens have been rounded to the nearest $100. As a result of rounding, the sum of the entries in columns (D) and (E) of the tables may not exactly equal the corresponding entry in column (C).

[126] This figure is based on our estimate of the total number of affected responses by listed issuers.

[127] This figure is based on our estimate of the total number of affected responses by listed issuers.

[128] This figure is based on our estimate of the total number of affected responses by listed issuers, as adjusted for the number of responses where Part III information would be incorporated by reference from a proxy or information statement.

[129] This figure is based on our estimate of the total number of affected responses by listed issuers, as adjusted for the number of responses where Part III information would be incorporated by reference from a proxy or information statement.

[130] This figure is based on our estimate of the total number of affected responses by listed issuers.

[131] This figure is based on our estimate of the total number of affected responses by listed issuers.

[132] Issuers that file their annual report on Form 20-F are already required to identify the members of their audit committee.

[133] This figure is based on our estimate of the total number of affected responses by listed issuers.

[134] This figure is based on our estimate of the total number of affected responses by listed issuers, as adjusted for the number of responses where Part III information would be incorporated by reference from a proxy or information statement.

[135] This figure is based on our estimate of the total number of affected responses by listed issuers, as adjusted for the number of responses where Part III information would be incorporated by reference from a proxy or information statement.

[136] This figure is based on our estimate of the total number of affected responses by listed issuers, as adjusted for the number of responses where Item 8 information would be incorporated by reference from a proxy or information statement.

[137] We estimate that proxy statements on Schedule 14A are already required to identify the members of their audit committee.

[138] We estimate that information statements on Schedule 14C are already required to identify the members of their audit committee.

of the proposed collections of information; (c) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; (d) evaluate whether there are ways to minimize the burden of the collections of information on those who respond, including through the use of automated collection techniques or other forms of information technology; and (e) evaluate whether the proposals will have any effects on any other collections of information not previously identified in this section.

Any member of the public may direct to us any comments concerning the accuracy of these burden estimates and any suggestions for reducing the burdens. Persons who desire to submit comments on the collection of information requirements should direct their comments to the OMB, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and send a copy of the comments to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609, with reference to File No. S7–02–03. Requests for materials submitted to the OMB by us with regard to these collections of information should be in writing, refer to File No. S7–02–03, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 450 Fifth Street, NW., Washington, DC 20549. Because the OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, your comments are best assured of having their full effect if the OMB receives them within 30 days of publication.

IV. Cost-Benefit Analysis

The proposals represent the implementation of a Congressional mandate. We recognize that implementation of the Sarbanes-Oxley Act will likely create costs and benefits to the economy. We are sensitive to the costs and benefits imposed by our rules, and we have identified certain costs and benefits of these proposals.

A. Background

Section 10A(m)(1) of the Exchange Act, as added by Section 301 of the Sarbanes-Oxley Act, requires us to direct, by rule, the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with several enumerated standards regarding issuer audit committees. The new rule must become effective by April 26, 2003, which is 270 days after the date of enactment of the Sarbanes-Oxley Act and Section 10A(m) of the Exchange Act.

In general, according to the standards listed in Section 10A(m) of the Exchange Act, SROs would be prohibited from listing any security of an issuer that is not in compliance with the following standards:

- Each member of the audit committee of the issuer must be independent according to specified criteria;
- The audit committee of each issuer 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 related work or performing other audit, review or attest services for the listed issuer, and each such registered public accounting firm must report directly to the audit committee;
- Each 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 the issuer of concerns regarding questionable accounting or auditing matters;
- Each audit committee must have the authority to engage independent counsel and other advisors, as it determines necessary to carry out its duties; and
- Each issuer must provide appropriate funding for the audit committee.

Our proposals would respond directly to the requirements in Section 10A(m) of the Exchange Act. In addition, our proposals would include several additional provisions, such as:

- Our proposals would revise existing disclosure requirements regarding the composition of audit committees by also requiring this disclosure in annual reports of listed issuers filed with the Commission;
- Our proposals would require a company availing itself of one of our proposed exemptions from the requirements to disclose publicly that it is doing so; and
- Our proposals would update existing disclosure requirements regarding audit committees to reflect changes made by the proposals and the Sarbanes-Oxley Act.

B. Potential Benefits

One of the main goals of the Sarbanes-Oxley Act is to improve investor confidence in the financial markets. The proposals in this release are among many required by the Sarbanes-Oxley Act.[139] They seek to help achieve the Act's goals by promoting strong, effective audit committees to perform their oversight role. By increasing the competence of audit committees, the proposals are designed to further greater accountability and quality of financial disclosure and oversight of the process by qualified and independent audit committees. Vigilant and informed oversight by a strong, effective and independent audit committee could help to counterbalance pressures to misreport results and impose increased discipline on the process of preparing financial information. Improved oversight may help detect fraudulent financial reporting earlier and perhaps thus deter it or minimize its effects. All of these benefits imply increased market efficiency due to improved information and investor confidence in the reliability of a company's financial disclosure and system of internal controls. These benefits are not readily quantifiable. However, as the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees summarized regarding its own recommendations for audit committees:

> Improving oversight of the financial reporting process necessarily involves the imposition of certain burdens and costs on public companies. Despite these costs, the Committee believes that a more transparent and reliable financial reporting process ultimately results in a more efficient allocation of and lower cost of capital. To the extent that instances of outright fraud, as well as other practices that result in lower quality financial reporting, are reduced with improved oversight, the benefits clearly justify these expenditures of resources.[140]

In addition, we are proposing to require basic information about the composition of an issuer's audit committee in a listed issuer's annual report. The disclosure is currently only required in proxy or information statements where directors are being elected, and not all listed issuers are subject to the proxy rules or elect directors each year. Also, because the Exchange Act now provides that in the absence of an audit committee the entire board of directors will be considered to be the audit committee, we propose to require a listed issuer that has not or has chosen not to separately designate an

[139] See note 30 above.

[140] See note 22 above.

audit committee to disclose that the entire board of directors is acting as the issuer's audit committee. Also, if a company relied on one of the exemptions we propose to the requirements, some minimal additional disclosure would be required in its proxy or information statements where directors are elected and in their annual report (unless incorporated by reference). We also propose several updates to existing disclosure requirements regarding audit committees to reflect the proposals and changes made by the Sarbanes-Oxley Act.

As a result of these disclosure changes, investors would receive more detailed information on a consistent basis about the basic composition of an issuer's audit committee. These disclosures will afford investors greater visibility about the issuer's audit committee. Providing this information on a more widespread basis also may allow investors to ask more direct and useful questions of management and directors regarding the composition and role of the audit committee.

C. Potential Costs

SROs not in compliance with the standards would need to spend additional time and incur additional costs in modifying their rules to comply. There also may be ongoing costs in monitoring compliance with the standards and taking appropriate remedial steps. We request comment on the type, amount and duration of these costs. If the proposed standards had the effect of causing companies to delist or forego listing of their securities, SROs would lose trading volume. The proposed standards could have the effect of discouraging the formation of trading markets that specialize in particular types of issuers (*i.e.*, small issuers or foreign issuers), if those issuers found the proposed requirements too burdensome to seek a listing on those markets. The possibility of these effects and their magnitude if they were to occur are difficult to quantify.

Issuers would need to comply with the proposed audit committee standards if they wished to have their securities listed on a national securities exchange or national securities association. This may require companies to spend additional time and incur additional costs in establishing and modifying their audit committees (or full boards if they do not have a separate audit committee) to comply with the standards. There may be search costs involved in locating independent directors willing to serve on a company's audit committee, including the costs of preparing proxy statements and holding shareholder meetings to elect those directors. If the requirements reduce the pool of candidates that would be willing to serve on an issuer's audit committee, these search costs may increase. Convincing directors to serve on an audit committee may require additional compensation or increased liability insurance coverage due to the new requirements imposed on audit committees. Companies may decide to increase the size of their boards to accommodate new directors meeting the proposed requirements. If additional independent directors are added to the board, or if existing non-independent directors are replaced, this may increase the percentage of the board that is independent from management. If a company had previously received services from an audit committee member of the type that would be prohibited under the proposals, the company may incur costs in locating an alternative provider for these services.

There also may be ongoing costs in monitoring compliance with the standards or maintaining any additional procedures established by the standards, such as the procedures for handling complaints. To the extent the audit committee engages independent counsel or other advisors where it could not do so previously, there would be additional costs for the payment of compensation to these advisors. Companies also may incur additional ongoing expenses if they decide to increase the size of their boards in response to the requirements.

We believe that as a result of many current SRO listing standards,[141] the Commission's audit committee disclosure requirements adopted in 1999,[142] the prior disclosures related to the involvement of the audit committee in recommending or approving changes in auditors and the resolution of disagreements between management and the auditors,[143] and professional standards that require communications between the auditor and audit committees on auditor independence issues,[144] many companies currently have audit committees. However, these audit committees may not meet all of our proposed requirements. Smaller companies may constitute a larger representative share of issuers that do not meet the proposed requirements, particularly the independence requirements. However, we recognize that because the proposals apply only to listed issuers, the quantitative listing standards applicable to listed securities, such as minimum revenue, market capitalization and shareholder equity requirements, will limit the size of issuers that will be affected by the requirements. Companies that do not currently meet our proposed requirements would face all of the costs described above. However, these entities, because they currently lack the protections provided by the standards, may bear a disproportionately greater risk of fraudulent financial reporting, and thus may reap proportionately greater benefits.

We also have proposed limited exemptions to the requirements, such as an exemption for multiple listings, a limited exemption for new public companies and exemptions for certain foreign issuers, to alleviate some of the burdens companies may face where consistent with investor protection. Companies that perceived the proposals as too onerous could be dissuaded from seeking or maintaining a listing for their securities, which could impact capital formation and negatively impact the liquidity for its securities. We have no reliable basis for estimating the number of companies that would face increased costs as a result of the proposals or the amount of such costs.

Regarding the disclosure changes we propose regarding audit committees, issuers subject to the proxy rules are already required to compile most of this information for proxy or information statements where directors are being elected. Foreign private issuers that file their annual reports on Form 20–F also are already required to identify the members of their audit committee. The disclosure regarding if a listed issuer is availing itself of an exemption to the requirements should result in minimal additional disclosure. Using estimates derived from our Paperwork Reduction Act analysis, we estimate that the incremental impact of our proposed disclosure changes will result in a total cost of $185,225 for all affected companies.[145]

[141] See note 23 above.

[142] See note 24 above.

[143] See, *e.g.*, Item 4 of Form 8–K [17 CFR 249.308] and Item 304 of Regulation S–K [17 CFR 229.304].

[144] See, *e.g.*, American Institute of Certified Public Accountants (''AICPA'') ''Communications with Audit Committees,'' Statements of Auditing Standards (''SAS'') 61, as amended by SAS 89 and 90; AICPA, Codification of Statements on Auditing Standards (''AU'') § 380; Independence Standards Board, ''Independence Discussion with Audit Committees,'' Independence Standard No. 1 (Jan. 1999).

[145] The estimate is based on the burden hour estimates calculated under the Paperwork Reduction Act. For purposes of the Paperwork Reduction Act, we estimate that the additional disclosure will result in 685 internal burden hours and $99,600 in external costs. Assuming a cost of $125/hour for in-house professional staff, the total cost for the internal burden hours would be

In formulating our proposals, we considered several regulatory alternatives that would be consistent with the specific mandate required by Section 10A(m) of the Exchange Act. We considered the propriety of excluding all foreign issuers or issuers of a particular size, but such an exclusion may not be appropriate or consistent with the policies underlying the Sarbanes-Oxley Act. We think that improvements in the financial reporting process for all listed issuers are important for promoting investor confidence in our markets. We also considered whether we should provide objective guidance for determining who is an ''affiliated person'' for purposes of the proposed independence requirement. In considering the uncertainty that may arise in determining whether a person is an ''affiliated person,'' we have proposed a safe harbor from the definition of affiliate for non-investment companies. We have also proposed other limited exemptions to alleviate some of the burdens companies may face where consistent with investor protection.

D. Request for Comments

We request that commenters provide views and supporting information as to the benefits and costs associated with the proposals. We seek estimates of these costs and benefits, as well as any costs and benefits not already identified. We also request comment regarding the relative costs and benefits of pursuing alternative regulatory approaches that are consistent with the Sarbanes-Oxley Act's statutory mandate.

V. Consideration of Impact on the Economy, Burden on Competition and Promotion of Efficiency, Competition and Capital Formation

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or ''SBREFA,'' [146] we solicit data to determine whether the proposals constitute a ''major'' rule. Under SBREFA, a rule is considered ''major'' where, if adopted, it results or is likely to result in:

- An annual effect on the economy of $100 million or more (either in the form of an increase or a decrease);
- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effects on competition, investment or innovation. We request comment on the potential impact of the proposals on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their views if possible.

Section 23(a)(2) of the Exchange Act [147] requires us, when adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition. In addition, Section 23(a)(2) prohibits us from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

The proposals represent the implementation of a Congressional mandate. They are intended to increase the independence and effectiveness of listed company audit committees. We anticipate these proposals would enhance the proper functioning of the capital markets by increasing the quality and accountability of financial reporting and restoring investor confidence. This increases the competitiveness of companies participating in the U.S. capital markets. However, our specific proposals relate only to companies listed on a national securities exchange or national securities association. Competitors not subject to the standards specified in Section 10A(m) of the Exchange Act may be subject to less corporate governance burdens. Similarly, to the extent foreign exchanges or other markets do not impose these standards, competitors could, all things being equal, migrate to those markets to avoid compliance. This could cause U.S. exchanges and securities associations to lose trading volume. Competitors and markets not subject to the standard, however, also may suffer from decreased investor confidence compared to those that do comply with the new standards.

We request comment on whether the proposed amendments, if adopted, would impose a burden on competition. Commenters are requested to provide empirical data and other factual support for their views if possible.

Section 2(b) of the Securities Act,[148] Section 3(f) of the Exchange Act [149] and Section 2(c) of the Investment Company Act [150] require us, when engaging in rulemaking where we are required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. The proposals would enhance the quality and accountability of the financial reporting process and may help increase investor confidence, which implies increased efficiency and competitiveness of the U.S. capital markets. Increased market efficiency and investor confidence also may encourage more efficient capital formation. As noted above, however, the proposals could have certain indirect negative effects, such as inconsistent application across all competitors. In addition, the proposed standards, while providing great flexibility for implementation, do remove a certain amount of individual control over the corporate governance process, which could have the possible effect of stifling more efficient approaches from being implemented if they were to develop.

If a company found the proposed requirements too onerous, it could be dissuaded from accessing the public capital markets, which could impact capital formation. The possibility of these effects and their magnitude if they were to occur are difficult to quantify. We have proposed several limited exemptions from the requirements to alleviate some of the burdens companies may face where consistent with investor protection. For example, the proposed limited exemption for new public companies is intended to counteract any disincentive the proposed requirements may have on a company's willingness to access the public capital markets.

We request comment on whether the proposed amendments, if adopted, would promote efficiency, competition, and capital formation. Commenters are requested to provide empirical data and other factual support for their views if possible.

VI. Initial Regulatory Flexibility Analysis

This Initial Regulatory Flexibility Analysis, or IRFA, has been prepared in accordance with the Regulatory Flexibility Act.[151] This IRFA involves proposals 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 several enumerated standards relating to the issuer's audit committee.

A. Reasons for, and Objectives of, Proposed Amendments

We are proposing new Exchange Act Rule 10A–3 to comply with the mandate

$85,625. Hence the aggregate cost estimate is $185,225 ($99,600 + 85,625). The $125/hour cost estimate is based on data obtained from *The SIA Report on Management and Professional Earnings in the Securities Industry* (Oct. 2001).

[146] Pub. L. No. 104–121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

[147] 15 U.S.C. 78w(a)(2).

[148] 17 U.S.C. 77b(b).

[149] 15 U.S.C. 78c(f).

[150] 15 U.S.C. 80a–2(c).

[151] 5 U.S.C. 603.

of the Sarbanes-Oxley Act and new Section 10A(m)(1) of the Exchange Act. The proposals are intended to enhance investor confidence in the fairness and integrity of the securities markets by increasing the competence and independence, and hence effectiveness, of listed company audit committees. In addition, our proposals would make several changes to our current disclosure requirements regarding audit committees to increase the transparency of these committees. We believe that these proposals will help to improve the quality and accountability of financial disclosure and oversight of the process by qualified and independent audit committees.

B. Legal Basis

We are proposing the new rule and amendments under the authority set forth in Sections 2,[152] 6,[153] 7,[154] 8,[155] 10,[156]17 [157] and 19 [158] of the Securities Act, Sections 3(b), 10A, 12, 13, 14, 15, 23 and 36 [159] of the Exchange Act, Sections 8,[160] 20,[161] 24(a),[162] 30 [163] and 38[164] of the Investment Company Act of 1940 and Sections 3 and 301 of the Sarbanes-Oxley Act.

C. Small Entities Subject to the Proposed Amendments

The proposals will directly affect the national securities exchanges that trade listed securities, none of which is a small entity as defined by Commission rules. Exchange Act Rule 0–10(e) [165] states that the term ''small business,'' when referring to an exchange, means any exchange that has been exempted from the reporting requirements of Exchange Act Rule 11Aa3–1.[166] The proposals also will directly affect national securities associations. No national securities association is a small entity, as defined by 13 CFR 121.201.

The proposals may have an indirect effect on some small entities. We also have defined the term ''small business'' in Exchange Act Rule 0–10(a) to be an issuer, other than an investment company, that, on the last day of its most recent fiscal year, had total assets of $5 million or less and when used with reference to an investment company, an investment company together with other investment companies in the same group of related investment companies with net assets of $50 million or less as of the end of its most recent fiscal year.[167] Under these limits, depending on other restrictions imposed by the various SROs, such as quantitative listing standards, a small entity may be listed on a national securities exchange or a national securities association. We estimate that 7,250 issuers are listed on a national securities exchange or traded on Nasdaq, and we estimate that 6,640 of these issuers are not investment companies.[168] We estimate that less than 225, or approximately 3%, of the issuers that are not investment companies,[169] and less than 25, or approximately 4% of the issuers that are investment companies,[170] are ''small entities'' for purposes of the Regulatory Flexibility Act that possibly could be restricted by the proposals.

We request comment on the number of small entities that would be impacted by our proposals, including any available empirical data.

D. Reporting, Recordkeeping, and Other Compliance Requirements

Under the proposals, national securities exchanges and national securities associations are directed to prohibit the listing of any security of an issuer, both large and small, that is not in compliance with certain enumerated standards regarding the issuer's audit committee. These standards relate to: the independence of audit committee members; the audit committee's responsibility to select and oversee the issuer's independent accountant; procedures for handling complaints regarding the issuer's accounting practices; the authority of the audit committee to engage advisors; and funding for the independent auditor and any outside advisors engaged by the audit committee.

Small entities would need to comply with these standards if they wished to have their securities listed on a national securities exchange or a national securities association. The rules would not require an entity to maintain an audit committee. However, the Exchange Act now provides that in the absence of an audit committee the entire board of directors will be considered to be the audit committee. There are reasons to believe that many small entities currently have separately-designated audit committees.[171] However, not all of the audit committees of these small entities may comply with the requirements of the proposed rule. A small entity whose board or audit committee did not comply with the proposed rules would need to spend additional time and incur additional costs in modifying their audit committees or board to comply with the standards. Small entities may face particular difficulties in recruiting directors that meet the independence requirements of the proposed rules.

There also may be ongoing costs in monitoring compliance with the standards or maintaining any additional procedures established by the standards, such as the procedures for handling complaints. To the extent the audit committee engages independent counsel or other advisors where it could not do so previously, there would be additional costs for the payment of compensation to these advisors. Due to the small size of these small entities, these additional costs may have a larger proportional impact on these entities than larger listed issuers.

In addition, the small entity may need to make additional disclosure about its audit committee in its annual report as well as its proxy or information statement if directors are being elected. This may require additional costs in order to collect, record and report the information to be disclosed under the proposed rules. Small entities subject to the proxy rules are already required to disclose most of the information affected by our proposals in proxy or information statements where directors are being elected. This information should be readily available to small entities. Further, the disclosure regarding any exemption from the listing standards should entail only a minimal additional statement.

We have little data to determine how many small entities do not already comply with the proposals or how much it would cost to comply. We recognize that because the proposals apply only to listed issuers, the quantitative listing standards applicable to listed securities, such as minimum revenue, market capitalization and shareholder equity requirements, will limit the size of issuers that will be affected by the requirements. We request comment on the ability of affected small entities to meet the proposals. How many small entities already comply with the

[152] 15 U.S.C. 77b.
[153] 15 U.S.C. 77f.
[154] 15 U.S.C. 77g.
[155] 15 U.S.C. 77h.
[156] 15 U.S.C. 77j.
[157] 15 U.S.C. 77q.
[158] 15 U.S.C. 77s.
[159] 17 U.S.C. 78mm.
[160] 15 U.S.C. 80a–8.
[161] 15 U.S.C. 80a–20.
[162] 15 U.S.C. 80a–24(a).
[163] 15 U.S.C. 80a–29.
[164] 15 U.S.C. 80a–37.
[165] 17 CFR 240.0–10(e).
[166] 17 CFR 240.11Aa3–1.
[167] *See* Exchange Act Rule 0–10(a).
[168] *See* note 119 above.
[169] We derived this estimate from the Standard & Poors Research Insight Compustat Database.
[170] We derived this estimate from information compiled by Commission staff.
[171] See, *e.g.*, NACD, *2001–2002 Public Company Governance Survey* (Nov. 2001).

proposals? What are the burdens and costs that small entities would face? Would the proposal disproportionately impact small entities? Would the proposals have any effect on the willingness or ability of small entities to seek or maintain a listing for their securities?

E. Duplicative, Overlapping or Conflicting Federal Rules

The rules of several existing SROs contain minimum standards relating to audit committees.[172] To the extent any of these standards are in conflict with our proposals, our proposals would supercede these requirements. SROs would not be precluded from adopting additional listing standards regarding audit committees, as long as they were consistent with the proposed rule. We believe that there are no other rules that duplicate, overlap or conflict with the proposals, except for the inconsistency between proposed Rule 10A–3 and Section 32(a) of the Investment Company Act regarding the selection of auditors. That inconsistency would be resolved if the rule is adopted as proposed.

F. Significant Alternatives

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish our stated objectives, while minimizing any significant adverse impact on small entities. In connection with our proposals, we considered the following alternatives:

- Establishing different compliance or reporting requirements or timetables that take into account the resources available to small entities;
- Clarifying, consolidating or simplifying compliance and reporting requirements under the rules for small entities;
- Using performance rather than design standards; and
- Exempting small entities from all or part of the requirements.

The coverage of Section 10A(m) of the Exchange Act, as added by Congress in Section 301 of the Sarbanes-Oxley Act, makes no distinction based on an issuer's size. We think that improvements in the financial reporting process for listed issuers of all sizes are important for promoting investor confidence in our markets. For example, a 1999 report commissioned by the organizations that sponsored the Treadway Commission found that the incidence of financial fraud was greater in small companies.[173] However, we are sensitive to the costs and burdens that would be faced by small entities.

Although we preliminarily believe that an exemption for small entities from coverage of the proposals is not appropriate and inconsistent with the policies underlying the Sarbanes-Oxley Act, we solicit comment on the propriety of a complete or partial exemption from the requirements for small entities. We preliminarily believe that different compliance requirements or timetables for small entities also would interfere with achieving the primary goal of the proposals of increasing the competency and effectiveness of audit committees for all companies with listed securities. In addition, we are not aware of how to further clarify, consolidate or simplify these proposals for small entities. We recognize that because the proposals apply only to listed issuers, the quantitative listing standards applicable to listed securities, such as minimum revenue, market capitalization and shareholder equity requirements, already serve somewhat as a limit on the size of issuers that will be affected by the requirements. We do, however, solicit comment on these views and whether different compliance requirements or timetables for small entities would be appropriate, consistent with the mandate and purposes of Section 10A(m) of the Exchange Act.

The proposals use performance standards in a number of respects. We do not propose to specify the procedures or arrangements an issuer or audit committee must develop to comply with the standards. For example, we do not propose to specify the procedures that an audit committee must establish for handling complaints, as we believe companies should have the flexibility to develop procedures most efficient for their individual circumstances. We do provide design standards regarding audit committee member independence, as these are the standards we are directed to implement by Congress. Accordingly, we believe that design standards are necessary to achieve the objectives of the proposals. We do have the authority under Section 10A(m)(3)(C) to exempt particular relationships with respect to audit committee members, although, for the reasons discussed above, we do not propose to use that authority at this time for small entities. We request comment on these views.

G. Request for Comments

We encourage the submission of comments with respect to any aspect of this IRFA. In particular, we request comment on the number of small entities that would be affected by the proposals, the nature of the impact, how to quantify the number of small entities that would be affected, and how to quantify the impact of, the proposals. Commenters are requested to describe the nature of any effect and provide empirical data and other factual support for their views if possible. These comments will be considered in preparing the Final Regulatory Flexibility Analysis, if the proposals are adopted, and will be placed in the same public file as comments on the proposals.

VII. Statutory Authority and Text of Rule Amendments

The proposals contained in this document are being proposed under the authority set forth in Sections 2, 6, 7, 8, 10, 17 and 19 of the Securities Act, Sections 3(b), 10A, 12, 13, 14, 15, 23 and 36 of the Exchange Act, Sections 8, 20, 24(a), 30 and 38 of the Investment Company Act of 1940 and Sections 3 and 301 of the Sarbanes-Oxley Act.

Text of Proposed Amendments

List of Subjects in 17 CFR Parts 228, 229, 240, 249 and 274

Investment companies, Reporting and recordkeeping requirements, Securities.

In accordance with the foregoing, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 228—INTEGRATED DISCLOSURE SYSTEM FOR SMALL BUSINESS ISSUERS

1. The authority citation for Part 228 is amended by adding the following citation in numerical order to read as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z–2, 77z–3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77jjj, 77nnn, 77sss, 78l, 78m, 78n, 78o, 78u–5, 78w, 78*ll*, 78mm, 80a–8, 80a–29, 80a–30, 80a–37 and 80b–11.

* * * * *

Section 228.401 is also issued under secs. 3(a) and 301, Pub. L. No. 107–204, 116 Stat. 745.

2. Amend § 228.401 by adding paragraph (e) to read as follows:

§ 228.401 (Item 401) Directors, Executive Officers, Promoters and Control Persons.

* * * * *

(e) *Identification of the audit committee.* If you are a listed issuer, as defined in § 240.10A–3 of this chapter, filing an annual report on Form 10–KSB (17 CFR 249.310b) or a proxy statement or information statement pursuant to the

[172] *See* note 23 above.

[173] See note 91 above.

Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*) if action is to be taken with respect to the election of directors:

(1) State whether or not the small business issuer has a separately-designated standing audit committee established in accordance with section 3(a)(58)(A) of the Exchange Act (15 U.S.C. 78c(a)(58)(A)), or a committee performing similar functions. If the small business issuer has such a committee, however designated, identify each committee member. If the entire board of directors is acting as the small business issuer's audit committee as specified in section 3(a)(58)(B) of the Exchange Act (15 U.S.C. 78c(a)(58)(B)), so state.

(2) If applicable, provide the disclosure required by § 240.10A–3(d) of this chapter regarding an exemption from the listing standards for audit committees.

3. Amend § 228.601 by removing the last sentence of paragraph (a)(1).

PART 229—STANDARD INSTRUCTIONS FOR FILING FORMS UNDER SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934 AND ENERGY POLICY AND CONSERVATION ACT OF 1975—REGULATION S–K

4. The authority citation for Part 229 is amended by adding the following citations in numerical order to read as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z–2, 77z–3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77iii, 77jjj, 77nnn, 77sss, 78c, 78i, 78j, 78l, 78m, 78n, 78o, 78u–5, 78w, 78*ll*(d), 78mm, 79e, 79n, 79t, 80a–8, 80a–29, 80a–30, 80a–31(c), 80a–37, 80a–38(a), and 80b–11, unless otherwise noted.

* * * * *

Section 229.401 is also issued under secs. 3(a) and 301, Pub. L. No. 107–204, 116 Stat. 745.

Section 229.601 is also issued under secs. 3(a) and 301, Pub. L. No. 107–204, 116 Stat. 745.

5. Amend § 229.401 by adding paragraph (h) to read as follows:

§ 229.401 (Item 401) Directors, executive officers, promoters and control persons.

* * * * *

(h) *Identification of the audit committee.* If you are a listed issuer, as defined in § 240.10A–3 of this chapter, filing an annual report on Form 10–K or 10–KSB (17 CFR 249.310 or 17 CFR 249.310b) or a proxy statement or information statement pursuant to the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*) if action is to be taken with respect to the election of directors:

(1) State whether or not the registrant has a separately-designated standing audit committee established in accordance with section 3(a)(58)(A) of the Exchange Act (15 U.S.C. 78c(a)(58)(A)), or a committee performing similar functions. If the registrant has such a committee, however designated, identify each committee member. If the entire board of directors is acting as the registrant's audit committee as specified in section 3(a)(58)(B) of the Exchange Act (15 U.S.C. 78c(a)(58)(B)), so state.

(2) If applicable, provide the disclosure required by § 240.10A–3(d) of this chapter regarding an exemption from the listing standards for audit committees.

6. Amend § 229.601 by:

a. Removing the second sentence of paragraph (a);

b. Revising the phrase ''Notwithstanding the provisions of paragraphs (b)(27) and (c) of this Item, registered investment companies'' at the beginning of the third sentence of paragraph (a) to read ''Registered investment companies'';

c. In the Exhibit Table, adding a designation for exhibit (27) entitled ''Statement re audit committees for registrants with boards of auditors or similar bodies'';

d. In the Exhibit Table, adding an ''X'' corresponding to exhibit (27) under the caption ''Exchange Act Forms'', ''10–K'';

e. In the Exhibit Table, reserving exhibits (28) through (98);

f. Adding the text of paragraph (b)(27); and

g. Reserving paragraphs (b)(28) through (b)(98).

The addition of paragraph (b)(27) reads as follows:

§ 229.601 (Item 601) Exhibits.

* * * * *

(b) *Description of exhibits.* * * *

(27) *Statement re audit committees for registrants with boards of auditors or similar bodies.* If you are availing yourself of the exemption in § 240.10A–3(c)(2) of this chapter from the listing standards for audit committees because you have a board of auditors or similar body, a statement that you are availing yourself of that exemption and a reference to the section of the report to which the exhibit relates disclosing information regarding your use of that exemption.

* * * * *

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

7. The authority citation for Part 240 is amended by adding the following citations in numerical order to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77z–3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j–1, 78k, 78k–1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u–5, 78w, 78x, 78ll, 78mm, 79q, 79t, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4 and 80b–11, unless otherwise noted.

* * * * *

Section 240.10A–3 is also issued under secs. 3(a) and 301, Pub. L. No. 107–204, 116 Stat. 745.

Section 240.14a–101 is also issued under secs. 3(a) and 301, Pub. L. No. 107–204, 116 Stat. 745.

* * * * *

8. Add § 240.10A–3 to read as follows:

§ 240.10A–3 Listing standards relating to audit committees.

(a) Pursuant to section 10A(m) of the Act (15 U.S.C. 78j–1(m)) and section 3 of the Sarbanes-Oxley Act of 2002 (Pub. L. No. 107–204, sec. 3, 116 Stat. 745):

(1) *National securities exchanges.* The rules of each national securities exchange registered pursuant to section 6 of the Act (15 U.S.C. 78f) must prohibit the initial or continued listing of any security of an issuer that is not in compliance with the requirements of any portion of paragraph (b) or (c) of this section.

(2) *National securities associations.* The rules of each national securities association registered pursuant to section 15A of the Act (15 U.S.C. 78o–3) must prohibit the initial or continued listing in an automated inter-dealer quotation system of any security of an issuer that is not in compliance with the requirements of any portion of paragraph (b) or (c) of this section.

(3) *Opportunity to cure defects.* The rules required by paragraphs (a)(1) and (a)(2) of this section must provide for appropriate procedures for an issuer to have an opportunity to cure any defects that would be the basis for a prohibition under paragraph (a) of this section, before the imposition of such prohibition.

(4) *Notification of noncompliance.* The rules required by paragraphs (a)(1) and (a)(2) of this section must include a requirement that a listed issuer must notify the applicable national securities exchange or national securities association promptly after an executive officer of the listed issuer becomes aware of any material noncompliance by the listed issuer with the requirements of this section.

(5) *Implementation.* (i) The rules of each national securities exchange or national securities association meeting the requirements of this section must be operative no later than the first

anniversary of the publication of this section in the **Federal Register**.

(ii) Each national securities exchange and national securities association must provide to the Commission, no later than 60 days after publication of this section in the **Federal Register**, proposed rules or rule amendments that comply with this section.

(iii) Each national securities exchange and national securities association must have final rule or rule amendments that comply with this section approved by the Commission no later than 270 days after publication of this section in the **Federal Register**.

(b) *Required standards.*

(1) *Independence.* (i) Each member of the audit committee must be a member of the board of directors of the listed issuer, and must otherwise be independent.

(ii) *Independence requirements for non-investment company issuers.* In order to be considered to be independent for purposes of this paragraph (b)(1), a member of an audit committee of a listed issuer that is not an investment company may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee:

(A) Accept directly or indirectly any consulting, advisory, or other compensatory fee from the issuer; or

(B) Be an affiliated person of the issuer or any subsidiary thereof.

(iii) *Independence requirements for investment company issuers.* In order to be considered to be independent for purposes of this paragraph (b)(1), a member of an audit committee of a listed issuer that is an investment company may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee:

(A) Accept directly or indirectly any consulting, advisory, or other compensatory fee from the issuer; or

(B) Be an ''interested person'' of the investment company as defined in section 2(a)(19) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(19)).

(iv) *Exemptions from the independence requirements.*

(A) One member of a listed issuer's audit committee may be exempt from the independence requirements of paragraph (b)(1)(ii) of this section for 90 days from the date of effectiveness of a registration statement under section 12 of the Act (15 U.S.C. 78*l*), or a registration statement under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*) covering an initial public offering of securities of the issuer, if the issuer was not immediately prior to such effective date required to file reports with the Commission pursuant to section 13(a) or 15(d) of the Act (15 U.S.C. 78m(a) or 78o(d)).

(B) An audit committee member that sits on the board of directors of both a listed issuer and its direct or indirect consolidated majority-owned subsidiary (or that sits on the board of both a listed issuer and its parent, if the listed issuer is a direct or indirect consolidated majority-owned subsidiary of the parent) is exempt from the requirements of paragraph (b)(1)(ii)(B) of this section if the member, except for sitting on both boards, otherwise meets the independence requirements of paragraph (b)(1)(ii) of this section for both the parent and the subsidiary, 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 the parent or subsidiary.

(C) An employee of a foreign private issuer who is not an executive officer of the foreign private issuer is exempt from the requirements of paragraph (b)(1)(ii) of this section if the employee is elected or named to the board of directors or audit committee of the foreign private issuer pursuant to home country legal or listing requirements.

(D) One member of the audit committee of a foreign private issuer may be exempt from the requirements of paragraph (b)(1)(ii)(B) of this section if that member meets the following requirements:

(*1*) The member is a beneficial owner of more than 50% of the voting common equity of the foreign private issuer or is a representative or designee of such an owner or a group of owners that collectively are the beneficial owner of more than 50% of the voting common equity of the foreign private issuer;

(*2*) The member has only observer status on, and is not a voting member or the chair of, the audit committee; and

(*3*) The member is not an executive officer of the foreign private issuer.

(E) One member of the audit committee of a foreign private issuer may be exempt from the requirements of paragraph (b)(1)(ii)(B) of this section if that member meets the following requirements:

(*1*) The member is a representative or designee of a foreign government or foreign governmental entity that is an affiliate of the foreign private issuer; and

(*2*) The member is not an executive officer of the foreign private issuer.

(F) In addition to paragraphs (b)(1)(iv)(A) through (E) of this section, the Commission may exempt from the requirements of paragraphs (b)(1)(ii) or (b)(1)(iii) of this section a particular relationship with respect to audit committee members, as the Commission determines appropriate in light of the circumstances.

(2) *Responsibilities relating to registered public accounting firms.*

(i) Except as provided in paragraph (b)(2)(ii) of this section, the audit committee of each listed issuer, in its capacity as a committee of the board of directors, must be directly responsible for the appointment, compensation, retention and oversight of the work of any registered public accounting firm engaged (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work or performing other audit, review or attest services for the listed issuer, and each such registered public accounting firm must report directly to the audit committee.

(ii) Paragraph (b)(2)(i) of this section does not apply in the case of the selection of a registered public accounting firm engaged by a listed issuer that is an investment company.

(3) *Complaints.* Each audit committee must establish procedures for:

(i) The receipt, retention, and treatment of complaints received by the listed issuer regarding accounting, internal accounting controls, or auditing matters; and

(ii) The confidential, anonymous submission by employees of the listed issuer of concerns regarding questionable accounting or auditing matters.

(4) *Authority to engage advisers.* Each audit committee must have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties.

(5) *Funding.* Each listed issuer must provide for appropriate funding, as determined by the audit committee, in its capacity as a committee of the board of directors, for payment of compensation:

(i) To any registered public accounting firm engaged for the purpose of rendering or issuing an audit report or related work or performing other audit, review or attest services for the listed issuer; and

(ii) To any advisers employed by the audit committee under paragraph (b)(4) of this section.

(c) *General exemptions.*

(1) At any time when an issuer has a class of common equity securities (or similar securities) that is listed on a national securities exchange or national securities association subject to the requirements of this section, listing of

other classes of securities of the issuer, and other classes of securities of a direct or indirect consolidated majority-owned subsidiary of the issuer (except classes of equity securities, other than non-convertible, non-participating preferred securities, of the majority-owned subsidiary), is not subject to the requirements of this section.

(2)(i)The listing of securities of a foreign private issuer will not be subject to the requirements of paragraphs (b)(1) or (b)(2) of this section if the foreign private issuer meets the following requirements:

(A) The securities of the foreign private issuer are also listed or quoted on a securities exchange or inter-dealer quotation system outside the United States;

(B) The foreign private issuer has a board of auditors (or similar body), or has statutory auditors, separate from the board of directors that are established and selected pursuant to home country legal or listing provisions requiring or permitting such a board or similar body;

(C) The board or body, or statutory auditors, are not elected by management of such issuer and no executive officer of the foreign private issuer is a member of such board or body, or statutory auditors;

(D) Home country legal or listing provisions set forth standards for the independence of such board or body, or statutory auditors, from the foreign private issuer or the management of such issuer;

(E) Such board or body, or statutory auditors, are directly responsible, in accordance with standards prescribed by home country legal or listing provisions, for the oversight of the work of any registered public accounting firm engaged (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work or performing other audit, review or attest services for the issuer; and

(F) Such board or body, or statutory auditors, are responsible, to the extent permitted by law, for the appointment and retention of any registered public accounting firm engaged by the issuer. Such responsibility may be vested in such board or body, or statutory auditors, in any manner, including without limitation by law or listing provision or delegation.

(ii) For purposes of foreign private issuers relying on the exemption in this paragraph (c)(2), the term *audit committee* in paragraphs (b)(3), (b)(4) and (b)(5) of this section refers to the foreign private issuer's board of auditors or similar body, or its statutory auditors.

(3) The listing of a security futures product cleared by a clearing agency that is registered pursuant to section 17A of the Act (15 U.S.C. 78q–1) or that is exempt from the registration requirements of section 17A pursuant to paragraph (b)(7)(A) of such section is not subject to the requirements of this section.

(4) The listing of a standardized option, as defined in § 240.9b–1(a)(4), issued by a clearing agency that is registered pursuant to section 17A of the Act (15 U.S.C. 78q–1) is not subject to the requirements of this section.

(5) The securities of the following listed issuers are exempt from the requirements of this section:

(i) Asset-Backed Issuers (as defined in § 240.13a–14(g) and § 240.15d–14(g)); and

(ii) Unit investment trusts (as defined in 15 U.S.C. 80a–4(2)).

(d) *Disclosure.* Any listed issuer availing itself of any exemption from the independence standards contained in paragraph (b)(1)(iv) of this section, or any general exemption contained in paragraph (c) of this section, other than the exemptions contained in paragraphs (c)(1) and (c)(5)(ii) of this section, must:

(1) Disclose its reliance on the exemption and its assessment of whether, 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 this section in any proxy or information statement for a meeting of shareholders at which directors are elected that is filed with the Commission pursuant to the requirements of section 14 of the Act (15 U.S.C. 78n); and

(2) Disclose the information specified in paragraph (d)(1) of this section in, or incorporate such information by reference from such proxy or information statement filed with the Commission into, its annual report filed with the Commission pursuant to the requirements of section 13(a) or 15(d) of the Act (15 U.S.C. 78m(a) or 78o(d)).

(e) *Definitions.* Unless the context otherwise requires, all terms used in this section have the same meaning as in the Act. In addition, unless the context otherwise requires, the following definitions apply:

(1)(i) The term *affiliate* of, or a person *affiliated* with, a specified person, means a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer. A person will be deemed not to be in control of the issuer for purposes of this section if the person:

(A) Is not the beneficial owner, directly or indirectly, of more than 10% of any class of equity securities of the issuer;

(B) Is not an executive officer of the issuer; and

(C) Is not a director of the issuer.

(ii) A director, executive officer, partner, member, principal or designee of an affiliate will be deemed to be an affiliate.

(2) In the case of foreign private issuers with two-tier boards of directors, the term *board of directors* means the supervisory or non-management board.

(3) The term *control* (including the terms *controlling*, *controlled by* and under *common control with*) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.

(4) The term *executive officer* has the meaning set forth in § 240.3b–7.

(5) The term *foreign private issuer* has the meaning set forth in § 240.3b–4(c).

(6) The term *indirect* acceptance by a member of an audit committee of any consulting, advisory or other compensatory fee includes acceptance of such a fee by a spouse, a minor child or stepchild or a child or stepchild sharing a home with the member or by an entity in which such member is a partner, member or principal or occupies a similar position and which provides accounting, consulting, legal, investment banking, financial or other advisory services or any similar services to the issuer.

(7) The terms *listed* and *listing* refer to securities listed on a national securities exchange or listed in an automated inter-dealer quotation system of a national securities association or to issuers of such securities.

(8) Until the Public Company Accounting Oversight Board has established the registration of independent public accountants, the term *registered public accounting firm* means an independent public accountant engaged for the purposes indicated in this section.

Instructions to § 240.10A–3

1. The requirement in paragraph (b)(2) or (c)(2)(i)(F) of this section does not conflict with, and does not affect the application of, any requirement under an issuer's governing law or documents or other home country requirements that requires shareholders to ultimately elect, approve or ratify the selection of the issuer's auditor. The requirement instead relates to the assignment of responsibility to oversee the auditor's

work as between the audit committee and management. In such an instance, however, if the issuer provides a recommendation or nomination of an auditor to its shareholders, the audit committee of the issuer, or body performing similar functions, must be responsible for making the recommendation or nomination. Also, the requirement in paragraph (b)(2) or (c)(2)(i)(F) of this section does not conflict with any requirement in a company's home jurisdiction that prohibits the full board of directors from delegating the responsibility to select the company's auditor. In that case, the audit committee, or body performing similar functions, must be granted advisory and other powers with respect to such matters to the extent permitted by law, including submitting nominations or recommendations to the full board.

2. For the purposes of paragraph (e)(1) of this section, the determination of a person's beneficial ownership must be made in accordance with § 240.13d–3(d)(1).

9. Amend § 240.14a–101 by:

a. Adding a sentence to the end of paragraph (d)(1) of Item 7;

b. Revising paragraph (d)(3)(iv) of Item 7; and

c. Revising the introductory text of paragraph (b)(14) of Item 22.

The additions and revisions read as follows:

§ 240.14a–101 Schedule 14A. Information required in proxy statement.

Schedule 14A Information

* * * * *

Item 7. Directors and executive officers. * * *

(d)(1) * * * Such disclosure need not be provided to the extent it is duplicative of disclosure provided in accordance with Item 401(h) of Regulation S–K (§ 229.401(h) of this chapter).

* * * * *

(3) * * *

(iv)(A) If the registrant is a listed issuer, as defined in § 240.10A–3, disclose whether the members of the audit committee are independent, as independence for audit committee members is defined in the listing standards applicable to the listed issuer. If the registrant does not have a separately designated audit committee, or committee performing similar functions, the registrant must provide the disclosure with respect to all members of its board of directors.

(B) If the registrant, including a small business issuer, is not a listed issuer, disclose whether the registrant has an audit committee established in accordance with section 3(a)(58)(A) of the Act (15 U.S.C. 78c(a)(58)(A)) and, if so, whether the members of the committee are independent. In determining whether a member is independent, the registrant must use a definition for audit committee member independence of a national securities exchange or national securities association that has been approved by the Commission (as such definition may be modified or supplemented), and state which definition was used. Whichever definition is chosen must be applied consistently to all members of the audit committee.

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Item 22. Information required in investment company proxy statement.

* * *

(b)(14) State whether or not the Fund has a separately designated audit committee established in accordance with section 3(a)(58)(A) of the Act (15 U.S.C. 78c(a)(58)(A)). If the entire board of directors is acting as the Fund's audit committee as specified in section 3(a)(58)(B) of the Act (15 U.S.C. 78c(a)(58)(B)), so state. If applicable, provide the disclosure required by § 240.10A–3(d) regarding an exemption from the listing standards for audit committees. Identify the other standing committees of the Fund's board of directors, and provide the following information about each committee, including any separately designated audit committee:

* * * * *

PART 249—FORMS, SECURITIES EXCHANGE ACT OF 1934

10. The authority citation for Part 249 is amended by revising the following citations in to read as follows:

Authority: 15 U.S.C. 78a, *et seq.*, unless otherwise noted.

* * * * *

Section 249.220f is also issued under secs. 3(a), 301, and 302, Pub. L. No. 107–204, 116 Stat. 745.

Section 249.240f is also issued under secs. 3(a), 301, and 302, Pub. L. No. 107–204, 116 Stat. 745.

Section 249.331 is also issued under secs. 3(a) and 301, Pub. L. No. 107–204, 116 Stat. 745.

* * * * *

11. Amend Form 20–F (referenced in § 249.220f) by:

a. Revising the Instruction to Item 6.C;

b. Adding paragraph (f) to Item 15;

c. Redesignating paragraph 11 of ''Instructions as to Exhibits'' as paragraph 12; and

d. Adding new paragraph 11 to ''Instructions as to Exhibits''.

The additions and revisions read as follows:

Note: The text of Form 20–F does not, and this amendment will not, appear in the Code of Federal Regulations.

Form 20–F

* * * * *

Item 6. Directors, Senior Management and Employees

* * * * *

Instructions to Item 6.C:

1. The term ''plan'' is used very broadly and includes any type of arrangement for compensation, even if the terms of the plan are not contained in a formal document.

2. If the company is a listed issuer as defined in Exchange Act Rule 10A–3 (17 CFR 240.10A–3) and its entire board of directors is acting as the company's audit committee as specified in section 3(a)(58)(B) of the Exchange Act (15 U.S.C. 78c(a)(58)(B)), so state.

* * * * *

Item 15. Certain Disclosures

* * * * *

(f) Exemptions from the Listing Standards for Audit Committees.

If applicable, provide the disclosure required by Exchange Act Rule 10A–3(d) (17 CFR 240.10A–3(d)) regarding an exemption from the listing standards for audit committees. You do not need to provide the information called for by this Item 15(f) unless you are using this form as an annual report.

* * * * *

Instructions as to Exhibits

* * * * *

11. If you are availing yourself of the exemption in Exchange Act Rule 10A–3(c)(2) (17 CFR 240.10A–3(c)(2)) from the listing standards for audit committees because you have a board of auditors or similar body, a statement that you are availing yourself of that exemption and a reference to the section of the report to which the exhibit relates disclosing information regarding your use of that exemption. You do not need to provide the information called for by this paragraph 11 unless you are using this form as an annual report.

* * * * *

12. Amend Form 40–F (referenced in § 249.240f) by adding paragraph (11) to General Instruction B to read as follows:

Note: The text of Form 40–F does not, and this amendment will not, appear in the Code of Federal Regulations.

Form 40–F

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General Instructions

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B. Information To Be Filed on This Form.

* * * * *

(11) Identification of the Audit Committee. If you are a listed issuer subject to Exchange Act Rule 10A–3 (17 CFR 240.10A–3) that is using this form as an annual report:

(a) State whether or not the registrant has a separately-designated standing audit committee established in accordance with section 3(a)(58)(A) of the Exchange Act (15 U.S.C. 78c(a)(58)(A)), or a committee performing similar functions. If the registrant has such a committee, however designated, identify each committee member. If the entire board of directors is acting as the registrant's audit committee as specified in section 3(a)(58)(B) of the Exchange Act (15 U.S.C. 78c(a)(58)(B)), so state.

(b) If applicable, provide the disclosure required by Exchange Act Rule 10A–3(d) (17 CFR 240.10A–3d)) regarding an exemption from the listing standards for audit committees.

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PART 274—FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940

13. The authority citation for Part 274 continues to read, in part, as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78*l,* 78m, 78n, 78o(d), 80a–8, 80a–24, 80a–26, and 80a–29, unless otherwise noted.

* * * * *

14. Form N–CSR (referenced in §§ 249.331 and 274.128) is amended by:

a. Redesignating Items 8 and 9 as Items 9 and 10;

b. Removing the phrase ''and 7(b)'' from General Instruction D and in its place adding ''8, and 10(b)'';

c. Removing the phrase ''The information required by Item 5'' from General Instruction D and in its place adding ''The information required by Items 5 and 8''; and

d. Adding new Item 8 to read as follows.

Note: The text of Form N–CSR does not, and this amendment will not, appear in the Code of Federal Regulations.

Form N–CSR

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Item 8. Audit Committee of Listed Registrants

(1) If the registrant is a listed issuer subject to Rule 10A–3 under the Exchange Act (17 CFR 240.10A–3), state whether or not the registrant has a separately-designated standing audit committee established in accordance with Section 3(a)(58)(A) of the Exchange Act (15 U.S.C. 78c(a)(58)(A)). If the registrant has such a committee, however designated, identify each committee member. If the entire board of directors is acting as the registrant's audit committee as specified in Section 3(a)(58)(B) of the Exchange Act (15 U.S.C. 78c(a)(58)(B)), so state.

(2) If applicable, provide the disclosure required by Rule 10A–3(d) under the Exchange Act (17 CFR 240.10A–3(d)) regarding an exemption from the listing standards for audit committees.

Instruction. The information required by this Item 8 is only required in a report on this Form N–CSR that is required by Item 10(a) to include a copy of an annual report transmitted to stockholders.

Dated: January 8, 2003.

By the Commission.

Jill M. Peterson,

Assistant Secretary.

[FR Doc. 03–690 Filed 1–16–03; 8:45 am]

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