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SEC Adopts New Requirements to Strengthen Independence of Audit Committees

In connection with the implementation of Section 301 of the Sarbanes-Oxley Act of 2002 (the "Act"), the SEC has adopted Exchange Act Rule 10A-3 that prohibits the listing in the United States of any security of an issuer not complying with the audit committee requirements set out in Section 301 of the Act. Rule 10A-3 also expands the existing disclosure requirements regarding audit committees and requires additional audit committee disclosure in annual reports and proxy statements.

The new listing standards required by Rule 10A-3 will address, among other things:

- the independence of listed company audit committee members; and
- the functions and duties of the audit committee, including the audit committee's oversight responsibilities, the receipt and treatment of accounting-related complaints and the authority of the audit committee to engage, and pay for, auditors and advisors.

For companies without a separate audit committee, the board of directors is deemed to constitute the audit committee and the requirements of Rule 10A-3 apply to the board of directors as a whole.

The new listing standards will apply to foreign private issuers as well as domestic issuers. However, to avoid conflict with legal requirements, corporate governance standards and the methods for providing auditor oversight in the home jurisdiction of some foreign private issuers, Rule 10A-3 provides specific limited accommodations to foreign private issuers.

Rule 10A-3 is effective April 25, 2003. Each national securities exchange and association must provide to the SEC, no later than July 15, 2003, proposed rules or rule amendments that comply with the requirements of the new rules. Additionally, each national securities exchange and association must have final rules or rule amendments that comply with Rule 10A-3 approved by the SEC no later than December 1, 2003. Listed issuers, other than foreign private issuers and small business issuers, must be in compliance with the new listing standards by the earlier of their first annual shareholders meeting after January 15, 2004 and October 31, 2004. Listed foreign private issuers and small business issuers must be in compliance with the new listing standards by July 31, 2005.

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As the independence requirements ultimately will be applicable as a result of listing standards, the Act contemplates a process for curing defects that could result in a delisting. The national securities exchanges and associations will be required to establish procedures for curing failures to comply.

I. Audit Committee Independence

The Act requires that each member of the audit committee of a listed company be independent. Rule 10A-3 implements the two basic criteria for determining independence set forth in Section 301 of the Act. It provides that audit committee members:

- may not accept any consulting, advisory or other compensatory fee from the issuer or any subsidiary of the issuer, other than in the member's capacity as a member of the board of directors and any board committee; and

- may not be an affiliate of the issuer or any subsidiary of the issuer other than in his or her capacity as a member of the board and any board committee.

A. "No Compensation" Requirement

Generally. The "no compensation" requirement precludes payments to an audit committee member for service as an officer or employee, as well as other compensatory payments. Disallowed payments include payments made either directly or indirectly. Under Rule 10A-3, indirect compensatory payments include payments to:

- spouses;

- minor children or stepchildren;

- children or stepchildren sharing a home with the audit committee member; and

- an entity in which the audit committee member is a partner, member, managing director occupying a comparable position, or executive officer or person performing similar functions (except limited partners, non-managing members and those occupying similar positions who, in each case, have no active role in providing services to the entity) and which provides accounting, consulting, legal, investment banking or financial advisory services to the issuer or any subsidiary.

Consistent with the express language of the Act, Rule 10A-3 prohibits the receipt of "any" consulting, advisory or compensatory fees and does not contain a *de minimis* exception.

Indirect Compensation. The indirect compensation test involves a two-part analysis. Where an audit committee member is associated with an entity that provides services to the issuer, one needs to examine the type of entity providing the services and the relationship between the audit committee member and that associated entity.

- To clarify the application of the prohibition, Rule 10A-3 specifies that the prohibition covers compensation from entities that provide accounting, consulting, legal, investment banking and financial advisory services. The SEC stated that other commercial relationships are not covered by the rule, although the stock exchanges may separately provide that relationships with other entities are covered. But as far as Rule 10A-3 is concerned, the prohibitions do not include compensation from entities providing non-advisory financial services such as lending, check clearing, maintaining customer accounts, stock brokerage services or custodial and cash management services.

- The SEC also provided additional guidance regarding the types of positions that are covered at associated entities. The proposed rule would have applied the prohibition to an audit committee member who is a "partner, member or principal or occupies a similar position" with the associated entity. The SEC clarified that the prohibition does not extend to just any employee of an associated entity, but does include those persons, such as partners or members in professional organizations, regardless of control, whose compensation could be directly affected by the prohibited fees, even if they are not the primary service provider.

Rule 10A-3 applies the prohibitions only to current relationships with the audit committee member and related persons. The rule does not impose a "look-back" requirement prior to appointment to the audit committee or effectiveness of the rule. Additionally, Rule 10A-3 specifies that, unless the listing standards of a national securities exchange or association provide otherwise, compensatory fees do not include the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the issuer, provided that such compensation is not contingent in any way on continued service.

The SEC recognized that the listing standards of some securities markets (notably the NYSE and Nasdaq) currently restrict additional business or personal relationships, and that these markets are seeking to add to these requirements. Nevertheless, the SEC stated that its mandate under Section 301 of the Act is limited to determining independence by reference to payments of compensatory fees. Rule 10A-3 does not extend to the broad categories of business and personal relationships that may be reached by NYSE and Nasdaq listing standards. The SEC pointed out that Rule 10A-3 does allow U.S. securities markets to adopt further requirements of these sorts, but they would do so within the more flexible environment of listing standards.

Curing defects. Rule 10A-3 also addresses the situations in which an audit committee member ceases to be independent for reasons outside the member's reasonable control. For example, an audit committee member could be a partner in a law firm that provides no services to the issuer but does provide services to a company that is acquired by the issuer. Without an opportunity to cure such a defect, the audit committee member would cease to be independent. Accordingly, under Rule 10A-3 the listing standards of the national securities exchanges and associations may provide that if a member of an audit committee ceases to be independent for reasons outside the member's reasonable control, that person, with notice by the issuer to the applicable securities market, may remain an audit

committee member of the issuer until the earlier of the next annual meeting of the issuer or one year from the occurrence of the event that caused the member to be no longer independent.

B. Affiliated Persons

The second prong of the independence test requires that an independent audit committee member may not be an affiliate of the issuer or any of its subsidiaries. For purposes of this test, one needs to focus on the definition of "control" and its interaction with share ownership.

"Control." Rule 10A-3 defines an "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 specified person. The term "control" is defined 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.

Safe harbor for under 10% ownership. The determination of whether or not a person is an affiliate requires a factual determination based on a consideration of all relevant facts and circumstances. However, because the SEC recognizes that it can be difficult to determine whether someone controls another person, Rule 10A-3 creates a safe harbor. Under the safe harbor, a person who is not an executive officer or a shareholder owning 10% or more of any class of voting securities of a specified person "is deemed" not to control such specified person. The test was modified to focus only on voting equity securities. Beneficial ownership is to be calculated based on Rule13d-3.

Outside the safe harbor. The 10% threshold is not an upper limit, and the safe harbor only establishes that a person holding 10% or less will not be deemed to control the issuer. The safe harbor does not create a presumption that a person beneficially owning in excess of 10% controls, or is otherwise an affiliate of, the issuer. As a result, 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. In other words, a director who is not an executive officer but beneficially owns more than 10% of the issuer's voting equity securities could, for purposes of Rule 10A-3, be eligible to serve on the audit committee if the director otherwise does not control the issuer.

However, in the adopting release, the SEC noted that while Rule 10A-3 does not establish an upper limit on share ownership that would become a per se bar to independence, the listing standards of the national securities exchanges and associations could establish an upper ownership limit that would preclude independence (e.g. the Nasdaq has proposed that an audit committee member will be considered an affiliated person of the issuer if such member owns or controls, directly or indirectly, 20% of an issuer's voting stock). Such upper limit would preclude committee membership notwithstanding a conclusion that a director does not "control" the issuer for Rule 10A-3 purposes.

Associated persons of affiliates. The proposed rule would have deemed a director, executive officer, partner, member, principal or designee of an affiliate to be an affiliate and therefore ineligible to serve on an audit committee. Rule 10A-3, as adopted, provides that only executive officers, directors that are also employees of an affiliate, and general partners and managing members of an affiliate will

be deemed to be affiliates. As a result, the following would not be deemed ineligible to serve on an audit committee:

- outside directors of an affiliate;
- others with passive, non-control positions, such as limited partners, and those that do not have policy making functions with the affiliate; and
- designees of a controlling shareholder (who are not otherwise ineligible).

It should be noted that the formulation for being deemed to be an affiliate is narrower than the formulation of covered positions for purposes of the "no compensation" prong. However, the SEC noted that, consistent with the historical interpretation of the term "affiliate," an affiliate could not evade the prohibitions in Rule 10A-3 simply by designating a third party representative or agent that it directs to act in its place.

C. Exemptions from the Independence Requirement

First-time issuers. Recognizing that companies coming to market for the first time may face particular difficulty in recruiting members that meet the independence requirements, Rule 10A-3 provides an exemption from the independence requirements for first-time issuers. For a company listing securities for the first time, or a company that has filed a registration statement under the Securities Act covering an initial public offering of the company's securities, Rule 10A-3 requires at least one independent member on the company's audit committee at the time of the company's initial listing or the effective date of the company's registration statement, a majority of independent members on the company's audit committee within 90 days, and a fully independent audit committee within one year. This differs from the rule as originally proposed, which would have only exempted one member of a company's audit committee from the audit committee requirements for a period of 90 days from the effective date of an initial public offering.

Overlapping board relationships. Further, Rule 10A-3 exempts from the "affiliated person" requirement an audit committee member who sits on the board of both a listed company and any affiliate, if the committee member, but for sitting on both boards, otherwise meets the independence requirements for each such entity, 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 each such entity.

Dual holding companies. To accommodate certain foreign private issuers that operate under a dual holding company structure, Rule 10A-3 provides that:

- where a listed company is one of two dual holding companies, those companies may designate one audit committee for both companies so long as each member of the audit committee is a member of the board of directors of at least one of such dual holding companies; and

- dual holding companies will not be deemed to be affiliates of each other by virtue of their dual holding company arrangements with each other, including where directors of one dual holding company are also directors of the other dual holding company, or where directors of one or both dual holding companies are also directors of the businesses jointly controlled, directly or indirectly, by the dual holding companies (and in each case receives only ordinary-course compensation for service as a board or committee member).

As discussed below, any issuer availing itself of the above exceptions must disclose that fact. Apart from the limited exemptions discussed above and the accommodations for foreign private issuers discussed below, the SEC did not exempt any other particular relationships from the independence requirements at this time. The Act does not, and therefore Rule 10A-3 does not, contain any exemptions based on exceptional and limited circumstances similar to those that exist currently under stock exchange and Nasdaq rules. Moreover, although the rules include a provision permitting the SEC to exempt particular relationships with respect to audit committee members from the independence provisions of the rules, the SEC indicated that it believes that general case-by-case exemptions would be neither appropriate nor consistent with the policies and purposes of the Act. However, the SEC acknowledged that it has exemptive authority to respond to, and will remain sensitive to, evolving standards of corporate governance, including changes in domestic or foreign law, to address any new conflicts that cannot be anticipated at this time.

D. Curing Defects

The Act specifies that Rule 10A-3 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 listing of the issuer's securities as a result of its failure to meet the Act's audit committee standards, before imposition of such a prohibition. To give effect to this mandate, Rule 10A-3 requires the national securities exchanges and associations to establish such procedures before they prohibit the listing of or delist any security of an issuer.

II. Functions of the Audit Committee

A. Auditor Oversight

Rule 10A-3 requires that:

- the audit committee of each listed company 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; and

- the independent auditor must report directly to the audit committee.

As adopted, the audit committee's oversight responsibilities include the authority to retain the outside auditor, which includes the power not to retain (or to terminate) the outside auditor. In addition, in connection with these oversight responsibilities, the audit committee has ultimate authority to approve all audit engagement fees and terms, as well as all significant non-audit engagements of the independent auditor.

Rule 10A-3 includes an instruction that none of the audit committee requirements (that is, the appointment, compensation, retention or oversight of an issuer's auditors or the authority of an audit committee to engage advisors, receive and handle complaints or receive funding from the issuer) conflict with, nor do they affect the application of, any requirement or ability under an issuer's governing law or documents or other home country legal or listing provisions that requires or permits shareholders to ultimately vote on, approve or ratify such actions. However, Rule 10A-3 provides that if such responsibilities are vested with shareholders, and the issuer provides a recommendation or nomination regarding such matters to its shareholders, the audit committee of the issuer, or body performing similar functions, must be responsible for making the recommendation or nomination. For example, if home country rules require that shareholders vote on, approve or ratify the selection of auditors, the shareholders may do so, provided the audit committee (or other body acting in accordance with the new rules) makes the initial recommendation or nomination.

In addition, Rule 10A-3 includes an instruction that clarifies that none of the audit committee requirements in the rule, including the requirement that the audit committee provide recommendations to shareholders where such responsibilities are vested with shareholders, conflicts with any legal or listing requirement in an issuer's home jurisdiction that prohibits the full board of directors from delegating such responsibilities to the audit committee or that limits the degree of such delegation. However, in the adopting release the SEC indicated that in such an instance, the audit committee, or body performing similar functions, must be granted such responsibilities, which can include advisory powers, with respect to such matters to the extent permitted by law, including submitting nominations or recommendations to the full board of directors.

B. Receipt and Handling of Complaints

Rule 10A-3 requires that the audit committee of each listed company establish procedures for:

- the receipt, retention and treatment of complaints received by the issuer regarding accounting, internal accounting controls or auditing matters; and

- the confidential and anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.

The SEC did not mandate specific procedures that audit committees must establish. Instead, each audit committee is expected to develop procedures that work best consistent with its company's individual circumstances.

C. Authority to Engage Advisors/Funding

Rule 10A-3 requires each listed company's audit committee to have the authority to engage outside advisors, including counsel, as it determines necessary to carry out its duties. In addition, Rule 10A-3 requires listed companies 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 independent auditors 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.

In addition to the above, Rule 10A-3 requires that listed companies provide appropriate funding for the ordinary administrative expenses of the audit committee that are necessary or appropriate in carrying out its duties.

III. Foreign Issuer Accommodations

As indicated above, Rule 10A-3 applies to both domestic and foreign issuers that have securities listed in the United States. However, several exceptions in the rule address the special circumstances of foreign private issuers. These provisions include the following:

- ***Employee representation.*** An employee of a foreign private issuer is exempt from the independence requirements of the rule (provided the employee is not an executive officer of the issuer) if the employee is elected or named to the board of directors or audit committee of the foreign private issuer pursuant to the issuer's governing law or documents, an employee collective bargaining or similar agreement, or other home country legal or listing requirements.

- ***Controlling shareholder representation.*** Notwithstanding the treatment of audit committee members that are affiliates of an issuer, one member of the audit committee may be a representative of a controlling shareholder of the foreign private issuer (regardless of the level of stock ownership or other indicia of control, in contrast to the proposal which would have required a 50% ownership threshold), if:

    - the "no compensation" component of the independence requirements is satisfied;

    - the member has only observer status on, and is not a voting member or chair of, the audit committee; and

    - the member is not an executive officer of the issuer.

- ***Foreign government representation.*** Any member of an audit committee (and not just one, as was proposed) may be a representative of a foreign government or foreign governmental entity that is an affiliate of the foreign private issuer (regardless of how the government holds its interest), if:
  - the "no compensation" component of the independence requirements is satisfied; and
  - the member is not an executive officer of the issuer.
- ***Board of auditors or statutory auditors.*** A foreign private issuer will be exempt from all of the audit committee requirements under Rule 10A-3, if:
  - the foreign private issuer has a board of auditors (or similar body), or has statutory auditors (collectively, a "Board of Auditors"), established and selected pursuant to home country legal or listing provisions expressly requiring or permitting such a board or similar body;
  - the Board of Auditors is separate from the board of directors, or composed of one or more members of the board of directors and one or more members that are not also members of the board of directors;
  - the Board of Auditors is not elected by management and no executive officer of the issuer is a member of the Board of Auditors;
  - home country legal or listing provisions set forth or provide for standards for the independence of the Board of Auditors from the issuer and management;
  - the Board of Auditors, in accordance with any applicable home country legal or listing requirements or the issuer's governing documents, is responsible, to the extent permitted by law, for the appointment, retention and oversight of the work of any registered public accounting firm engaged (including, to the extent permitted by law, the resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the issuer; and
  - the remaining requirements of Rule 10A-3, such as the complaint procedures requirement, advisors requirement and funding requirement, apply to the Board of Auditors, to the extent permitted by law.

The SEC had initially proposed that to be eligible for the exemption from certain of the audit committee requirements where the foreign issuer had a Board of Auditors, the issuer would have to be listed on a market outside the United States. The SEC eliminated this requirement in the final rule, as

the board of auditor requirement is often a home country legal requirement and not a listing requirement.

In its release adopting rules under Section 407 of the Act (relating to audit committee financial experts), the SEC expressed its intention to revisit the disclosure requirements regarding the independence of audit committee financial experts of foreign private issuers. In the Rule 10A-3 adopting release, the SEC adopted amendments to the audit committee financial expert disclosure provisions as they apply to foreign private issuers that are discussed below. It is important to note, however, that for issuers with a Board of Auditors, the adopting release clarifies that for purposes of identifying a financial expert who serves on the audit committee, the term "audit committee" means the Board of Auditors. Moreover, the amendments provide that it is the Board of Auditors itself that is required to make the determination that it has, or does not have, at least one audit committee financial expert in its ranks.

Foreign governments. Issuers that are "foreign governments," which encompasses all registrants that are eligible to register securities under Schedule B of the Securities Act, are exempt from the requirements of Rule 10A-3.

Two-tiered boards. Rule 10A-3 clarifies that in the case of foreign private issuers with two-tier boards, the term "board of directors" means the supervisory or non-management board. As such, the supervisory or non-management board can either form a separate audit committee or, if all of the members of the supervisory or non-management board are independent within the provisions and exceptions to the rules, the entire board can be designated as the audit committee.

Waivers and additional exemptions. In the past, U.S. securities exchanges and Nasdaq have granted waivers from certain corporate governance related listing standards to foreign private issuers. Under Rule 10A-3, there is no ability to exempt or waive the requirements for foreign private issuers. This would not affect the exchanges' ability to provide an exemption or waiver from other exchange listing requirements. The SEC recognized that corporate governance structures throughout the world will continue to evolve, and that all future conflicts cannot be currently anticipated. As a result, the SEC has the authority to respond to, and will remain sensitive to, the evolving standards of corporate governance throughout the world to address any new conflicts that may arise with foreign corporate governance rules and practices that cannot currently be anticipated.

IV. Securities Covered

Listed securities. Rule 10A-3 only applies to issuers with securities listed in the United States on a national securities exchange (such as the NYSE) or listed in an automated inter-dealer quotation system of a national securities association (such as Nasdaq). The requirements do not apply to other reporting companies under Section 13(a) or 15(d) of the Exchange Act or to issuers of securities quoted on an interdealer quotation system (such as the OTC Bulletin Board (OTCBB) or the Pink Sheets), unless their securities also are listed on an exchange or Nasdaq. In addition, issuers of asset-backed securities are not subject to Rule 10A-3.

The Act prohibits the listing of "any security" of an issuer that does not meet the new standards for audit committees. Accordingly, Rule 10A-3 applies 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.

Additional listings. Rule 10A-3 includes an exemption for additional listings of securities by a company if that company is already subject to the rule as a result of the listing of any class of securities on a national securities exchange or association. The additional listings could be on the same stock market or on different markets. This differs from the rule as originally proposed which provided that the exemption was only available if a company was subject to the rule as a result of the listing of a class of its equity securities.

Listing non-equity securities of a subsidiary. Rule 10A-3 also includes an exemption for listings of non-equity securities by a direct or indirect subsidiary that is consolidated or at least 50% beneficially owned by a parent company, if the parent company is subject to the rule 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, including trust-preferred and similar securities) the subsidiary would be required to meet the audit committee requirements to protect its own public shareholders. It should be noted that the multiple listing exemption is available to U.S. subsidiaries of a foreign parent, even if the foreign parent is relying on one of the special exemptions for foreign private issuers.

V. Disclosure Changes Regarding Audit Committees

A. Disclosure Regarding Exemptions

Under Rule 10A-3, issuers taking advantage of one of the exemptions from the provisions of the audit committee rules are required to disclose in, or incorporate by reference into, their annual report (on Form 10-K, 20-F or 40-F, as applicable) filed with the SEC:

- 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 the rules.

For domestic issuers, the disclosure is also required to appear in proxy statements or information statements for shareholders' meetings at which elections for directors are held.

The proposed rule would have required that foreign private issuers availing themselves of the exemption for Boards of Auditors would be required to file an exhibit to their annual reports (on Form 20-F or 40-F) stating that they were doing do. Because this exhibit would have been in addition to the disclosure required in the body of the report regarding the issuer's use of that exemption, the final version of Rule 10A-3 did not adopt the exhibit requirement.

Issuers availing themselves of the multiple listing exemption outlined above are exempted from the disclosure requirements relating to their use of that exemption. However, if such an issuer also avails itself of another exemption from the requirements (e.g., the temporary exemption from the independence requirements for newly listed issuers), disclosure of the use of that exemption is required.

B. Identification of Audit Committee in Annual Reports

A domestic issuer subject to the proxy rules of Section 14 of the Exchange Act 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. Rule 10A-3 requires that disclosure of the members of the audit committee be included or incorporated by reference in each listed issuer's annual report on Form 10-K, 20-F or 40-F, as applicable.

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, the rules 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.

Listed issuers that are not required to provide disclosure of their reliance on one of the exemptions to Rule 10A-3, such as a subsidiary relying on the multiple listing exemption, are not required to disclosure whether or not they have an audit committee.

C. Additional Changes to Audit Committee Disclosure Requirements

Domestic issuers. A domestic issuer subject to the proxy rules, whether listed or not, 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. This disclosure includes, among other things, whether the members of the audit committee are independent. Under the existing requirements, issuers whose securities are not listed on the NYSE or AMEX or quoted on the Nasdaq, may choose which definition of independence to use from any of the NYSE, AMEX or Nasdaq listing standards.

Under Rule 10A-3, all national securities exchanges and associations are required to have independence standards for audit committee members, not just the NYSE, AMEX and Nasdaq. As such, in determining whether a member is independent, a non-listed issuer is permitted to choose any definition for audit committee member independence of a national securities exchange or association that has been approved by the SEC.

Foreign private issuers. As discussed above, the SEC adopted amendments to the audit committee financial expert disclosure provisions as they apply to foreign private issuers. If the foreign private issuer is listed, the amendments require the foreign private issuer to disclose whether its audit committee financial expert, if it has one, is "independent," as that term is defined by the listing

standards applicable to the issuer. If a foreign private issuer is not listed, it is permitted to choose any definition for audit committee member independence of a national securities exchange or associate that has been approved by the SEC. The foreign private issuer must also disclose which definition was used. Foreign private issuers need not comply with these disclosure requirements until July 31, 2005.

VI. Observations

The rules designed to enhance the role of audit committees are a significant component of the corporate governance reforms. These rules may have a greater impact on corporate governance than any of the other Sarbanes-Oxley Act initiatives. One cannot fault the motivations underlying these rules.

The rules, together with the other stock exchange listing standards, have been eagerly awaited not only by management teams, but also by those who expect to serve on audit committees. For this latter group, particularly major shareholders of public companies, there remains some uncertainty, namely how the restrictions on "affiliates" will be applied in practice. Will the exchanges set upper limits? Will the exchanges provide interpretive advice, or will directors be left with relying on Rule 144-style analyses (which developed in view of the SEC's position that it would not provide interpretive advice on whether someone is an affiliate) on issues of "control"? Will a *de facto* set of parameters develop as a result of delisting proceedings or notifications? How will questions concerning compliance arise in the first place? Perhaps in its effort to avoid drawing a bright-line test for fear of being too restrictive, the SEC has created more uncertainty in this crucial area than necessary.

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The descriptions set forth herein are intended to be general in nature. This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any member of the Paul Weiss Securities Group, including:

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