

Critical Issues in the Sarbanes-Oxley Act: Audit Committee

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Audit Committee

Section I Introduction: The SOX Audit Committee

Since the passage of The Sarbanes Oxley Act of 2002 (“SOX” or the “Act”), the audit committee has been transformed. Once a simple board committee with few specific duties, the audit committee is now a key element of corporate governance. As the SEC explained in its final Release on Standards Relating to Listed Company Audit Committees:

The audit committee, composed of members of the board of directors, plays a critical role in providing oversight over and 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.¹

The post Sarbanes-Oxley audit committee is more than the supervisor of the issuer’s financial functions, however. Its SOX expanded portfolio makes it a conduit for employee complaints, a hotline for whistleblowers and the investigator of all things gone awry—all with an uncapped budget the company is required to fund. The committee has been transformed into an in-house monitor which at times appears to be virtually a separate entity from the company.

This newly empowered audit committee traces its origins at least to discussions by the Securities and Exchange Commission (“SEC”) in the 1940s. Over time, issuers began to form audit committees, although they were not required to have such a committee until the 1970s. In the early part of that decade, the Commission encouraged self regulatory organizations to adopt provisions requiring that issuers have an audit committee composed of independent directors. That effort was bolstered by subsequent SEC Rules requiring issuers to disclose whether they had such a committee. Those rules spawned a requirement by the New York Stock Exchange (“NYSE”) that listed issuers establish an audit committee.² Typically

¹ Standards Relating to Listed Company Audit Committees, Securities Act Release No. 33-8220 (Apr. 25, 2003), *available at* 2003 SEC LEXIS 846 (“SEC Audit Committee Release”).

² *See generally*, Philip A. Loomis, Jr., Commissioner, Securities and Exchange Commission, Speech to The Institute of Chartered Accountants in England and Wales, London, England (Nov. 3, 1978), *available at* <http://www.sec.gov/news/speech/1978/110378loomis.pdf> (Brief history of the audit committee).

Section I

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those committees had few specific duties.³

In the late 1990s, the SEC again focused on the role of the audit committee. In 1998, then SEC Chairman Arthur Levitt stated in a speech that the responsibility of the audit committee is to “ask hard questions” and “ensure that shareholders receive relevant and reliable financial information.”⁴ Subsequently, Chairman Levitt announced an action plan to improve the quality of financial reporting. The NYSE and the NASDAQ formed what came to be known as the “blue ribbon” panel to improve audit committee performance.⁵

In February 1999, the Blue Ribbon panel issued a report which contained ten recommendations.⁶ Those recommendations focused on the independent composition of the committee and suggestions to strengthen the committee’s financial reporting oversight role. Underlying those recommendations is a concern that some companies, in response to short-term market pressures, were managing their earnings. These recommendations became the basis for certain audit committee listing requirements later adopted by the self-regulatory organizations (“SROs”).⁷

In the wake of corporate scandals such as Enron and Worldcom, the SEC requested that the self-regulatory organizations review their corporate governance and listing standards.⁸ By late July 2002, NASDAQ adopted new rules on corporate governance.⁹ At about the same time, the New York Stock Exchange

³ See SEC Audit Committee Release at II(B)(3)(d). See also Exchange Act Release No. 34-11147 (Dec. 20, 1974); Exchange Act Release No. 34-15384 (Dec. 6, 1978). In the late 1970s, the SEC effectively used the audit committee in a series of what were then called questionable payment cases. Those cases eventually resulted in the passage of the Foreign Corrupt Practices Act in 1977. Foreign Corrupt Practices Act of 1977, 15 U.S.C. §§ 78dd-1, *et seq.* (1998) (“FCPA”); E.D. Herlihy and T.A. Levine, *Corporate Crisis: The Overseas Payment Problem*, 8 *LAW & POLICY IN INTERNATIONAL BUSINESS* 547 (1976). In the 1980s, others focused on the role of the audit committee in corporate governance matters. See, e.g., National Commission on Fraudulent Financial Reporting, *Report of the National Commission on Fraudulent Financial Reporting* (Oct. 1987), available at <http://www.coso.org/Publications/NCFFR.pdf> (“Treadway Report”).

⁴ Arthur Levitt, Chairman, Securities and Exchange Commission, *Remarks on Corporate Governance: Integrity in the Information Age*, Tenth Annual Corporate Law Institute (Mar. 12, 1998), available at <http://www.sec.gov/news/speech/speecharchive/1998/spch206.txt>.

⁵ See Press Release, SEC Chairman Levitt, Concerned That The Quality of Corporate Financial Reporting Is Ending, Announcing Action Plan to Remedy Problem (Sep. 28, 1998), available at <http://www.sec.gov/news/press/pressarchive/1998/98-95.txt>.

⁶ Blue Ribbon Committee, *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees* (1999), available at http://www.nasdaq.com/about/Blue_Ribbon_Panel.pdf (“Blue Ribbon Committee”).

⁷ NASD and NYSE Rulemaking: Relating to Corporate Governance, Exchange Act Release No. 34-48745 (Nov. 4, 2003) available at 2003 SEC LEXIS 2654 (“SEC Approval Release”).

⁸ Press Release, Securities and Exchange Commission, Pitt Seeks Review of Corporate Governance, Code of Conduct (Feb. 13, 2002), available at <http://www.sec.gov/news/headlines/codereview.htm>.

⁹ Press Release, NASDAQ Takes New Actions On Corporate Governance Reform (Jul. 25, 2002), available at http://www.nasdaq.com/newsroom/news/pr2002/ne_section02_141.html.

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Section II

approved its Corporate Governance Section Proposals Reflecting Recommendations from the NYSE Corporate Accountability and Listing Standards Committee (Aug. 1, 2002).¹⁰ The revisions by the NYSE and NASDAQ to their listing requirements significantly augmented existing requirements.

On July 30, 2002, the Sarbanes Oxley Act was signed into law. The Act contains specific provisions regarding the audit committee, its composition, obligations and authority.¹¹ In some senses, the Act seems to have ignored the NYSE and NASDAQ initiatives regarding corporate governance and the audit committee.¹² Indeed, some of the listing standards adopted by these self regulatory organizations in 2002 exceeded the requirements of the Act.

Subsequently, the SEC passed Rules implementing the provisions of the Act.¹³ The NYSE and NASDAQ (collectively the “Self Regulatory Organizations” or “SRO”) modified their listing standards and sections in view of the passage of the Act and the SEC Rules. The requirements of the Act, the SEC and the SRO’s were later fortified through rules passed by The Public Company Accounting Oversight Board (“PCAOB”).

Section II Defining the Audit Committee

Section 202 of Sarbanes Oxley¹⁴ defines the audit committee:

The term “audit committee” means—(A) 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 (B) if no such committee exists with respect to an issuer, the entire board of directors of the issuer.

This provision effectively mandates that each issuer have an audit committee, since the failure to do so means that the entire board becomes the committee.¹⁵ In

¹⁰ Securities and Exchange Commission, Corporate Governance Section Proposals Reflecting Recommendations from the NYSE Corporate Accountability and Listing Standards Committee (Aug. 1, 2002), *available at* http://www.nyse.com/pdfs/corp_gov_pro_a.pdf.

¹¹ For an overview of the Act, *see* Thomas O. Gorman & Heather J. Stewart, *Is there a New Sheriff in Corporateville? The Obligations of Directors, Officers, Accountants, and Lawyers After Sarbanes-Oxley of 2002*, 56 ADMIN. L. REV. 135 (2004).

¹² *See* SEC Approval Release at II.

¹³ *See* Audit Committee Release; *see also* NYSE Rulemaking, Notice of Filing of Proposed Rule No. 1, Exchange Act Release No. 34-47672 (Apr. 11, 2003), *available at* 2003 SEC LEXIS 874; *see also* NASD Rulemaking, Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the National Association of Securities Dealers, Inc. Relating to Proposed Amendments to NASD Rules 4200 and 4350 Regarding Board Independence and Independent Committee, Exchange Act Release No. 34-47516 (Mar. 17, 2003), *available at* 2003 SEC LEXIS 645. *See* SEC Approval Release at 2003 SEC LEXIS 2654.

¹⁴ Sarbanes Oxley Act of 2002, 15 U.S.C. § 7201 *et. seq.* (2002) (“SOX”).

¹⁵ SOX Section 202 (codified in Securities and Exchange Act of 1934, 15 U.S.C. § 78, *et seq.* (1998) (“Exchange Act”), Exchange Act § 3(a)(58), 15 U.S.C. § 78c(a)(58) (1998)). Generally, the

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that instance, each member of the board must comply with the requirements for being a member of the audit committee.¹⁶ This requirement only applies to issuers listed on a national securities exchange or on an automated inter-deal quotation system of a national securities association.¹⁷

Section III Composition of the SOX Audit Committee

The basic composition of the committee is dictated by the Act, the pertinent SEC regulations and the listing standards for the New York Stock Exchange and NASDAQ. Generally, the Act and the SEC rules focus on independence and financial expertise. The requirements of the exchanges build on those basic requirements, although the specific provisions for each exchange differ. Requirements for all issuers are discussed below as “basic requirements” while those which apply only to a specific exchange are set forth under that exchange.

[1] Basic Requirements

The Sarbanes Oxley Act, amplified by SEC rules, contains two basic requirements regarding the composition of the committee. The first requires that each member of the committee be “independent.” The second essentially requires that the committee have a member who is a “financial expert.”

The term “independent director” is not specifically defined in either the Act or the SEC regulations. Section 301 of the Act discusses independence in terms of the relationships between the committee member the issuer viewed in terms of compensation and affiliations. The independence requirement is based on the notion that “[a]n audit committee composed 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 compensation or other incentives focused on short-term stock appreciation, which can promote self-interest rather than long-term shareholder interest.”¹⁸

Under the Act and SEC rules, a committee member is precluded from accepting “directly or indirectly” any compensation from the issuer or any subsidiary other

SEC requirements focus on independence. The NYSE and NASDAQ add other requirements as discussed *infra* in Section III(2) and (3). Regulation S-K, 17 C.F.R. § 229 , *et seq.* (2000) (“Regulation S-K”), requires the disclosure of whether or not the registrant has a separately-designated audit committee as defined in Exchange Act § 78c(a)(58)(A) or a committee performing similar functions. If there is such a committee each member must be identified. *See also* Regulation S-K, 17 C.F.R. § 229.407, Item 407(d)(4)(i)(B)(ii)(A).

¹⁶ *See also* SEC Audit Committee Release at II(A)(1).

¹⁷ The term “board of directors” is not defined. The SEC added clarifications in its Sections for issuers organized in a fashion other than a typical corporation. SEC Audit Committee Release at II(F)(3).

¹⁸ SEC Audit Committee Release at II(A)(1).

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than in his or her capacity as a member of the audit committee or board of directors. This does not include amounts paid under a retirement or deferred compensation plan for prior service with a listed issuer which is not contingent upon continued service “unless the Rules of the national securities exchange or national securities association provide otherwise.”¹⁹ This prohibition includes any affiliated person of the issuer or any subsidiary.²⁰

A committee member is also precluded under the Act²¹ and SEC rules from being an affiliated person of the issuer or any subsidiary thereof.²² Affiliate is defined 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.²³ This is essentially a facts and circumstances test focused on voting control.²⁴

The scope of these prohibitions is reflected in four key facets of the SEC Section:

- *Direct/indirect:* The SEC Section applies to direct or indirect payments. This language is designed to prevent evasion of the prohibition. It includes payments “to spouses, minor children or stepchildren or children or stepchildren sharing a home with the member. In addition, indirect acceptance includes payments accepted by an entity in which such member is a partner, member, officer such as a managing director occupying a comparable position or executive officer or occupies a similar position (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

¹⁹ Securities and Exchange Act of 1934 Rule 10A-3, 17 C.F.R. § 240.10A-3 (2008) (“Exchange Act Rule”).

²⁰ *Id.* at Exchange Act Rule 10A-3(b)(ii)(B).

²¹ SOX Section 301(3)(B) (codified in Exchange Act § 10A(m)(3)).

²² Exchange Act Rule 10A-3(b)(ii)(B). For investment company issuers, this portion of the rule is the same as for non-investment company issuer except that the term “interested person” as defined in Section 2(a)(19) of the Investment Company Act of 1940 is substituted for “affiliated person.” Investment Company Act of 1940, 15 U.S.C. § 80a-1, *et seq.* (2005) (“Investment Company Act”).

²³ The term “control” is defined in a manner which is consistent with other Exchange Act definitions. Regulation S-X, 17 C.F.R. § 210, *et seq.* (2008) (“Regulation S-X”), Regulation S-X Rule 1-02g, 17 C.F.R. § 210.1-02g.

²⁴ Exchange Act Rule 10A-3(e)(1)(i). The term is used here in the same manner as Exchange Act Rule 12b-2, 17 C.F.R. § 240.12b-2 (2008).

Initially, the SEC proposed to broaden the definition to deem a director, executive officer, partner, member, principal or designee of an affiliate to be an affiliate. In the final Section, the SEC chose to narrow the scope of the Section to executive officers, directors that are also employees of an affiliate, general partners and managing members of an affiliate to be affiliates. SEC Audit Committee Release at II(A)(3).

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or any subsidiary.”²⁵

- *Non-financial services:* The prohibitions do not include non-advisory financial services such as lending, check clearing, maintaining customer accounts, brokerage services or other custodial and cash management services.²⁶ Likewise, the prohibitions do not extend to any employee of an associated entity unless such a relationship is specified by an SRO.²⁷
- *No look back:* The prohibitions do not have a “look back” provision keyed to prior relationships involving the person and the company. Rather, the compensation provisions focus on the time of the appointment to the audit committee forward. In adopting this position, the SEC made it clear that “we expect the SROs to require such periods in their own listing standards.”²⁸
- *Safe harbor:* There is a safe harbor in the definition of affiliate. Here, the rule provides that “A person will be deemed not to be in control of a specified person for purposes of this section if the person:
 1. Is not the beneficial owner, directly or indirectly, of more than 10% of any class of voting equity securities of the specified person; and
 2. Is not an executive officer of the specified person.”²⁹

This safe harbor is designed to give comfort to a group of non-affiliates. Failing to meet the requirements of the safe harbor, however, does not have any bearing on whether the person is in fact an affiliate.³⁰

The approach of the SEC is modeled on the two specifications in the Act regarding committee member qualifications. As the SEC noted in its Release, “Our final Rules enhance audit committee independence by implementing the two basic criteria for determining independence enumerated in Section 10A(m) of the Exchange Act.”³¹ While the agency focused on the two points specified in the statute in its implementing Rules, the SEC acknowledged that other factors might

²⁵ *Id.*

²⁶ The SEC made it clear in its issuing the Release that these prohibitions only apply to member of the audit committee. They do not impact the ability of a director associated with an entity that renders services to an issuer from serving on the board of directors to the extent permitted by SRO Sections allow. Audit Committee Release at II(B).

²⁷ *Id.*

²⁸ *Id.* The SEC expressly rejected a de minimis or immaterial fees exception suggested by some commentators, noting: “We are not persuaded that such an exception is an appropriate deviation from the explicit mandate in Exchange Act Section 10A(m). We believe the policies and purposes behind that section, and particularly the use of the term ‘any’ when describing such fees in the statute, weighs against providing for such an exception.” *Id.* at II(A)(2).

²⁹ Exchange Act Rule 10A-3(e)(1)(ii)(A).

³⁰ Audit Committee Release at II(A)(3).

³¹ *Id.* at II(A)(1).

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be considered. The Commission chose to leave the identification of other criteria to the SROs:

We continue to believe that our specific mandate under Section 10A(m) of the Exchange Act, where independence is evaluated by reference to payments of advisory and compensatory fees and affiliate status, is best fulfilled by the final Section. These requirements standing alone do not, for example, preclude independence on the basis of other commercial relationships not specified in the final Section, and they do not extend to the broad categories of family members that may be reached by SRO listing standards. Instead, as proposed, our requirements build and rely on SRO standards of independence that cover additional relationships not specified in Exchange Act Section 10A(m). Our final Rule allows SROs flexibility to adopt and administer additional requirements of these sorts through SRO rulemaking conducted under Commission oversight and approval. As mentioned in the Proposing Release, we encourage SRO's to review and adopt rigorous independence requirements in connection with their implementation of the standards in Exchange Act Section 10A-3. We will review the Rules submitted by the SROs to implement Exchange Act Section 10A-3 so that they contain appropriate overall standards for audit committee independence.³²

The SEC has created a limited number of exemptions from these requirements.³³ Generally, these are limited to new issuers and certain affiliates and foreign issuers. Typically, reliance on the exemption must be disclosed. These exceptions are:

- *New registrants*: Issuers conducting a initial public offering to be registered or filing a registration statement under Section 12 of the Exchange Act have been given a temporary exemption from part of the independence requirements for non-investment company issuers. Under this provision at the time of the listing the company must have:
 1. One fully independent member;
 2. Within 90 days a majority of the committee members must be fully independent; and
 3. Within one year the all members of the committee must be fully independent.³⁴
- *Affiliate of issuer*: A committee member that meets all of the independence requirements except that he or she sits on the board of directors of an affiliate (and is paid in the ordinary course) will be deemed indepen-

³² *Id.*

³³ Exchange Act § 10A(m)(3)(C), gives the Commission the authority to exempt "a particular relationship with respect to audit committee members, as the Commission determines appropriate in light of the circumstances."

³⁴ *Id.* at Exchange Act Rule 10A-3(b)(iv)(A).

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dent.³⁵

- *Foreign private issuer:*³⁶ There are three exemptions related to foreign private issuers, one regarding employees and two regarding the question of affiliates:
 1. If a non-executive officer of such an issuer is elected or named to the board of directors or audit committee pursuant to the issuer's governing law or documents or a collective bargaining or similar agreement, he or she is exempt from the independence requirements of the Section.³⁷
 2. Such a member is exempt from the "affiliate" provisions of the independence Section if: a) The member is an affiliate of the company or a representative of the affiliate; b) The person is a non-voting member; and c) Neither the member nor the affiliate is an executive officer of the foreign private issuer.³⁸
 3. A committee member may be exempt from the affiliate provision of the Section if: a) The member is a representative or designee of a foreign government or foreign government entity which is an affiliate of the issuer; and b) The member is not an executive officer of the foreign private issuer.³⁹

The Act and SEC Rules also effectively mandate that at least one member of the committee be a financial expert. Specifically, Section 407 requires that the issuer disclose whether the audit committee has a SOX financial expert and if not the reasons for not having such an expert. Financial expert is defined as a person who "through education and experience as a public accountant or auditor or a principal financial officer, comptroller, or principal accounting officer of an issuer . . . [has an] understanding of generally accepted accounting principles and financial statements."⁴⁰ Accordingly, under the Act and SEC Sections the audit committee must be composed of independent directors defined in terms of compensation and affiliations and one of its members should be a financial expert.

³⁵ *Id.* at Exchange Act Rule 10A-3(b)(iv)(B).

³⁶ 17 C.F.R. § 230.405 (2008) (defines "Foreign Private Issuer" generally as any foreign issuer other than a foreign government, with specific exceptions.).

³⁷ *Id.* at Exchange Act Rule 10A-3(b)(iv)(D).

³⁸ *Id.* at Exchange Act Rule 10A-3(b)(iv)(E).

³⁹ *Id.* While the Commission can on a case by case basis grant exemptions, the agency has concluded that "we still believe that general case-by-case exemptions would be neither appropriate nor consistent with the policies and purposes of the Sarbanes-Oxley Act. However . . . the Commission has exemptive authority to respond to, and will remain sensitive to, evolving standards of corporate governance, including changes in U.S. or foreign law, to address any new conflicts that cannot be anticipated at this time." Audit Committee Release at II(A)(6).

⁴⁰ SOX Section 407(b), 15 U.S.C. § 7265. *See also* Regulation S-K, Item 407(d)(5)(i)(A) (requiring disclosure regarding financial expert or lack thereof which must be in the annual report per Instruction 1); Regulation S-K, Item 407(d)(5)(ii) (defining financial expert).

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Section III[2]

[2] NYSE Requirements

The NYSE standards expand on the requirements of the Act and the SEC Rules. Accordingly, the Exchange requirements incorporate, expand and in some respects exceed those established by SOX and the SEC.

The Exchange requires that listed issuers have an audit committee which has at least three members. Each issuer is also required to have an internal audit function.⁴¹ Members of the audit committee must have certain basic qualifications. Each member of the audit committee must have basic knowledge of financial matters. Specifically, the exchange requires that each member be “financially literate, as such qualification is interpreted by the listed company’s board in its business judgment, or must become financially literate within a reasonable period of time after his or her appointment to the audit committee.”⁴² One member must also have accounting or related financial management experience.⁴³

A key requirement for committee membership is independence.⁴⁴ The term is essentially defined in a two part test. Initially, the board of directors must determine affirmatively that the director does not have any “material relationships” with the company “directly or as a partner, shareholder or officer of an organization that has a relationship with the company.”⁴⁵ Material relationships include commercial, industrial, banking, consulting, legal, accounting charitable and family relationships. In assessing independence, a facts and circumstances determination which can be based on standards adopted by the board,⁴⁶ the key

⁴¹ New York Stock Exchange, Listed Company Manual, *available at* <http://www.nyse.com/regulation/nyse/1182508124422.html> (“NYSE Section”). Securities > Find Self-Regulatory Organizations (SRO) Materials > NYSE Listed Company Manual. The Exchange amended its bright line independence test in 2008. Notice of Proposed Rule Change to Amend Section 303A.02(b) of the Listed Company Manual, Exchange Act Release No. 34-58367, 73 Fed. Reg. 50,061 (Aug. 2, 2008) (to be codified 17 C.F.R. pt. 240). These modifications, which may not be reflected on the website, are noted in the text. The Exchange also requires in Section 303A.09 that a listed company adopt and disclose corporate governance guidelines. NYSE Section 303A.09. These include a number of topics which impact members of the audit committee as well as all directors including responsibilities, access to management and independent advisors, compensation, orientation and continuing education and performance evaluation.

⁴² NYSE Section 303A.07(a), Commentary.

⁴³ NYSE Section 303A.07(a), Commentary. Members who meet this requirement are presumed to be qualified according to the Commentary of Section 303A.07. *See* Regulation S-K, Item 401(h).

⁴⁴ NYSE Section 303A.02. Members must also have the time to devote to the work of the committee. For any committee member who serves on the board of more than three public companies the board must make a determination that this will not impair the ability of the person to serve. NYSE Section 303A.00. This determination must be disclosed in the proxy statement or, if there is no proxy, the Form 10-K.

⁴⁵ NYSE Section 303A.02(a).

⁴⁶ The board can adopt and disclose standards to assist in the determination. In that event, the company can make a general disclosure that the directors meet this standard. If, however, a director with relationships which do not fit within the standard adopted is determined to be independent, the

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concern “is independence from management, the Exchange does not view ownership of even a significant amount of stock, by itself, as a bar to an independence finding.”⁴⁷ The identity of the independent directors, and the reasons the board concluded that any relationship is not material, must be disclosed in the proxy or, if the company does not file a proxy, its Form 10-K.

The second prong of the test focuses on specific relationships which are deemed to impair independence. Each contains a three year look back provision. Under this provision, the Exchange requires that three years elapse before a director (including a member of his or her immediate family) with any of the following relationships can be deemed independent. Here, the director will not be deemed independent if he or she

- *Employed*: Is employed by the company including a subsidiary or parent during the past three years or an immediate family member is, or has been within the last three years, an executive officer of the company.⁴⁸
- *Compensation*: Receives more than \$120,000 in any year within the last three years in direct compensation from the listed company.⁴⁹
- *Auditors*: Is a current partner or employee of a firm that is the internal or external auditor; the director has an immediate family member who is a current partner of such a firm; the director has an immediate family member who is a current employee of such firm and personally works on the issuer’s audit; or the director or an immediate family member was within the last three years a partner or employee of such firm and personally worked on the issuer’s audit within that time.⁵⁰
- *Business relationships*: There are two key restrictions here: 1) The director or an immediate family member is or has within the last three years, employed as an executive officer of a company where any of the issuer’s present executive officers at the same time served on the compensation committee;⁵¹ 2) The director is a current employee or an immediate family member is a current executive officer of a company that

company must disclose the basis for its decision. NYSE Section 303A.02(a), Commentary.

⁴⁷ *Id.*

⁴⁸ NYSE Section 303A.02(b)(iv). Executive officer is defined the same as “officer” in 17 C.F.R. § 240.16a-1(f). Employment as an interim chairman or CEO or other executive officer is not a disqualification. NYSE Section 303A.02(b)(i), Commentary. Immediate family for this Section includes the person’s spouse, parents, children, siblings, mothers-in-law and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law and anyone other than domestic employees who shares the person’s home. *See* NYSE Section 303A.02(b), General Commentary. *See also* SEC Approval Release at II(B)(2).

⁴⁹ NYSE Section 303A.02(b)(ii). Excluded from these payments are “director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service).” NYSE Section 303A.02(b)(ii).

⁵⁰ NYSE Section 303A.02(b)(iii)(A).

⁵¹ NYSE Section 303A.02(b)(iv).

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has made payments to, or received payments from, the issuer for property or services in an amount which, in any of the last three years exceeds the greater of \$1 million or 2% of the other company's consolidated gross revenues.⁵² The look back provision here only applies to financial relationships between the issuer and the director or immediate family member's current employer, not former employers.⁵³

These are the minimum standards which the director must meet to become a member of the audit committee.⁵⁴

[3] NASDAQ Requirements

NASDAQ audit committee requirements are similar to those of the New York Stock Exchange. They begin by incorporating the pertinent provisions of the Act and the SEC and add additional requirements focused on the financial background of the members and their independence.⁵⁵

The exchange requires that the audit committee have at least three members.⁵⁶ Each member must be able to read and understand basic financial statements which include a balance sheet, income statement and cash flow statement.⁵⁷ At least one member must have "financial sophistication" as a result of past employment or comparable experience such as being a CEO, CFO or other senior official.⁵⁸

Each member of the audit committee must also meet an exchange crafted two part independence test. The first part of the exchange test applies to all board members.⁵⁹ Here, independence means not having a relationship which, in the opinion of the board, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director, other than as an officer or

⁵² NYSE Section 303A.02(b)(v).

⁵³ NYSE Section 303A.02(b)(v), Commentary. *See also* SEC Approval Release at II(B)(2). Charitable organizations are not considered "companies" for purposes of this provision if there is disclosure in the annual proxy (or Form 10-K if a proxy is not filed) of any charitable contributions made by the listed company to any charitable organization in which a director serves as an executive officer if, within the preceding three years, such contributions in any single year exceeded the greater of \$1 million or 2% of the organization's consolidated gross revenues. *Id.*

⁵⁴ *See supra* Section III(1).

⁵⁵ This is subject to the exemptions of Exchange Act Rule 10A-3(c) regarding independence. National Association of Securities Dealers Manual (2008) ("NASDAQ Rule") 4350(d)(2)(A).

⁵⁶ The issuer must certify that it has met the requirements of NASDAQ Rule 4350(d)(1) as to the composition of the audit committee and its charter, the scope of responsibilities and how it carries out those responsibilities. NASDAQ Rule 4350(d)(1). The issuer must also certify that its audit committee meets the requirements as to composition and independence. NASDAQ Rule 4350(d)(2)(A).

⁵⁷ *Id.* at 4350(d)(2)(A).

⁵⁸ *Id.* at 4350(d)(2)(A)(iv).

⁵⁹ *Id.* at 4200(a)(15).

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employee of the company or its subsidiaries. This is essentially a facts and circumstances determination.⁶⁰

The second part only applies to the audit committee. It specifies that if any of the following relationships exist, the member is not independent:⁶¹

- *Financial statements:* If he or she participated in the preparation of the financial statements of the company or any current subsidiary of the company at any time during the past three years.⁶²
- *Employed:* Is employment by the company including a subsidiary or parent during the past three years.⁶³
- *Compensation:* Accepts or has a family member who accepts more than \$120,000 per year in direct compensation from the listed company in any of the past three years.⁶⁴
- *Family of Executive Officer:* Is the family member⁶⁵ of an individual who is, or at any time during the past three years has been, employed by the company or by any parent or subsidiary of the company as an executive officer.⁶⁶
- *Business relationships:* This is a two part test: 1) Is, or has a family member who is, a partner in, or a controlling shareholder or an executive officer of, any organization to which the company made, or from which the company received, payments for property or services in any of the last three years that exceeded 5% of the recipient's consolidated gross

⁶⁰ *Id.*

⁶¹ If the company is an investment company rather than the disqualifications listed in the text [of NASDAQ Rule 4200(a)(15)(A)—(F)] the director is disqualified if he is an “interested person” of the company within the meaning of Section 2(a)(19) of the Investment Company Act. NASDAQ Rule 4200(a)(15)(G).

⁶² NASDAQ Rule 4350(d)(2)(A).

⁶³ NASDAQ Rule 4200(a)(15)(A); *see also* SEC Approval Release II(B)(2). For purposes of this provision employment as an executive officer on an interim basis in the past does not disqualify the director from being independent if that employment did not last longer than one year. The three year look back period here and in each other Rule 4200(a)(15) factor begins on the date the employment terminates. NASDAQ Rule 4200(a)(15).

⁶⁴ NASDAQ Rule 4200(a)(15)(B). The Rule excludes the following: 1) compensation for the board or board committee since; 2) compensation paid to a family member who is an employee, or 3) benefits under a tax qualified retirement plan or non discretionary compensation. Also excluded is compensation paid for service as an interim executive officer in the past provided the service did not last longer than one year unless the person participated in the preparation of the financial statements. Other types of payments such as for business services in the ordinary course or from investments in the company securities are excluded. NASDAQ Rule 4200. Members must also meet the requirements of NASDAQ Rule 4350(d).

⁶⁵ Family member means “a person’s spouse, parents, children and siblings, whether by blood, marriage or adoption, or anyone residing in such person’s home.” NASDAQ Rule 4200(a)(14).

⁶⁶ NASDAQ Rule 4200(a)(15)(D); *see also* SEC Approval Release II(B)(2).

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revenues for that year, or \$200,000 whichever is more other than certain permitted payments; 2) Is, or has a family member who is, employed as an executive officer of another entity at any time during the past three years where any of the executive officers of the listed company serves on the compensation committee of such other entity.⁶⁷

- *Auditors:* Is, or has a family member who is, a current partner of the company's outside auditor, or was a partner or employee of the outside auditor and worked on the company's audit at any time during the past three years.⁶⁸

There is an "exceptional and limited circumstances" exception for those who meet the requirements of SEC Section, but not of the exchange. To use this exception the board must determine that permitting an exception is in the best interest of the company and the shareholders and disclose this fact, along with the reasons for granting the exception, in the next annual proxy statements. The person can only serve for two years and can not be the chairman of the audit committee.⁶⁹

Section IV Responsibilities of the Audit Committee

The Sarbanes Oxley audit committee is an important part of corporate governance and, in some senses, virtually an outside monitor. Its role in the financial reporting process is now so important that the committee has become a part of internal controls—it is part of the system it monitors. At the same time, its role as a corporate monitor continues to expand, making it key to future compliance.

[1] Basic Requirements

The activities of the audit committee can be divided into five key areas for purposes of discussion: 1) authority and responsibility; 2) purchasing services from the independent registered public accounting firm or outside auditor; 3) retaining auditors; 4) materials available; and 5) disclosures related to its operations.

[a] Authority and responsibility

The post-SOX audit committee has three key areas of authority and responsi-

⁶⁷ NASDAQ Rule 4200(a)(15)(D); *see also* SEC Approval Release II(B)(2).

⁶⁸ NASDAQ Rule 4200(a)(15)(F); *see also* SEC Approval Release II(B)(2).

⁶⁹ NASDAQ Rule 4350(d)(2)(B). Foreign Private Issuers are generally exempt from the dictates of Rule 4350 to the extent the provisions of that Rule are contrary to a law, Rule or regulation of any public authority that has jurisdiction over the company or are contrary to generally accepted business practices in the home country, with certain exceptions. NASDAQ Rule 4350(a)(1). There are also certain exemptions for asset-backed and other passive issuers. NASDAQ Rule 4350(a)(3). Certain cooperatives are exempt from the independence requirements of Rule 4350(c). NASDAQ Rule 4350(a)(4). Companies listed in connection with an initial public offering or that are emerging from bankruptcy or have ceased to be Controlled Companies within the meaning of Rule 4350(c) are permitted to phase-in the independence and audit committee requirements. NASDAQ Rule 4350(a)(5).

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bility: the auditors; employee complaints; and authority to retain consultants. While these may seem like discrete areas of concern, in fact they have significantly empowered the committee.

Under the Act and SEC rules, the audit committee is essentially responsible for the financial function of the company. The Audit Committee is solely responsible for the selection, hiring and replacement of external auditors.⁷⁰ Those auditors must report directly to the committee for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the issuer.⁷¹ These requirements effectively give the committee supervision over all key financial reporting functions of the company. This includes periodic filings such as the annual report on Form 10-K which contains the audited financial statements⁷² and the quarterly reports on Form 10-Q which contain financial statements reviewed by those accountants.⁷³ As part of its oversight of the financial function, the committee has to resolve any disagreements between management and the auditor regarding financial reporting.⁷⁴

The purpose of these requirements is to enhance the audit function and separate it from the control of management, a key SOX goal. As the SEC noted: “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 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 audit committee. This may occur if the auditor views management as its employer with hiring, firing and compensatory powers.”⁷⁵ For these reasons, the committee is ultimately responsible for the selection, retention and payment of the auditors, not management.

The Act also requires the Committee to establish and maintain what is essentially a two part complaint structure which gives it a direct conduit to employees of the company. Part one requires that the committee provide a mechanism for receiving and treating complaints regarding accounting, internal accounting controls or auditing issues. The purpose of this requirement is to ensure that the committee has an open and effective channel of information in addition to, and outside of, management.⁷⁶

In part two, the committee must provide a procedure for receiving confidential,

⁷⁰ SOX Section 301 (codified in Exchange Act § 10A); Exchange Act Rule 10A-3(b)(2).

⁷¹ Exchange Act § 10A(m)(2); Exchange Act Rule 10A-3(b)(2).

⁷² SOX Section 302(a)(5), 15 U.S.C. § 7241.

⁷³ *Id.* at Section 302(a).

⁷⁴ Exchange Act Rule 10A-3(b)(2).

⁷⁵ SEC Audit Committee Release II(B)(1).

⁷⁶ SOX Section 301 (codified at Exchange Act § 10A(m)(4)); SEC Audit Committee Release at II(C). The SEC did not specify any particular procedures. Rather, the Section leaves it to the issuer to craft procedures which are effective for it under the circumstances. *Id.*

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anonymous submissions by employees regarding questionable accounting or auditing matters, in effect a type of whistleblower hot line. This provides employees with an opportunity to report potential difficulties without going outside the company and in a context which safe guards them from possible retribution.

Finally, SOX empowers the committee to engage independent counsel and other advisors as it deems appropriate. The company must fund these undertakings as well as the every day operations of the committee.⁷⁷ Neither SOX nor the SEC's Sections impose any funding limitation on the obligations of the company. As the SEC noted: "An audit committee's effectiveness may be compromised if it is dependent on management's discretion to compensate the independent auditor or the advisors empowered by the committee, especially when potential conflicts of interest with management may be apparent."⁷⁸ Accordingly, the SEC in its Rules did not put any cap on the amount of funding that must be provided.⁷⁹

These requirements regarding the audit committee apply to all issuers, not just large companies.⁸⁰ During the rule-making process, the SEC considered the question of whether these requirements should apply to smaller companies. The Commission concluded that the audit committee requirements should apply equally to large and small issuers to promote investor confidence.⁸¹

The SEC has, however, used its rule making authority to provide for certain exemptions. Foreign private issuers⁸² are generally exempt from the provisions regarding the audit committee if certain conditions are met.⁸³ Other specific types of issuers are also exempted from these requirements.⁸⁴ The exemptions however have disclosure requirements. Essentially, the fact that an exemption is being

⁷⁷ SOX Section 301 (codified in Exchange Act § 10A(m)(6)); Exchange Act Rule 10A-3(b)(5).

⁷⁸ SEC Audit Committee Release at II(E).

⁷⁹ *Id.*

⁸⁰ SEC Audit Committee Release at II(F)(3)(b) ("we think that improving the effectiveness of audit committees of small and large companies is important. The final Section, therefore, applies to listed issuers of all sizes as proposed.")

⁸¹ *Id.*

⁸² 17 C.F.R. § 230.405 (2008) (defines "Foreign Private Issuer" generally as any foreign issuer other than a foreign government, with specific exceptions.).

⁸³ Exchange Act Rule 10A-3(c) provides that foreign private issuers are exempt from the requirements of Exchange Act Rule 10A-3(b)(1)—(5) concerning independence, responsibilities regarding the registered public accounting firm, complaints, authority to engage advisors and funding if the requirements of Rule 10A-3(c)(3)(i-v) are met. Generally those relate to home country requirements and procedures. Rule 10A-3(c)(vi) does note however that the requirements regarding complaints, the authority to engage advisors and funding do apply to the extent permitted by local law.

⁸⁴ Exchange Act Rule 10A-3(c)(4), (5) & (6) (exempting certain securities such as asset backed issuers, unit trusts and those of certain foreign governments).

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relied on, the reasons for it and the alternatives being utilized must be disclosed.⁸⁵

In concluding that the SOX audit committee requirements apply equally to all issuers, the SEC made it clear that they are not intended to conflict with certain legal or listing requirements in the issuer's home jurisdiction. The instructions to Exchange Act, Rule 10A-3 note that the obligations of the audit committee imposed by SOX and the SEC's implementing Rules do not conflict with any legal or listing requirements in the issuer's home jurisdiction that: 1) require or permit shareholders to ultimately vote on, approve or ratify these requirements;⁸⁶ or 2) prohibit the full board from delegating these responsibilities to the audit committee.⁸⁷ Rather, the requirements under Exchange Act, Rule 10A-3(b) relate "to the assignment of responsibility to oversee the auditor's work as between the audit committee and management."⁸⁸ Thus, in the case of a governmental entity or tribunal, the committee can have an advisory role if permitted by local law.⁸⁹

There is no doubt that having responsibility for the outside auditors, much of the financial function of the company as well as employee and whistleblower complaints has transformed the audit committee. At the same time, the SOX funding provisions may ultimately have the most significant impact. Armed with the authority of that provision, the audit committee is becoming an in-house corporate self-investigative authority and, at times, an in-house branch of law enforcement. It is now common when a possible malfeasance is discovered for the audit committee to retain outside advisors such as a law firm, forensic accountants and others depending on the nature of the situation, and the direct those advisors to conduct an internal investigation.⁹⁰ The focus of the investigation is typically to determine what happened, assess responsibility and take the necessary corrective action. In some instances, the inquiry is conducted in connection with a law enforcement inquiry and under circumstances where privilege has been waived. This can effectively deputize the committee and its advisors, transforming

⁸⁵ Exchange Act Rule 10A-3(d). In this regard the SEC noted that "We recognize that we cannot anticipate all of the various types of these entities that may seek a listing on a national securities exchange or national securities association. Under the final Section, SRO's may exclude from Exchange Act Rule 10A-3's requirements issuers that are organized as trusts or other unincorporated associations that do not have a board of directors or persons acting in a similar capacity and whose activities are limited to passively owning or holding (as well as administering any distributing amounts in respect of) securities, rights, collateral or other assets on behalf of or for the benefit of the holders of the listed securities." SEC Audit Committee Release at II(F)(3)(c).

⁸⁶ Exchange Act Rule 10A-3, instruction 1.

⁸⁷ Exchange Act Rule 10A-3, instruction 2.

⁸⁸ SEC Audit Committee Release at II(B)(2).

⁸⁹ Exchange Act Rule 10A-3, instruction 3. *See also* SEC Audit Committee Release at II(B)(2).

⁹⁰ *See generally*, American College of Trial Lawyers, *Recommended Procedures for Companies and Their Counsel In Conducting Internal Investigations* (Feb. 2008), available at http://www.actl.com/AM/Template.cfm?Section=All_Publications&Template=/CM/ContentDisplay.cfm&ContentID=3390.

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them into law enforcement officials inside the company⁹¹—the ultimate internal watch dog.⁹²

[b] *Procedures for purchasing services from the outside auditors*

The audit committee must pre-approve all services the issuer purchases from the outside auditors⁹³ including its fees.⁹⁴ The approval can be made either directly by committee action or through policies and procedures established by the committee for this purpose.

The policies and procedures adopted by the committee for use in lieu of direct committee action must be “detailed as to the particular service and designed to safeguard the continued independence of the accountant. For example, the Sarbanes-Oxley Act allows for one or more audit committee members who are independent board directors to pre-approve the service. Decisions made by the designated audit committee members [under the procedures] must be reported to the full audit committee at each of its scheduled meetings.”⁹⁵

The pre-approval requirement does not apply to non-audit services if they fall within what is essentially a de minimis exception. To be within this exception, three requirements must be met: 1) the aggregate amount of the non-audit services must be no more than 5% of the total amount of revenues paid by the issuer to the auditor during the year in which the non-audit services are rendered; 2) the services were not recognized by the issuer at the time of the engagement to be non-audit services; and 3) the services are promptly brought to the attention of the audit committee and approved prior to the completion of the audit or to a

⁹¹ Under these circumstances witnesses interviewed during internal investigations by an outside law firm employed by the audit committee have been criminally prosecuted for making false statements to the interviewing attorneys. *See, e.g., United States v. Singleton*, NO. H-06-080, 2006 U.S. Dist LEXIS 47961 (S.D.Tex. July 14, 2006); *United States v. Kumar*, Cr. No. 04-846(S-2) (ILG) (E.D.N.Y. filed Sep. 20, 2004). *Cf. SEC v. Arthur Young*, 590 F.2d 785 (9th Cir. 1979) (noting that SEC would like to make outside auditors its watch dog but it lacks statutory authority).

⁹² *See, e.g., Thomas O. Gorman, New DOJ Cooperation Principles: Substituting the Culture of Avoidance for the Culture of Waiver*, Bloomberg Law Repts. (Sep. 29, 2008). *See generally, Ryan v. Gifford*, 2007 Del. Ch. LEXIS 168 (Del. Ch. 2007) (Investigation report of counsel to special board committee loses privilege status if disclosed to directors who are defendants). *See also* 2008 Emerging Issues 851 and 2008 Emerging Issues 2019 on the privilege ruling.

⁹³ SOX Section 202 (codified in Exchange Act § 3(a)(58)).

⁹⁴ The Commission’s Rules also provide that an accountant is not independent of an audit client if during the engagement the audit partner earns or receives compensation based on procuring engagements for the client. *See* Regulation S-X Rule 2-01(f)(8). *See also* Strengthening the Commission’s Requirements Regarding Auditor Independence, Securities Act Release No. 33-8183A, available at 2003 SEC LEXIS 241 (Jan. 28, 2003) (“SEC Independence Release”). Public Company Accounting Oversight Board (“PCAOB”), SAS No. 1, Codification of Auditing Standards and Procedures, Paragraph .03 of AU Sec. 220; PCAOB, Ethics and Independence Rules Concerning Independence, PCAOB Release No. 2005-014 (Jul. 26, 2005).

⁹⁵ SEC Independence Release at II(D).

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committee member or members who had delegated authority from the committee to grant such approvals.⁹⁶

The SEC's rules limit the circumstances under which a registered investment company must pre-approve services. Essentially, such a company "must pre-approve its accountant's engagements for non-audit services . . . (not including a sub-advisor whose role is primarily portfolio management and is sub-contracted or overseen by another investment advisor) . . . and any entity controlling, controlled by, or under common control with the investment advisor that provides ongoing services. . . [to the company] if the engagement related directly to the operations and financial reporting " of the investment company."⁹⁷

[c] *Qualifications***[i] *Independence—overview***

The audit committee has the responsibility for retaining and supervising the auditors. The committee must, accordingly, evaluate the ability of the proposed team to perform the engagement. As the SEC noted, "the audit committee has the responsibility for evaluating and determining that the audit engagement team has the competence necessary to conduct the audit engagement in accordance with GAAS."⁹⁸

In selecting an audit firm to perform the engagement, the committee must determine whether it is independent. Section 201(a) of the Act⁹⁹ specifies that a registered public accounting firm cannot be employed by an issuer as its auditor unless it is independent. In the Commission's view, the audit committee has a "unique position . . . in assuring auditor independence."¹⁰⁰

The term independence is not specifically defined by SOX or the SEC Rules. The Act specifies, however, that the audit firm is not independent if there are certain specified relationships and prohibits the audit firm from providing certain services to the issuer.¹⁰¹ It also requires that the engagement partner be rotated

⁹⁶ Exchange Act § 10A(h).

⁹⁷ Regulation S-X Rule 2-01(c)(7)(ii).

⁹⁸ SEC Independence Release at II(C). After making the statement noted in the text, the Commission stated: "Additionally, the accountant is required to conduct the audit in accordance with GAAS. In particular, the third general standard requires that the accountant exercise due professional care in the conduct of the audit. In order to exercise due professional care, it is necessary to ensure that the engagement is properly staffed with individuals competent to understand the unique issues relevant to that audit. Additionally, the accounting profession's quality control standards require that the firm have processes in place to ensure that appropriate personnel are assigned to each audit engagement." *Id.*

⁹⁹ Exchange Act § 10A(m)(3).

¹⁰⁰ SEC Independence Release at Summary.

¹⁰¹ See *In the Matter of Ernst & Young LLP*, Release No. 58309, Adm. Proc. File No. 3-13114 (Aug. 5, 2008) (administrative proceedings in which SEC claimed auditor not independent where consultant to audit firm was a board member of audit client); *In the Matter of Mark Cl. Thompson*,

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periodically. These provisions and the related Sections are, according to the SEC, “largely predicated on three basic principles, violations of which would impair the auditor’s independence: (1) an auditor cannot function in a role of management, (2) an auditor cannot audit his or her own work, and (3) an auditor cannot serve in an advocacy role for his or her client.”¹⁰² These principles can be used by the committee to guide its determination on this critical question.¹⁰³

The audit firm is referred to provide the committee with key information on the question of independence. PCAOB Sections require the registered public accounting firm to provide the committee a written assessment of all relationships between the firm and any of its affiliates and the potential audit client or persons in financial reporting oversight roles¹⁰⁴ which “may reasonably be thought to bear on independence.”¹⁰⁵ This information must be furnished by the firm when it is under consideration for the engagement and for each year it is engaged. The audit firm is also required to discuss this issue with the audit committee. The committee of course may extend its analysis into other areas, based on the particular facts and circumstances, to ensure that the audit firm retained exercises its independent judgment during the engagement.

[ii] Barred relationships

To help ensure independence, Section 206 of the Act provides one key test of independence. The Section precludes a registered public accounting firm from providing any auditing services where the CEO, controller, CFO, Chief accounting officer, or any person in an equivalent position for the issuer was employed by the auditing firm and participated in any manner in the audit of the issuer within

Release No. 58310, Adm. Proc. File No. 3-13115(Aug. 5, 2008) (same). *See also* Office of the Chief Accountant: Application of the Commission’s Sections on Auditor Independence, Frequently Asked Questions (Dec. 13, 2004), *available at* <http://www.sec.gov/info/accountants/ocafaqaudind121304.htm>.

¹⁰² SEC Independence Release at II(B); *see* Regulation S-X Rule 2-01, Preliminary note 2.

¹⁰³ *See generally* PCAOB Rule 3525. That Rule, which requires that the auditor document the discussions with the audit committee, contains a note which in part states that “Independence requirements provide that an auditor is not independent of his or her audit client if the auditor is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the auditor is not, capable of exercising objective and impartial judgment on all issues.” *See also* Regulation S-X Rule 2-01(b) (similar); PCAOB Rule 3520 (auditor independence); Ethics and Independence Section 3526, Communication with Audit Committees Concerning Independence, PCAOB Release No. 2008-003 (Apr. 22, 2008), *available at* http://www.pcaobus.org/rules/docket_017/2008-04-22_release_2008-003.pdf; SAS No. 1, Independence, Paragraph .03 of AU Sec. 220 (Nov. 1972) (accounting firms directed to avoid situations that may impair independence and those which “the existence of circumstances which reasonable people might believe likely to influence independence.”).

¹⁰⁴ The term Financial Oversight Role in the PCAOB rules is defined in the same manner as in SEC Sections regarding independence. That definition is set forth in Exchange Act § 10A(m)(3)(B).

¹⁰⁵ PCAOB Rule 3526. The rule requires that if the firm furnish the committee with a similar written description and discuss the question of independence with the audit committee annually.

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one year prior to the beginning of the engagement.¹⁰⁶

The scope of this ban is amplified in Regulation S-X, Rule 2-01. That Rule specifies that an accounting firm is not independent when a member of the engagement team assumes a financial reporting oversight role with an issuer, other than an investment company, within the one year period preceding the commencement of audit procedures for the year that included employment by the company. Financial reporting oversight role “refers to any individual who has direct responsibility for oversight over those who prepare the registrant’s financial statements and related information (e.g., management’s discussion and analysis) that are included in filings with the Commission.”¹⁰⁷ The Rule does, however, have certain exceptions where the circumstances of the employment suggest that independence would not be impaired.¹⁰⁸

Rule 2-01 contains a similar restriction with respect to the employment of a former audit team member by a registered investment company. The restriction there is broadened to include employment with the investment company itself and to any entity in the same investment company complex that is responsible for the financial reporting operations of the registered investment company or any other registered investment company in the same investment company complex.¹⁰⁹ This broader prohibition is necessary, according to the Commission, to avoid “bringing undue influence over the audit process of an investment company” by a former audit engagement team member.¹¹⁰

[iii] Partner rotation

To ensure independence, the Act adopted a practice previously used by many audit firms requiring the rotation of the engagement partner. Section 203 of the Act specifies that it is unlawful for the outside auditing firm to provide audit services to an issuer if “the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer.” Previously, audit partner rotation had been a component of

¹⁰⁶ Exchange Act § 10A(I); Regulation S-X Rule 2-01, preliminary note 2.

¹⁰⁷ SEC Independence Release at II(A). Audit procedures are deemed to have commenced the day after the issuer files its periodic annual report with the SEC for the previous fiscal period. *Id.* The members of the engagement team other than the lead and concurring partner, are defined to include any individual who provided more than ten hours of service during the annual audit period. Regulation S-X Rule 2-01(f)(7)(ii)(C).

¹⁰⁸ See Regulation S-X Rule 2-01(c)(2)(B)(3)(ii). The prohibition does not apply to individuals employed by the issuer as a result of a business combination between an issuer and an audit client when the employing company did not provide employment in contemplation of the business combination and the audit committee is aware of the relationship. It also does not apply to individuals employed by the issuer due to an emergency or unusual situation if the audit committee determines that the relationship is in the interest of investors. *Id.*

¹⁰⁹ Regulation S-X Rule 2-01(c)(2)(B)(3)(iii).

¹¹⁰ See SEC Independence Release at II(A).

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the quality control processes of many accounting firms.¹¹¹

The SEC's rules expand the basic requirements of the statute. Under Rule 1-02(f)(6)(B) a five year cooling off period is added to the rotation requirement. Accordingly, lead¹¹² and concurring partners¹¹³ must be rotated every five years and cannot return to the engagement for five years.

The Rule also expands the application of the rotation and time out concept to other significant partners on the engagement. Audit partners (other than the lead and concurring) must rotate every seven years. These partners are also subject to a two year cooling off period. In this manner, a partner could serve as an audit partner (not lead or concurring) for a period of time (e.g. two years) and then assume the position of lead or concurring partner and still serve in the latter two positions for five years. However, the total amount of time the partner can serve on the engagement is seven years after which he or she must be rotated.¹¹⁴

The term audit partner here includes those on the engagement team who have responsibility for decision making on: 1) significant auditing, accounting and reporting matters that affect the financial statements or 2) who maintain regular contact with management and the audit committee. This definition includes those who maintain regular contact with management and the audit committee and the lead partner on subsidiaries whose assets or revenues constitute 20% or more of the consolidated assets or revenues of the issuer. The definition excludes "specialty" partners however.¹¹⁵

For a registered investment company, the SEC's rule regarding rotation

¹¹¹ American Institute of Certified Public Accountants, *Division for CPA Firms SEC Practice Section Peer Review Manual*, 1978. Section 207 of Sarbanes Oxley also directed further study on the question of partner rotation. SOX Section 207, 15 U.S.C. § 7232. *See also*, United States General Accounting Office, Required Study on the Potential Effects of Mandatory Audit Rotation, available at <http://www.gao.gov/new.items/do4216.pdf> (Nov. 2003) (Study required by SOX Section 207, noting that this may not be efficient, but that several years of study are needed.).

¹¹² Lead partner is defined in Regulation S-X Rule 2-01(f)(7)(ii)(A) ("The lead or coordinating audit partner having primary responsibility for the audit or review (the "Lead partner").

¹¹³ Concurring partner is defined in Regulation S-X Rule 2-01(f)(7)(ii)(B). ("The partner performing a second level of review to provide additional assurance that the financial statements subject to the audit or review are in conformity with generally accepted accounting principles and the audit or review and any associated report are in accordance with generally accepted auditing standards and rules promulgated by the Commission or the Public Company Accounting Oversight Board (the "concurring or reviewing partner").

¹¹⁴ *See* SEC Independence Release at II(C). There is an exemption from the partner rotation rules for small audit firms. The exemption provides that audit firms with fewer than five audit clients that are issuers and fewer than ten partners are exempt provided that the PCAOB conducts a review of all of the firm's engagement subject to the rule at least once every three years. Regulation S-X Rule 2-01(c)(6)(B)(2)(ii). The Commission noted that the PCAOB in its review should focus on the overall quality of the engagement and the question of independence. *See* SEC Independence Release at II(C)(3).

¹¹⁵ Regulation S-X Rule 2-01(f)(7)(ii). The Commission noted that it expected the Public Company Accounting Oversight Board to monitor the impact of these rules on audit quality and

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prohibits the rotation of partners between different investment companies in the same complex. The Section does not, however, prohibit accountants from rotating to other entities in the investment company complex. The individuals required to rotate and the time out periods apply in the same manner to investment companies as to other issuers.¹¹⁶

[iv] *Prohibited services*

The audit committee must, as noted above, approve all services provided to the issuer by the outside auditors. The outside audit firm is however, precluded from providing some services to an audit client. Those services are:¹¹⁷

- *Bookkeeping*: Bookkeeping or similar services related to the accounting records or financial statements of the audit client. This prohibition includes maintaining or preparing the audit client's accounting records or the financial statements which are filed with the Commission or that form the basis for those statements. The prohibition includes preparing or originating the source data underlying those financial statements.¹¹⁸
- *Information systems*: Financial information systems design and implementation unless it is reasonable to conclude that the results of the services will not be subject to audit procedures during an audit of the client's financial statements. This prohibition includes directly or indirectly operating or supervising the client's information system or local area network or designing or implementing a hardware or software system that aggregates source data underlying the financial statements or generates information significant to that purpose.¹¹⁹

independence. See SEC Independence Release at II(C)(3). Regulation S-X Rule 2-01(c)(6)(B)(1)(iii).

¹¹⁶ Regulation S-X Rule 1-02(6)(ii). Since there may be different fiscal year-ends within the same investment company complex, the rule provides a definition for consecutive years of service.

The SEC rules also apply the partner rotation requirements to audits of both foreign private issuers and foreign subsidiaries and affiliates of U.S. issuers. However, the rotation requirements only apply to partners that serve the client at the issuer or parent level and the lead partner serving an issuer's subsidiary whose revenues constitute 20% or more of the consolidated assets or revenues of the parent. See SEC Independence Release at II(C)(2); Regulation S-X Rule 2-01(c)(1)(i)(A)(2).

¹¹⁷ SOX Section 201(g) (codified in Exchange Act § 10A(g)); Regulation S-X Rule 2-01(c)(4).

¹¹⁸ *Id.* See also SEC Independence Release at II(B)(1). Note that the prohibition on providing bookkeeping, financial information system, appraisal actuarial or internal audit services is subject to the proviso that if "it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements . . ." then they are not prohibited. The PCAOB may, on a case-by-case basis exempt any person, company, public accounting firm, or transaction from the prohibition to the extent that it is necessary or appropriate in the public interest and is consistent with the protection of investors. Any exemption granted is subject to SEC review. Exchange Act § 10A(h).

¹¹⁹ This prohibition does not preclude the accountant from "evaluating the internal controls of a system as it is being designed, implemented or operated either as part of an audit or attest service and making recommendations to management. Likewise, the accountant would not be precluded

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- *Appraisal*: Appraisal or valuation services, fairness opinions, or contribution-in-kind reports.
- *Actuarial services*: Any actuarially-oriented advisory service involving a determination of amounts recorded in the financial statements and related accounts other than assisting a client in understanding methods, models, assumptions and imputes in computing an amount.
- *Internal auditing outsourcing services*: This prohibition includes any internal auditing service that relates to the client's internal accounting controls, financial systems or financial statements.¹²⁰
- *Management functions*: The prohibition includes acting as an officer or director of the client or in any decision making or supervisory capacity.¹²¹
- *Human resources*: This includes functions such as executive search, psychological testing or other evaluation programs including a hiring recommendation. It does not however, preclude the auditor from, on request, interviewing candidates and advising on competence for financial reporting or similar positions.
- *Legal services*: Rendering any type of service to the client that could only be provided by a person qualified to practice law in the jurisdiction.
- *Expert services*: The prohibition includes providing any type of expert opinion or other expert service unrelated to the audit for the purpose of advocating the client's position in litigation or a similar proceeding.
- *Broker*: Acting as a broker-dealer, investment adviser, or investment banking services, promoter, underwriter or making investment decisions for the client or having discretionary authority over client investments or custody of client assets.

[v] *Other services*

The fact that the outside auditor is not precluded from providing a specific

from making recommendations on internal control matters to management or other service providers in conjunction with the design and installation of a system by another service provider." See SEC Independence Release at II(B)(2).

¹²⁰ This does not preclude the accountant from performing nonrecurring evaluations of discreet items or other programs that do not constitute outsourcing the internal audit function. The audit committee must pre-approve these procedures however. *Id.* at Summary.

¹²¹ In crafting these prohibitions, the Commission drew a distinction between designing and implementing internal accounting and risk management controls and testing the operation of those controls: "we believe that designing and implementing internal accounting and risk management controls is fundamentally different from obtaining an understanding of the controls and testing the operation of the controls which is an integral part of any audit of the financial statements of a company. Likewise, design and implementation of these controls involves decision-making and, therefore, is different from recommending improvements in the internal accounting and risk management controls of an audit client (which is permissible, if pre-approved by the audit committee)." *Id.* at II(B)(6).

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service to an audit client does not authorize providing the service.¹²² The committee must in each instances pre-approve the service. The committee's determination in this regard is aided by PCAOB Rule 3525 which requires that outside auditors seeking approval for a specific service must furnish the committee in writing a description of the scope of the proposed services. The auditors are also required to discuss with the audit committee the potential impact of the performing the proposed services with the committee.

In some instances, the committee may conclude that a service which is not specifically precluded by the Act or an SEC rule will nevertheless impair independence and thus cannot be approved.¹²³ For example, while rendering tax services is not specifically prohibited if the auditor provides this type of service to an audit client it may in fact impair independence according to the SEC. This may happen if the audit firm represented a client before the tax court where the auditor served as an advocate, where the auditor formulated tax strategies which the auditor later was required to audit, or where giving a tax opinion might make the auditor an advocate or constitute legal services.¹²⁴ In making this determination, the committee may be guided by the three prong framework used by the SEC.

[d] Information

The committee should be provided with, and have available, a variety of information relevant to its duties. The registered independent accounting firm is required to report in a timely manner to the audit committee on certain items. Specifically, SOX Section 204 and Regulation S-X Rule 2-07 require that the

¹²² SOX Section 201(h) (codified in Exchange Act § 10A(h)).

¹²³ Exchange Act § 10A(g); Regulation S-X Rule 2-01. Note that the prohibition on providing bookkeeping, financial information system, appraisal actuarial or internal audit services is subject to the proviso that if "it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements . . ." then they are not prohibited. The PCAOB may, on a case-by-case basis exempt any person, company, public accounting firm, or transaction from the prohibition to the extent that it is necessary or appropriate in the public interest and is consistent with the protection of investors. Any exemption granted is subject to SEC review. Exchange Act, § 10A(h).

¹²⁴ SEC Independence Release at II(B). The auditor is prohibited from providing certain types of tax services. PCAOB Rule 3522 precludes the outside auditor from providing tax services for confidential transactions and from recommending certain aggressive tax positions. *See also* PCAOB Notice of Filing of Proposed Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees, Exchange Act Release No. 34-53427 (Mar. 7, 2006), *available at* 2006 SEC LEXIS 557 (discussing PCAOB Rule on prohibited tax transactions); PCAOB Order Approving Proposed Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees, Exchange Act Release No. 34-53677 (Apr. 19, 2006), *available at* 2006 SEC LEXIS 906 (approving rules). In addition, PCAOB, Rule 3523 generally prohibits performing tax services for persons in financial reporting oversight roles. The term "financial reporting oversight roles" is defined by the PCAOB Rule 3501(f)(i) to track Regulation S-X Rule 2-01. *See supra* fn. 104.

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auditors report on a timely basis:¹²⁵

- *Critical accounting policies:* All critical accounting policies used by the registrant. Critical accounting policies are those that are most important to the portrayal of the company's financial condition and results and which require management's most difficult, subjective or complex judgments. This frequently occurs as a result of the need to make estimates about the effect of matters that are inherently uncertain.¹²⁶ In this regard, the SEC noted that "we expect, at a minimum, that the discussion of critical accounting estimates and the selection of initial accounting policies will include the reasons why estimates or policies meeting the criteria in the Guidance are or are not considered critical and how current and anticipated future events impact those determinations. In addition, we anticipate that the communications regarding critical accounting policies will include an assessment of management's disclosures along with any significant proposed modifications by the accountants that were not included."¹²⁷
- *Alternative treatments:* All alternative accounting treatments that have been discussed with management along with the potential ramifications of using those alternatives. This should include the identification of those preferred by the auditors. The SEC has made it clear that these communications, which can be oral or in writing, are intended to cover "recognition, measurement, and disclosure considerations related to the accounting for specific transactions as well as general accounting policies."¹²⁸ They should also include the underlying facts, the financial statement accounts impacted and the applicability of existing corporate accounting policies to the transaction. The discussions should include the reasons for any modification or change¹²⁹
- *Other communications:* Other written communications provided by the auditor to management, including a schedule of unadjusted audit differences. Examples of additional disclosures which the SEC views as material include: the management representation letter; reports regarding observations and recommendations on internal controls; a schedule of

¹²⁵ SOX Section 204 (codified in Exchange Act § 10A(j)); Regulation S-X Rule 2-07. In addition, to the materials noted in this section, the auditors are required to provide the committee with certain information regarding the question of independence. *See supra* Section III(A).

¹²⁶ Cautionary Advice Regarding Disclosure About Critical Accounting Policies, Securities Act Release No. 33-8040, *available at* 2001 SEC LEXIS 2575 (Jan. 16, 2002). In this Release, the Commission issued cautionary advice about disclosing these policies in the Management Discussion and Analysis section of the annual report.

¹²⁷ SEC Independence Release at II(G).

¹²⁸ *See* SEC Independence Release at II(G)(2).

¹²⁹ *Id.* The separate discussion of critical accounting polices and practices is not a substitute for communications regarding general accounting policies. The two do not necessarily overlap.

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unadjusted audit differences and a listing of adjustments and reclassifications not recorded, if any; the engagement letter; and the independence letter.¹³⁰ The SEC requires that these communications be made to the audit committee prior to the filing of the annual report.¹³¹ In view of the nature of these disclosures, however, they should occur periodically as quarterly reports are filed.¹³²

PCAOB Rule 3200T, which adopted AU Section 380, requires that the outside auditors discuss each of the items listed above with the committee and in addition:¹³³

- *Management judgments and accounting estimates.* The auditor is required to discuss with the committee the process used by management in formulating particularly sensitive accounting estimates and the basis for the auditor's conclusions regarding the reasonableness of those estimates.
- *Audit adjustments:* The auditor is required to inform the committee about adjustments that could either individually or in the aggregate, have a significant effect on the financial reporting process.
- *Auditor's judgments about the quality of entity's accounting principles:* This discussion, which should include management, goes beyond the acceptability of the accounting principles applied and focuses on their quality. It includes items that have a "significant impact on the representational faithfulness, verifiability, and the neutrality of the accounting information included in the financial statements."¹³⁴
- *Other information:* This discussion should focus on the auditor's role and responsibility for other information in documents containing the financial statements such as the Management Discussion and Analysis.
- *Disagreements with management:* The auditor is required to discuss with the committee any disagreements with management, whether or not resolved satisfactorily, about items which individually or in the aggregate could have a significant impact on the financial statements.

¹³⁰ *Id.* at I. These items are provided for in the auditing literature. *See, e.g.*, SAS No. 85, Management Representations, AU Sec. 333; SAS No. 60, Communications of Internal Control Related Matters Noted in an Audit, AU Sec. 325; and SAS No. 89, Audit Adjustments, AU Sec. 333; PCAOB, SAS No.83, Establishing an Understanding With the Client, AU Sec. 10.

¹³¹ Regulation S-X Rule 2-07.

¹³² *See* SEC Independence Release at I. The SEC modified the timing requirements for investment companies. Regulation S-X Rule 2-07(a).

¹³³ Communication with Audit Committees, AU Sec. 380. Unlike the discussions required by Regulation S-X Rule 2-07, AU Section 380 does not require that the discussions take place prior to the issuance of the auditor's report on the issuer's financial statements although the standard notes that this may be desirable. The standard also does not require that the communications be repeated each year. The auditor is required to consider periodically whether because of changes in the audit committee or the passage of time it is appropriate to review these matters with the committee.

¹³⁴ *Id.* at Paragraph .11.

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- *Consultations with other accountants:* If the auditor is aware that the committee consulted with other accountants about auditing and accounting matters, it should be reviewed with the committee.
- *Difficulties:* The auditor should inform the committee about any serious difficulties encountered in dealing with management related to the performance of the audit. This may include unreasonable delays in commencement or providing information or similar matters.¹³⁵

Management is also required to prepare certain reports which impact on the work of the committee. SOX Section 404(b) and Exchange Act, Rule 13a—15(f) require management to execute an annual report on the internal controls of the company. This report must include:

- *Management responsibility:* A statement regarding management's responsibility for establishing and maintaining adequate internal control over financial reporting. This is a responsibility of management which cannot be delegated to the outside auditors. If management determines that there is a material weakness in the controls it is precluded from concluding that the controls are effective.¹³⁶
- *Framework to evaluate:* A statement identifying the framework used by management to evaluate the effectiveness of the controls.
- *Assessment of effectiveness:* Management's assessment regarding the effectiveness of the internal controls as of the end of the year and whether or not they are effective. If a material weakness is identified, it must be disclosed (this precludes management from stating that the controls are effective).¹³⁷
- *Auditor attestation:* A statement that the registered public accounting firm's attestation report on management's assessment of the registrant's internal controls and that the report is included in the annual report.¹³⁸

¹³⁵ The auditor is also required to inform the committee about any discussions with management in connection with the initial or recurring retention of the audit firm. This may include discussions regarding the application of accounting principles and auditing standards. *Id.* at Paragraph .16.

¹³⁶ Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 33-8238. 2003 SEC LEXIS 1380 (Aug. 14, 2003). The SEC also differentiates between internal controls and disclosure controls. *Id.* at II(D).

¹³⁷ Management is also required to retain documents and other evidence on which its assessment is based. That evidence must support not just the assessment of the internal controls but also the integrity of the testing process. The outside auditors will want to review this material. *See* Regulation S-X Rule 2-02(f). The committee may also request this material if there are questions.

¹³⁸ *See* Regulation S-X Rule 2-02(f). The inclusion of the auditor's attestation in the annual report is provided for in Regulation S-K, Item 308(b). In addition, Item 308(c) requires the disclosure of any change in internal control regarding financial reporting that occurred during the last fiscal quarter which has materially affected or is reasonably likely to materially affect the financial internal controls. Regulation S-K, Item 308(c). *See also*, Exchange Act § 13(m) (requiring

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Sections 304 and 906 of Sarbanes Oxley also require the CEO and CFO to execute quarterly certifications. Under Section 302, the principal executive officer and the principal financial officer must certify in each annual or quarterly report that, to their knowledge:

- *Reviewed*: The signing officer has reviewed the report.
- *No untrue statement*: The report does not contain any untrue statement of a material fact.
- *Fairly presents*: The financial information fairly presents in all material respects the financial condition of the issuer.
- *Responsible*: The signing officer is responsible for: (1) establishing and maintaining the internal controls of the company; (2) ensuring that those controls are properly designed to bring material information to the attention of the officers and others; and (3) that the effectiveness of those controls has been evaluated.
- *Disclose to audit committee*: The signing officers have disclosed to the auditors and the audit committee: (1) all significant deficiencies in the design or operation of the controls; (2) any fraud, regardless of whether material or not, that involves management or other employees who have a significant role in the internal controls of the company; and (3) that the signing officers have indicated any significant changes in the internal controls of the issuer.¹³⁹

[e] Disclosure

There are disclosure obligations which relate to the Audit Committee, its composition, procedures and activities. While these disclosures must be made by the issuer in specific filings, in part they are effectively substantive obligations imposed on the committee.

Regarding the committee, the issuer is required to disclose in its annual report on Form 10-K whether it in fact has an audit committee and if so its members, functions and the number of committee meetings held each year. If the entire board is the committee because the issuer chose not to designate a specific separate committee, the company must disclose that the entire board is acting as the audit committee.¹⁴⁰ The company must also disclose the audit fees billed for

that the audit report include an evaluation stating whether the internal controls/procedures within the contours of the definition set forth in the text). *See e.g.* Regulation S-X Rule 1-02(a)(2).

¹³⁹ Section 406 of SOX requires that issuers disclose whether or not they have a code of ethics for senior financial officers. 15 U.S.C. § 7264. If the issuer does not have such a code the reasons why not must be disclosed. Since this is in effect another part of the internal controls of the issuer the committee should also review it. *See also* Regulation S-K, Item 406 (defining code of ethics and discussing the disclosure requirements).

¹⁴⁰ Exchange Act § 3(a)(58)(B). *See also* SEC Audit Committee Release at II(G)(2). In making this disclosure, the issuer is also required to state whether each board member is independent under the standards of the exchange on which the company's shares are listed or, if the company is not

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each of the last two fiscal years for professional services rendered by the principal accountant, including those incurred relating to taxes and the amount paid under the de minimis exception. These disclosures also must be included in the annual report filed on Form 10-K.¹⁴¹

The issuer is also required to disclose whether the audit committee has a financial expert, and if so, the name of the person.¹⁴² If the committee does not have a financial expert that fact must be disclosed.¹⁴³ This item is only required to be disclosed in the annual report unless it is being incorporated by reference into that report from the proxy or information statement.¹⁴⁴

Additional disclosures must be made regarding the composition of the committee and its policies and procedures if action is taken regarding the election of directors.¹⁴⁵ Those disclosures include:

- Whether the members of the audit committee are independent.¹⁴⁶
- If the audit committee has a charter, and, if so, include a copy as an appendix to the proxy statements.¹⁴⁷

If the registrant is an investment company, the disclosures must also include the

listed on an exchange, then under either the standards of the NYSE or NASDAQ. *Id.*; SEC Audit Committee Release at II(G)(3). Disclosures regarding the committee were required prior to the passage of the Act in the proxy materials which still include those requirements. 15 U.S.C. § 78n; *see also* SEC Audit Committee Release at II(G)(3). If the required information about the committee is contained in the proxy materials, it can be incorporated by reference in the Form 10-K.

¹⁴¹ Form 10-K, General Instructions, Item 14, *available at* <http://www.sec.gov/about/forms/form10-k.pdf>. *See also* SEC Independence Release at IV(B)(3).

¹⁴² This term is defined in *supra* at fn. 40.

SOX Section 407 requires that the issuer disclose if it has a financial expert as a member of the audit committee and, if not, the reason for the omission. SOX Section 407, 15 U.S.C. § 7265. SOX Section 404 takes a similar approach to a corporate code of ethics, requiring disclosure as to whether the company has such a code and, if not, the reasons for the omissions. SOX Section 404, 15 U.S.C. § 7262. Both NYSE and NASDAQ require that listed issuers have such a code.

¹⁴³ Financial expert is defined for this section essentially as under SOX Section 407. SOX Section 407, 15 U.S.C. § 7265; *see* Regulation S-K, Item 407(d)(5).

¹⁴⁴ Regulation S-K, Item 407, Instructions to Item 407(d)(5) There is also a safe harbor regarding the disclosure of the financial expert which provides that this disclosure does not impose liability on the person for duties and obligations under than those with regard to the audit committee. Regulation S-K, Item 407(d)(5)(iv).

¹⁴⁵ Exchange Act Rule 14a-101, Schedule 14A, Item 7(e)(3)(i). *See also* Final Rule: Audit Committee Disclosure, Exchange Act Release No. 34-42266, *available at* 1999 SEC LEXIS 2713 (Dec. 22, 1999) (“Audit Committee Disclosure”).

¹⁴⁶ Exchange Act Rule 14a-101, Schedule 14A, Item 7(d). If the issuer is listed on the NYSE or NASDAQ, then the disclosure must be in accord with the standards of the listing exchange. If the issuer is not listed on either of these exchanges, then it must disclose whether the members of the audit committee are independent and it may chose which exchange listing standards to use in making the disclosure.

¹⁴⁷ Exchange Act Rule 14a-101, Schedule 14A, Item 7(d).

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aggregate non-audit fees billed by the outside auditors.¹⁴⁸

Finally, the issuer must make certain disclosures regarding the activities of the audit committee which, like the ones required regarding whether the committee has a financial expert,¹⁴⁹ effectively impose obligations on the committee. Here the committee must state whether: 1) it has reviewed and discussed the audited financial statements with management; 2) if it has discussed with the independent auditors the matters required by SOX Section 204, SEC Section 2-07 and AU section 380;¹⁵⁰ and 3) the disclosures regarding relationships between the audit firm and the issuer.¹⁵¹ In addition, the committee must state, based on its discussions with management and the independent auditors, and its review, whether it recommended to the board of directors that the audited financial statements be included in the company's annual report on Form 10-K for the last fiscal year for filing with the SEC.

[2] NYSE Requirements

The New York Stock Exchange standards require that the audit committee adopt a governing charter. That charter must incorporate the requirements of Exchange Act Rule 10A-3(b)(2), (3), (4) and (5) and specific provisions regarding the committee's purpose, reporting obligations and responsibilities as required by the exchange.¹⁵² It can also include other duties and responsibilities assigned to it by the board of directors.

The required exchange charter provisions can be divided into three areas. First, the charter must specify the purpose of the committee. That purpose is to assist the board with oversight of the issuer's financial and reporting functions. As to the financial functions the committee is charged with four key responsibilities under NYSE requirements: 1) the integrity of the financial statements; 2) compliance with legal and regulatory requirements; and 3) the independent auditor's qualifications and independence; and 4) the performance of the internal audit function and independent auditors. The committee is also required to prepare a report to be included in the annual proxy statement regarding its operations which is keyed to

¹⁴⁸ Investment companies also must make other disclosures regarding non-audit services and its fees. Exchange Act Rule 14a-101, Schedule 14A, Item 9(e).

¹⁴⁹ These disclosures are only required if there is a vote of the shareholders. Regulation S-K, Item 407, instruction 1. The requirements for the report are specified in Regulation S-K, Item 308, 17 C.F.R. § 229.308 (2003), and Regulation S-B, Item 310, 17 C.F.R. § 228.310 (2003).

¹⁵⁰ PCAOB Rule 3200T (2003), available at http://www.pcaobus.org/Rules/Rules_of_the_Board/All.pdf.

¹⁵¹ PCAOB Rule 3600T (2003), available at http://www.pcaobus.org/Rules/Rules_of_the_Board/All.pdf.

¹⁵² NYSE Section 303A.07(c). The Exchange requires listed companies to have an audit committee which complies with Exchange Act Rule 10A-3. NYSE Section 303A.06. Failure to have such an audit committee can result in being delisted. NYSE Section 303A.13.

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the company's disclosure requirements.¹⁵³

Second, the charter must provide that the committee will prepare a report annually. This report is an evaluation of the committee's work during the year.¹⁵⁴

Third, the charter must specify the duties of the committee. These duties, at a minimum, include those specified in Exchange Act Rule 10A-3(b)(2), (3), (4) and (5).¹⁵⁵ In addition, the exchange requires that the committee undertake the following specific matters:

- *Report*: annually obtain a report from the independent auditors describing: 1) The firm's internal quality-control procedures; 2) Any material issues raised in a review of those procedures, any peer review, or any inquiry by a governmental or professional authority within the preceding five years regarding any of its audits (and any steps taken to deal with the issues in such a report); and 3) All relationships between the firm and the company.¹⁵⁶
- *Discuss financial statements*: Discuss the company's annual audited financial statements and quarterly financial statements with management and the independent auditor;
- *Earnings releases*: Discuss the company's earnings press releases, as well as financial information and earnings guidance provided to analysts and rating services;¹⁵⁷
- *Risk assessment*: Discuss policies with respect to risk assessment and risk management;¹⁵⁸
- *Separate meetings*: Meet separately and periodically, with management, the internal auditors (or other personnel responsible for the internal audit

¹⁵³ *Id.* at Section 303A.07(c)(i)(B). These disclosure obligations are discussed *supra* at Section IV[1].

¹⁵⁴ *Id.* at Section 303A.07(c)(i)(B)(ii).

¹⁵⁵ The obligations under this Rule are discussed *supra* at Section IV(1)(A).

¹⁵⁶ After reviewing this report and the work of the independent audit firm for the year, the Committee should be in a position to evaluate the audit firm and the lead partner on the engagement. Part of that evaluation involves a recommendation to the board as to whether the lead partner should be rotated to assure independence (in addition to what is required by SOX). The committee should report its conclusions regarding the performance of the audit firm and on the question of partner rotation to the full board. NYSE Section 303A.07(c)(iii)(A), Commentary.

¹⁵⁷ The Commentary to this portion of the Section makes it clear that the Committee is only required to have a general discussion of these items. It is not required to review each release prior to its issuance. NYSE Section 303A.07(c)(iii)(C), Commentary.

¹⁵⁸ The committee is not required to be solely responsible for risk assessment. Generally the CEO and senior management assess and manage risk. The Committee should however discuss the guidelines, policies and assessments of management in this regard. NYSE Section 303A.07(c)(iii)(D), Commentary.

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function), and with the independent auditors;¹⁵⁹

- *Review difficulties:* Review with the independent auditors any audit problems or difficulties with management's response;¹⁶⁰
- *Hiring policies:* Set clear hiring policies for employees or former employees of the independent auditors;¹⁶¹ and
- *Report:* Report regularly to the board.¹⁶²

Foreign Private issuers, under NYSE Listed Company Manual Section 303A.11, are permitted (see Exchange Act, Rule 3b-4) to follow the practice of their home country in lieu of the listing requirements. Nevertheless these companies are required to:

- *SEC Sections:* Have an audit committee that satisfies Exchange Act, Rule 10A-3;
- *Notice:* The company must immediately notify the Exchange in writing if any executive officer becomes aware of any non-compliance with the applicable provisions;¹⁶³ and
- *Disclose differences:* Provide disclosure giving a brief description of the manner in which governance differs from that required by the Exchange for domestic entities. This disclosure can be either on the web site if cited in the annual report (in English and accessible from the U.S.) or the annual report.¹⁶⁴

[3] NASDAQ Requirements

NASDAQ also requires that the audit committee have a charter which specifies its SOX, SEC Rule and exchange mandated duties and obligations. That charter can also include other duties and responsibilities assigned to the committee by the board of directors.¹⁶⁵

Under NASDAQ Rules, the audit committee charter must include the provisions specified by Exchange Act, Rules 10A-3(b)(2), (3), (4) and (5), but subject to the exemptions of Rule 10A-3(c). The charter is also required to specify the

¹⁵⁹ The New York Stock Exchange requires that listed companies have an internal auditor. NYSE Section 303A.07(d).

¹⁶⁰ Items which might be included in these discussions are accounting adjustments noted or proposed by the auditor which were "passed" communications between the audit team and the firm's national officer regarding accounting or auditing issues from the engagement, any management or internal control letter issued or proposed, and the internal audit function, its staffing, budget and responsibilities. NYSE Section 303A.07(c)(iii)(F), Commentary.

¹⁶¹ NYSE Section 303A.07(c)(i)(G).

¹⁶² NYSE Section 303A.07(c)(i)(H).

¹⁶³ NYSE Section 303A.12(b).

¹⁶⁴ NYSE Section 303A.11, Commentary.

¹⁶⁵ NASDAQ Rule 4350(d).

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scope of the committee's responsibilities, how it carries those out and its structure, processes and membership requirements.¹⁶⁶

The duties of the committee under NASDAQ rules can be divided into two areas regarding the financial reporting functions of the company. First, regarding the auditors the committee is responsible for: 1) the receipt from the auditors of a formal written statement detailing all relationships between the auditor and the company per Independence Standards Board Standard 1;¹⁶⁷ 2) for actively engaging in dialogue with the auditors with respect to any disclosed relationships or services that may impact objectivity and independence; and 3) for taking or recommending that the full board take appropriate action to oversee the audits of the financial statements.

Second, the committee is required to oversee the accounting and financial reporting processes of the company. This includes the work of the outside auditors. NASDAQ does not however, have a requirement that listed companies have an internal audit function.

The NASDAQ listing standards contain two other provisions which concern financial reporting and, while addressed to the issuer, impact work of the committee. NASDAQ Rule 4350(b) requires that any issuer receiving an audit opinion with a going concern qualification issue a press release and furnish a copy to StockWatch not later than seven calendar days after the filing of the audit opinion in a public filing with the SEC. In addition, NASDAQ Rule 4350(h) specifies that each issuer conduct an appropriate review of all related party transactions for potential conflict of interest situations on an ongoing basis. All such transactions must be approved by the audit committee or another independent body of the board of directors.¹⁶⁸

Finally, NASDAQ Rule 4350(a)(1) provides that foreign issuers are not required to take any action which is contrary to a law, Section or regulation of any public authority which exercises jurisdiction over the issuer. This proviso includes generally accepted business practices in the home country. The Section does not exempt compliance with the federal securities laws. The issuer is however required to disclose in its annual report filed with the SEC provisions from which it is exempt and describe the local practice.¹⁶⁹

Section V Key Considerations For Audit Committee Members

The key function of the audit committee, in the words of legendary investor

¹⁶⁶ NASDAQ Rule 4350(d)(1)(A).

¹⁶⁷ After the exchange adopted this provision, the PCAOB adopted the provisions of Independence Standards Board 1. *See* PCAOB Rule 3600T.

¹⁶⁸ Related party transactions are those which must be disclosed under Regulation S-K, Item 404.

¹⁶⁹ *See also* Regulation S-X Rule 2-01. NASDAQ also requires each issuer to adopt a code of conduct for all directors, officers and employees. NASDAQ Rule 4350(n); *see also* NASDAQ IM 4350-7. There are other limited exemptions such as cooperatives structured to comply with state and federal tax laws, certain asset backed issuers and other passive issuers such as investment trusts.

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Warren Buffett, is “to hold the auditor’s feet to the fire”¹⁷⁰ There is no doubt that this is important. The post SOX audit committee, however, is much more than the supervisor of the company’s financial function. Now it is virtually a separate entity and a key part of the company with significant internal monitoring and policing authority.

As an oversight and monitoring body, the committee of necessity must rely on the work of others as well as the systems of the company.¹⁷¹ Much of its work involves the evaluation of the people with whom it works and an assessment of the information being provided. The candor and credibility of those with whom it works, and on whom it relies, is thus critical as is the completeness of the information furnished to it. Accordingly, in approaching its tasks the committee should consider the following:

- *Expectations:* To facilitate its work, the committee should consider having candid discussions with management and the external and internal auditors. The purpose of these conversations is to define the expectations of the committee. In these discussions committee members should make it clear that they expect these groups to be candid and report matters to them—that is, the committee should not have to seek out information. Rather, management and the auditors should keep the committee fully and completely informed.
- *Credibility and integrity:* A key question for the committee is the credibility and integrity of the information it has received. This begins with the completeness of the information. In the end, the committee must determine if it is comfortable with the candor, credibility and reliability of the information received from the outside and internal auditors as well as the management team.
- *Evaluate:* It is essential that the committee carefully evaluate the information and the work performed.¹⁷²

[1] The Charter

The audit committee charter contains the key obligations of the committee

¹⁷⁰ Warren Buffett, Comments During SEC Roundtable Discussion on Financial Disclosure and Auditor Oversight (Apr. 2, 2003), available at <http://www.sec.gov/spotlight/roundtables/accountround030402.htm>.

¹⁷¹ See, e.g., *In re Caremark Int. Inc. Derivative Litigation*, 698 A. 2d 959 (Del. Ch. 1996) (discussing the oversight obligations of directors); see also *In re The Walt Disney Company Derivative Litigation*, 906 A. 2d 27 (Del. 2006) (same) and 2008 Emerging Issues 1929; see also *Stone v. Ritter*, 911 A. 2d 362 (Del. 2006); *Graham v. Allis Chalmers Mfg. Co.*, 188 A. 2d 125 (Del. 1963).

¹⁷² For a good discussion of this overall approach see: Mark S. Beasley and Dana R. Hermanson, *Audit Committees: Smart Questions And Smart Answers*, The Corporate Board at 7 (Nov/Dec. 2004).

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members. Both the NYSE¹⁷³ and NASDAQ¹⁷⁴ mandate that charter detail the role and responsibilities of the committee. The charter should be reviewed to make sure the required items are included and that the committee complies with each.¹⁷⁵

[2] The External Auditors

A key function of the audit committee is to retain, oversee and evaluate the external auditors.¹⁷⁶ Both the NYSE and NASDAQ require that the audit committee be directly responsible for the auditors.¹⁷⁷ The external auditors will, among other things, issue a report on the annual financial statements and review the quarterly financial statements as discussed below.

- *Responsibility*: The Committee is solely responsible for the selection, hiring and replacement of external auditors. Those auditors are to report directly to the committee.¹⁷⁸
- *Qualifications*: The committee should carefully consider the background and qualifications of the outside auditors to adequately perform the engagement.¹⁷⁹
- *Independence*: The outside auditors are prohibited from providing auditing services to an issuer unless they are independent. The committee must carefully assess this question and determine that the firm is independent. The auditors are required to provide the committee with a written statement on their relationships with the company to facilitate a review of the question of independence. Generally, any situation which creates a conflict of interest between the company and auditor, which would require the auditor to review its work, act as management, act as an employee or be an advocate for the company will impair independence. This is a facts

¹⁷³ The required items are listed in *supra* Section IV[2].

¹⁷⁴ The required items are listed in *supra* Section IV[3].

¹⁷⁵ See also Regulation S-K, Item 407(d), Instructions to Item 407(d) (requiring disclosure of whether or not the audit committee has a charter).

¹⁷⁶ The external auditors must be registered with the Public Company Accounting Oversight Board under SOX, 15 U.S.C. § 7212.

¹⁷⁷ Section 301 of SOX requires that the SEC adopt Sections requiring that as a condition to stock market listing that the company's audit committee "shall be directly responsible for the appointment, compensation, and oversight of the work of the" external auditors. Exchange Act § 10A(m)(2). This includes a resolution of disagreements between management and the auditors. The section also requires that the auditors report directly to the audit committee. The SEC Rules largely reiterate the statute.

¹⁷⁸ See also AU Section 310 which, generally, requires the independent auditor to discuss the engagement with the company and, among other things, to communicate in writing to the audit committee all significant deficiencies and material weaknesses in internal control identified during the audit. PCAOB, Appointment of the Independent Auditor, AU Sec. 310 (1972), available at http://www.pcaobus.org/standards/interim_standards/auditing_standards/au_300.html. This standard was adopted by the PCAOB Rule 3600T. See also Exchange Act Rule 10A-3(b)(2).

¹⁷⁹ Regulation S-X Rule 2-01.

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and circumstances analysis.¹⁸⁰ Under SEC Rules, the following will also impair the independence of the firm or cause it not to be independent:

- Financial interest: The firm, engagement team, chain of command or their immediate family have a direct or material indirect financial interest in the client.
- Loan: There is an outstanding loan between the auditing firm and the client.
- Investment: The client has an investment in the firm or the client's officers and directors own more than 5% of the firm's equity securities.
- Employee: If any partner, principal or professional employee is an employee or member of the client's board, the firm is not independent.
- Engagement team family member: If a family member of the engagement team has an accounting or financial oversight role at the client, the firm is not independent.
- Former partner: If a former partner, principal or professional employee of the firm who retains an interest or influence in the firm has an accounting or financial oversight role at the client the firm will not be considered independent.
- Business relationship: If the firm or engagement team and chain of command has a direct or material indirect business relationship with the client, other than their provision of professional services or as consumers in the ordinary course of business, the firm will not be considered independent.
- Contingent fee arrangement: If the firm provides any service or product on a commission or contingent fee basis it will not be considered independent.¹⁸¹
- *Pre-approval*: The Committee is required to pre-approve the services provided to the issuer by the outside auditors. This can be done by policies and procedures adopted by the committee.
- *Audit fees*: The committee is required by SOX Section 202 to pre-approve both audit and non-audit fees and services. Section 301 of SOX requires that the committee approve the compensation to external auditors.
- *Permitted services*: SOX Section 201(a) precludes the outside auditors from providing certain services to the company. Providing other services can impact that independence. Accordingly, even if an activity is not precluded, such as certain tax services, the audit committee must approve

¹⁸⁰ See Regulation S-X Rule 2-01(b) (detailing factors to consider in evaluating independence).

¹⁸¹ PCAOB Rule 3521.

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it. In considering approval the committee should carefully evaluate the impact of rendering the service on the independence of the auditors. Services which the statute specifically precludes are:

- Bookkeeping: Bookkeeping or similar services.
- Information services: Financial information systems design and implementation.
- Appraisal: Appraisal or valuation services, including fairness opinions.
- Actuarial: Actuarial services.
- Internal auditing: Internal auditing outsourcing services.
- Management: Management functions.
- Human resources: Human resources functions such as executive search, psychological testing or other evaluation programs, hiring recommendation (excluding evaluating a candidates qualifications for a financial position at the client's request).
- Legal: Legal services.
- Broker: Broker or dealer, investment adviser, or investment banking services.
- Other: Other services that the board determines are impermissible.
- *Partner rotation*: The lead and concurring partner of the audit team must be rotated every five years under Section 203 of SOX.¹⁸² Certain other partners must also be rotated and there are time-out provisions. While these obligations are imposed on the auditing firm, the committee should consider if more frequent rotation is required to ensure independence.¹⁸³
- *Differences, auditors/management*: The committee should review and discuss any disagreements between management and the external auditors.¹⁸⁴
- *Discussions with auditors*: The committee should also review key elements of the auditor's work with the firm as well as their relationship with management.¹⁸⁵ This review should include:

¹⁸² Exchange Act § 10A(j).

¹⁸³ SOX Section 206 also requires that a period of one year lapse between the time any member of the audit team can work for the issuer as either the CEO, CFO, controller or chief accounting officer. SOX Section 206 (codified in Exchange Act § 10A(l)).

¹⁸⁴ SOX Section 301 (codified in Exchange Act § 10A(m)). *Cf.* Regulation S-K, Item 407(d)(3)(i)(A) (audit committee must state whether it has reviewed and discussed the audited financial statements with management).

¹⁸⁵ *See, e.g.*, Statements on Auditing Standards, No. 61, Communication With Audit Committees. *See also*, Exchange Act § 10A(k); Regulation S-X, Rule 07; *Cf.* Statement on Auditing Standard No. 71, Interim Financial Information; *see also* Regulation S-K, Item 407(d)(3)(i)(B)

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- The accounting principles and policies. The auditors are required to report to the committee on the critical accounting policies and practices used for the audit. The report is also required to include alternative treatments for financial information within Generally Accepted Accounting Principles (“GAAP”) and any material written communications between the auditing firm and management of the issuer. The auditors are required to report to the committee on the critical accounting policies and practices used for the audit. The report is also required to include alternative treatments for financial information within GAAP and any material written communications between the auditing firm and management of the issuer. The committee should carefully review each of these items with the auditors. The discussion should also include all alternative treatments discussed with management and the ramification of those treatments; trends in the market place and industry which may impact their selection, the consistency of application over time and the comparability of the principles used from period to period; and any material discussions with management on these subjects.¹⁸⁶
- Management judgments and accounting estimates. The discussion should include a review of the judgments and estimates made by management and their impact, the reasonableness of those judgments, the adequacy of the reserves and any material changes in those reserves, trends which can impact any of these judgments or the carrying value of assets and liabilities and management’s criteria for materiality and cost/benefit analysis.
- Disclosure. A review of the transparency and disclosure of related party transactions including any sales, leases, purchases or transactions involving management or their family and the company.
- Audit adjustments. A review and discussion of any recommended adjustments from the statements prepared by management. This should include a discussion of how the proposed adjustments were resolved.
- Management: A discussion of any differences with management in the financial reporting process and how those differences were resolved.
- *Illegal acts:* Exchange Act, Section 10A(b) requires that the auditors inform the committee of any illegal acts found during the audit. The

(audit committee must state whether it has discussed with the independent auditors the matters required to be discussed by Statement on Auditing Standards, No. 61 as adopted by the PCAOB).

¹⁸⁶ SOX Section 204 (codified in Exchange Act § 10A(k)) specifies topics which the outside registered auditing company must bring to the attention of the audit committee. To a large extent, those obligations are also reflected in Regulation S-X Rule 2-07.

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committee should review this question with the auditors.¹⁸⁷

[3] Controls

A key part of the financial function for which the committee has oversight is internal controls over financial reporting. Those controls can be defined as:

A process designed by or under the supervision of, the issuer's Principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer's Board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Generally Accepted Accounting principles.¹⁸⁸

These policies and procedures must be designed to provide for the maintenance of records in reasonable detail so that they accurately and fairly reflect the transactions and disposition of assets of the issuer. They must also be designed to permit the preparation of financial statements in accord with GAAP and provide a reasonable assurance regarding the prevention and timely detection of unauthorized transactions that could have a material effect on the financial statements. These controls differ from disclosure controls which are designed "to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the [Exchange] Act is accumulated and communicated to the issuer's management."¹⁸⁹ In view of the key role of the audit committee in this process under SOX, the committee itself has become a part of the internal controls which must be assessed by the auditors.

- *Review controls and policies:* The controls and policies directly impact the reliability of the financial statements. Management must base their review on a recognized control framework. The committee should review the controls with the auditors and management.¹⁹⁰

¹⁸⁷ SOX Section 307, 15 USC § 7246; Implementation of Standards of Professional Conduct For Attorneys, Securities Act Release No. 33-8185 (Aug. 5, 2003), available at 2003 SEC LEXIS 256.

¹⁸⁸ Exchange Act Rule 13a-15(f); see also Exchange Act Rule 15d-15. See also Exchange Act § 13(b)(2)(B) which provides in part that every registrant shall "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurance that—(i) transactions are executed in accordance with management's general or specific authorization; (ii) transactions are recorded as necessary (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (iii) to maintain accountability for assets; (iii) access to assets is permitted only in accordance with management's general or specific authorization; and (iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences."

¹⁸⁹ Exchange Act Rule 13a-15(e); see also Exchange Act Rule 15d-15(e).

¹⁹⁰ Management can select the framework for its review. The SEC has noted that the COSO framework meets the criteria. The agency does not require that this framework be used however. See, e.g., *supra* fn. 136 at II(A)(1). While there is an overlap between internal controls and disclosure controls, there are also different elements.

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- *Related party transactions:* Any transactions involving management or a member of management's family and the company should be reviewed. NASDAQ requires this review.¹⁹¹
- *Legal and regulatory requirements:* The NYSE requires that the committee review these matters.
- *Internal auditors:* The NYSE requires that listing companies have an internal audit function. Having an internal audit function can aid the committee in reviewing the controls of the company.¹⁹²
- *Code of Ethics:* Both the NYSE¹⁹³ and NASDAQ¹⁹⁴ require that listing companies have a code of ethics (and SOX provides that the company must disclose the reasons it does not have such a code if in fact one is not adopted). Since this is part of the internal controls of the company, a pro-active committee should consider reviewing this matter.
- *Going concern qualification:* NASDAQ has notice provisions if the auditors issue a going concern qualification.¹⁹⁵
- *Management's report on internal controls:* SOX Section 404(b) and Exchange Act Rule 13a—15(f) requires management to execute an annual report on the internal controls of the company. This report, which should be reviewed by the Committee, must include:
 - Management responsibility: A statement regarding management's responsibility for establishing and maintaining adequate internal control over financial reporting;
 - Framework to evaluate: A statement identifying the framework used by management to evaluate the effectiveness of the controls; and
 - Assessment of effectiveness: Management's assessment regarding the effectiveness of the internal controls as of the end of the year and whether or not they are effective. If a material weakness is identified it must be disclosed (this precludes management from stating that the controls are effective).

¹⁹¹ American Institute of Certified Public Accountants ("AICPA"), Consideration of Fraud in a Financial Audit Statement, SAS No. 82, AU Section 316, available at <http://www.aicpa.org/download/members/div/auditstd/AU-00316.PDF>.

¹⁹² The Blue Ribbon Committee stressed the importance of an internal audit function. See generally *supra* fn. 6.

¹⁹³ NYSE Section 303A.10 (requiring listed companies to adopt and disclose a code of business conduct and ethics for directors, officers and employees and to disclose any waivers of the code for directors or executive officers).

¹⁹⁴ NASDAQ Rule 4350(n) (requiring each issuer to adopt a code of conduct applicable to all directors, officers and employees which is available to the public).

¹⁹⁵ AICPA, The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern, AU Section 341 (1989), available at <http://www.aicpa.org/download/members/div/auditstd/AU-00341.PDF>.

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- Auditor attestation: A statement that the registered public accounting firm's attestation report on management's assessment of the registrant's internal controls and that the report is included in the annual report.¹⁹⁶
- *Management certifications*: Sections 304 and 906 of Sarbanes Oxley require the CEO and CFO to execute quarterly certifications. While the committee is not required to review these certifications, since one portion of Section 304 is concerned with disclosures to the audit committee, they should be reviewed. Under Section 304 the principal executive officer and the principal financial officer must certify in each annual or quarterly report that, to their knowledge:
 - Reviewed: The signing officer has reviewed the report;
 - No untrue statement: The report does not contain any untrue statement of a material fact;
 - Fairly presents: The financial information fairly presents in all material respects the financial condition of the issuer.
 - Responsible: The signing officer is responsible for: 1) establishing and maintaining the internal controls of the company; 2) ensuring that those controls are properly designed to bring material information to the attention of the officers and others; and 3) that the effectiveness of those controls has been evaluated.
 - Disclose to audit committee: The signing officers have disclosed to the auditors and the audit committee: 1) all significant deficiencies in the design or operation of the controls; 2) any fraud, regardless of whether material or not, that involves management or other employees who have a significant role in the internal controls of the company; and 3) any significant changes in the internal controls of the issuer.
 - Section 906: This section is similar to 304 but broader. In essence, the Section, which carries criminal penalties, requires that the signing officers certify that the periodic report containing the financial statements fully comply with the requirements of Section 13(a) or 15(d) of the Exchange Act and that the information in the report fairly presents in all material respects the financial condition

¹⁹⁶ See also Regulation S-K, Item 308(a). The inclusion of the auditor's attestation in the annual report is provided for in Regulation S-K, Item 308(b). In addition, Item 308(c) requires the disclosure of any change in internal control regarding financial reporting that occurred during the last fiscal quarter that has materially affected or is reasonably likely to materially affect the financial internal controls. See also SOX Section 103(a)(2)(A)(iii), 15 U.S.C. § 7213(2)(A)(i) (requiring that the audit report include an evaluation stating whether the internal controls/procedures within the contours of the definition set forth in the text).

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and result of operations of the company. This certification is filed with each periodic report.

[4] Financial Reports

The committee should review and discuss with management and the external auditors the periodic reports filed by the company.¹⁹⁷ The NYSE requires the committee to review the quarterly reports.¹⁹⁸ These reports include:

- **SEC filings:** The periodic reports which an Exchange Act registrant must file are:
 - **Annual report, Form 10-K:** This report includes a discussion of the business, unresolved SEC staff comments, a designation of certain legal proceedings, matters submitted for a vote of securities holders, management's discussion and analysis of the financial condition of the company and the results of operation, executive compensation, disclosures regarding the principal accounting fees and services and the audited financial statements.
 - **Quarterly report, Form 10-Q:** The report includes: The unaudited financial statements which must be reviewed by the auditors; certain events must be included: 1) The commencement of, or material developments in, legal proceedings; 2) Material changes in outstanding securities and the sale of unregistered securities; 3) Material defaults in senior securities; 4) Action taken by stockholders; 5) Material contracts entered into during the period must be filed as exhibits. The report also includes management's discussion and analysis.
 - **Report, Form 8-K:** Events which must be disclosed on current reports are: 1) Change in control of the company; 2) Significant acquisitions and dispositions; 3) Bankruptcy or receivership; 4) Change in auditor; 5) Reasons for director's withdrawal from the board, if a director requests; 6) Change in fiscal year; 7) Change in senior executive code of ethics; 8) Employee benefit plan trading blackouts; 9) Issuance of earnings release which must be attached as an exhibit; and 10) The company can report other information it deems material or which must be required to be filed under Regulation FD.
- **NYSE & NASDAQ:** The exchanges require that listed companies issue quarterly earnings releases. Neither the NYSE nor NASDAQ specifies the specific time for issuing a release. Generally, an earnings release should

¹⁹⁷ Regulation S-K, Item 407(d)(5)(i)(A) requires that that the committee state whether after reviewing certain items it recommended to the board of directors that the audited financial statements be included in the company's annual report on Form 10-K.

¹⁹⁸ NYSE Section 303A.07(c)(iii)(B).

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be issued as quickly as possible following the end of a reporting period. The release should contain key operating data and significant events impacting the results for the reporting period. The release should contain a balanced presentation of the results. If forward looking material is included, it should be updated as necessary to keep it current.

- **Key questions re reports:** Key sections of the reports the committee should review include:
 - **MD&A:** This section must be included in each annual and quarterly report filed with the SEC. This narrative supplement to the financial statements is management's discussion and analysis of the numbers in the report. The purpose of this section is to permit the reader to view the company through the eyes of management. It should thus include a discussion of the results for the period and the liquidity of the company and its needs and sources for funds. In this regard, the section should emphasize not just facts and events but also trends and contingencies that have a reasonable change of impacting the future results and financial conditions of the company. Key items in the section include:
 1. **Cash flow analysis:** This should include known and expected trends. The discussion is not limited to traditional materiality standards. Rather, if there are items or events which might reasonably have a significant impact on cash flow, they should be discussed.¹⁹⁹
 2. **Forward looking information:** Forward-looking disclosures can be included such as anticipated future trends or events which have a less predictive impact on known events and trends.
 3. **Off balance sheet arrangements:** In a separate section, the company must disclose discuss off-balance sheet arrangements that are reasonably likely to have a current or future impact that is material to investors. The disclosures must include: a) the business purpose and nature of the arrangement including the kinds of interests retain, securities issued, liabilities or obligations incurred and triggers for contingent obligations; b) known events, commitments, trends, or uncertainties resulting or reasonably likely to result in termination or material reduction in benefits provided by the arrangement; c) a contractual obligations table which lists amounts

¹⁹⁹ See, e.g. In the Matter of Caterpillar, Inc., Exchange Act Release No. 34-30532, 1992 SEC Lexis 786 (Mar. 31, 1992); see also, In the Matter of Clete D. Madden, CPA, Exchange Act Release No. 34-53574, 2006 SEC Lexis 735 (Mar. 30, 2006); In the Matter of Terex Corp., Exchange Act Release No. 34-41312, 1999 SEC Lexis 788 (Apr. 20, 1999).

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coming due in future years under long term debt, capital leases, operating leases and purchase obligations and under other long term liabilities listed on the balance sheet. Events that create, increase, or accelerate obligations must be described in footnotes.

- **To be avoided:** The section should avoid rote recitations of financial information with analysis or insight into past performance or the prospects of the enterprise and rote calculations of items such as percentage changes or other similar boiler plate recitations.
- **Disclosures:** Disclosures regarding the committee and its composition as well as its procedures must be made in the Form 10-K and/or the proxy materials.²⁰⁰
- **Non-GAAP measures:** As required by SOX, the SEC adopted Rules relating to the use of non-GAAP measures of financial performance included in earnings releases.²⁰¹ If non-GAAP measurements are used such as EBITDA or if there are adjustments to GAAP amounts to eliminate the impact of “non-recurring” items, there must be a presentation of the most directly comparable financial measure calculated and presented in accord with GAAP and a reconciliation between the two measures.²⁰²

[5] Hot Lines

The committee is required to establish a line for employees to report certain matters to it. In addition, the committee is required to have a confidential means of communication for employees to report matters to the committee. Any matters reported to the committee regarding financial reporting should be carefully considered and evaluated.

[6] Advisors

The committee has the authority to retain advisors to assist it with carrying out its functions. The committee should consider if in specific circumstances it may need to retain expert legal or accounting advisors or others to facilitate its work. In certain instances advisors may be retained to conduct an internal investigation and, as necessary, take any necessary corrective action.

Section VI Liability

Following the passage of the Sarbanes Oxley Act, the audit committee has greatly enhanced powers and authority. Those powers and that authority should

²⁰⁰ The specific disclosures for each report are discussed in *supra* Section IV[1][e].

²⁰¹ Regulation G, 17 C.F.R. § 244.100 (2003).

²⁰² See also, Release, Technical Committee of the International Organization of Securities Commissions, cautionary statement regarding non-GAAP results measures (May 19, 2002) available at <http://www.fsa.go.jp/inter/ios/pressll.pdf>.

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facilitate the work of the committee. At the same time, they also give the members of the committee duties and obligations beyond those of other members of the board of directors.

The principles for liability under the federal securities laws which apply to all corporate directors also apply to audit committee members.²⁰³ The additional duties and obligations of audit committee members arguably create the potential for additional liability.²⁰⁴ While the SEC has brought cases against directors since the passage of the Act,²⁰⁵ it has not brought an enforcement action solely against the audit committee based on a failure of committee members to carry out their specific duties.²⁰⁶ The audit committee of Hollinger International, Inc. did receive a Wells notice, that is, a notification that the SEC staff was considering recommending to the Commission that an enforcement action be instituted against the committee members. Ultimately, however, the Commission chose not to bring an enforcement action against the committee.²⁰⁷ An action was brought against its chairman and others for essentially looting the company, in part, through actions approved by the board and the committee.²⁰⁸

There have been private securities damage actions filed against audit committee members as well as other board members. To date, there is a split in the decisions on committee members. In *In re Enron Corporation Securities, Derivative & ERISA Litigation*,²⁰⁹ claims were brought against the committee and the board alleging, in part, that the financial statements were defective. The court dismissed the claim concluding that the directors reasonably relied on the outside auditors. However, in *In re Lenout & Hauspie Securities Litigation*,²¹⁰ the court refused to dismiss a similar claim on pre-trial motions.²¹¹

²⁰³ See *In re Alston SA Sec. Litigation*, 406 F. Supp. 2d 433 (S.D.N.Y. 2005); see also, *Stuart Buchalter and Kristin Yokomoto*, Audit Committees' Responsibilities and Liability, *The CPA Journal* (Mar. 3, 2005), available at <http://www.nysscpa.org/cpajournal/2003/0303/features/f031803.htm> ("Audit Committee Members are also subject to actions by the SEC under the Securities and Exchange Act of 1934.").

²⁰⁴ Cases discussing the obligations of directors are included *infra* fn. 205, 209, 210.

²⁰⁵ See, e.g., *SEC v. Kohavi*, No. 08-43-48 (N.D. Cal. filed Sept. 17, 2008) (settled SEC enforcement action against the outside directors based on claims of illegal option backdating where the Commission alleged the directors failed to carry out their duties).

²⁰⁶ The SEC has brought cases against audit committee members. See, e.g. *SEC v. Erickson*, Civil Action No. 03-07-cv-0254 (N.D.Tex.) (filed Feb. 7, 2007) (settled insider trading case). The cases are not based on a failure of the member to carry out his or her duties as an audit committee member.

²⁰⁷ Hollinger Inc., Report of a Foreign Investor (Form 6-K) at 2 (Aug. 31, 2004).

²⁰⁸ *SEC v. Black*, No. 04C03761 (N.D. Ill. filed Nov. 15, 2004). Mr. Black was indicted for securities fraud based on the conduct in the SEC's complaint. *U.S. v. Black*, No. 05-727 (N.D. Ill. Feb. 2, 2005).

²⁰⁹ 2003 U.S. Dist. LEXIS 3786 (S.D. Tex. Jan. 28, 2003).

²¹⁰ 2002 U.S. Dist. LEXIS 22708 (D. Mass. Nov. 18, 2002).

²¹¹ Efforts to use duties imposed by sections of Sarbanes Oxley such as the CEO/CFO

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certification requirements have not been successful. *See, e.g., Glazer Capital Management, LP v. Sergio Magistri*, No. No. 04-02181, 2008 U.S. App. Lexis 24245 (9th Cir. Nov. 26, 2008) (following decision from the Eleventh and Fifth Circuits the court rejected claim that the SOX certifications could be used to help plead a strong inference of scienter as required in a private securities fraud suit). In *In re Goodyear Tire and Rubber Co. Deriv. Litig.*, No. 03-2180, 2007 U.S. Dist. Lexis 1233 (N.D. Ohio Jan. 5, 2007), the court held that the plaintiffs failed to adequately allege that the audit committees' financial statements were defective. The court granted the defendant audit committee members' motion to dismiss.

Appendix A

SARBANES-OXLEY ACT (Selected Sections)

SEC. 103.

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SEC. 103. AUDITING, QUALITY CONTROL, AND INDEPENDENCE STANDARDS AND RULES.

(a) AUDITING, QUALITY CONTROL, AND ETHICS STANDARDS.—

(1) IN GENERAL.— The Board shall, by rule, establish, including, to the extent it determines appropriate, through adoption of standards proposed by 1 or more professional groups of accountants designated pursuant to paragraph (3)(A) or advisory groups convened pursuant to paragraph (4), and amend or otherwise modify or alter, such auditing and related attestation standards, such quality control standards, and such ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by this Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors.

(2) RULE REQUIREMENTS.— In carrying out paragraph (1), the Board—

(A) shall include in the auditing standards that it adopts, requirements that each registered public accounting firm shall—

(i) prepare, and maintain for a period of not less than 7 years, audit work papers, and other information related to any audit report, in sufficient detail to support the conclusions reached in such report;

(ii) provide a concurring or second partner review and approval of such audit report (and other related information), and concurring approval in its issuance, by a qualified person (as prescribed by the Board) associated with the public accounting firm, other than the person in charge of the audit, or by an independent reviewer (as prescribed by the Board); and

(iii) describe in each audit report the scope of the auditor's testing of the internal control structure and procedures of the issuer, required by section 404(b), and present (in such report or in a separate report)—

(I) the findings of the auditor from such testing;

(II) an evaluation of whether such internal control structure and procedures—

(aa) include maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;

(bb) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and

(III) a description, at a minimum, of material weaknesses in such

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internal controls, and of any material noncompliance found on the basis of such testing.

(B) shall include, in the quality control standards that it adopts with respect to the issuance of audit reports, requirements for every registered public accounting firm relating to—

(i) monitoring of professional ethics and independence from issuers on behalf of which the firm issues audit reports;

(ii) consultation within such firm on accounting and auditing questions;

(iii) supervision of audit work; (iv) hiring, professional development, and advancement of personnel;

(v) the acceptance and continuation of engagements;

(vi) internal inspection; and

(vii) such other requirements as the Board may prescribe, subject to subsection (a)(1).

(3) AUTHORITY TO ADOPT OTHER STANDARDS.—

(A) IN GENERAL.— In carrying out this subsection, the Board—

(i) may adopt as its rules, subject to the terms of section 107, any portion of any statement of auditing standards or other professional standards that the Board determines satisfy the requirements of paragraph (1), and that were proposed by 1 or more professional groups of accountants that shall be designated or recognized by the Board, by rule, for such purpose, pursuant to this paragraph or 1 or more advisory groups convened pursuant to paragraph (4); and

(ii) notwithstanding clause (i), shall retain full authority to modify, supplement, revise, or subsequently amend, modify, or repeal, in whole or in part, any portion of any statement described in clause (i).

(B) INITIAL AND TRANSITIONAL STANDARDS.— The Board shall adopt standards described in subparagraph (A)(i) as initial or transitional standards, to the extent the Board determines necessary, prior to a determination of the Commission under section 101(d), and such standards shall be separately approved by the Commission at the time of that determination, without regard to the procedures required by section 107 that otherwise would apply to the approval of rules of the Board.

(4) ADVISORY GROUPS.— The Board shall convene, or authorize its staff to convene, such expert advisory groups as may be appropriate, which may include practicing accountants and other experts, as well as representatives of other interested groups, subject to such rules as the Board may prescribe to prevent conflicts of interest, to make recommendations concerning the content (including proposed drafts) of auditing, quality control, ethics, independence,

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or other standards required to be established under this section.

(b) INDEPENDENCE STANDARDS AND RULES.—The Board shall establish such rules as may be necessary or appropriate in the public interest or for the protection of investors, to implement, or as authorized under, title II of this Act.

(c) COOPERATION WITH DESIGNATED PROFESSIONAL GROUPS OF ACCOUNTANTS AND ADVISORY GROUPS.—

(1) IN GENERAL.— The Board shall cooperate on an ongoing basis with professional groups of accountants designated under subsection (a)(3)(A) and advisory groups convened under subsection (a)(4) in the examination of the need for changes in any standards subject to its authority under subsection (a), recommend issues for inclusion on the agendas of such designated professional groups of accountants or advisory groups, and take such other steps as it deems appropriate to increase the effectiveness of the standard setting process.

(2) BOARD RESPONSES.— The Board shall respond in a timely fashion to requests from designated professional groups of accountants and advisory groups referred to in paragraph (1) for any changes in standards over which the Board has authority.

(d) EVALUATION OF STANDARD SETTING PROCESS.— The Board shall include in the annual report required by section 101(h) the results of its standard setting responsibilities during the period to which the report relates, including a discussion of the work of the Board with any designated professional groups of accountants and advisory groups described in paragraphs (3)(A) and (4) of subsection (a), and its pending issues agenda for future standard setting projects.

TITLE II —AUDITOR INDEPENDENCE**SEC. 201. SERVICES OUTSIDE THE SCOPE OF PRACTICE OF AUDITORS.**

(a) PROHIBITED ACTIVITIES.— Section 10A of the Securities Exchange Act of 1934 (15 U.S.C. 78j-1) is amended by adding at the end the following:

“(g) PROHIBITED ACTIVITIES.— Except as provided in subsection (h), it shall be unlawful for a registered public accounting firm (and any associated person of that firm, to the extent determined appropriate by the Commission) that performs for any issuer any audit required by this title or the rules of the Commission under this title or, beginning 180 days after the date of commencement of the operations of the Public Company Accounting Oversight Board established under section 101 of the Sarbanes-Oxley Act of 2002 (in this section referred to as the ‘Board’), the rules of the Board, to provide to that issuer, contemporaneously with the audit, any non-audit service, including—

“(1) bookkeeping or other services related to the accounting records or financial statements of the audit client;

“(2) financial information systems design and implementation;

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“(3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports;

“(4) actuarial services;

“(5) internal audit outsourcing services;

“(6) management functions or human resources;

“(7) broker or dealer, investment adviser, or investment banking services;

“(8) legal services and expert services unrelated to the audit; and

“(9) any other service that the Board determines, by regulation, is impermissible.

“(h) PREAPPROVAL REQUIRED FOR NON-AUDIT SERVICES.— A registered public accounting firm may engage in any non-audit service, including tax services, that is not described in any of paragraphs (1) through (9) of subsection (g) for an audit client, only if the activity is approved in advance by the audit committee of the issuer, in accordance with subsection (i).”.

(b) EXEMPTION AUTHORITY.— The Board may, on a case by case basis, exempt any person, issuer, public accounting firm, or transaction from the prohibition on the provision of services under section 10A(g) of the Securities Exchange Act of 1934 (as added by this section), to the extent that such exemption is necessary or appropriate in the public interest and is consistent with the protection of investors, and subject to review by the Commission in the same manner as for rules of the Board under section 107.

SEC. 202. PREAPPROVAL REQUIREMENTS.

Section 10A of the Securities Exchange Act of 1934 (15 U.S.C. 78j—1), as amended by this Act, is amended by adding at the end the following:

“(i) PREAPPROVAL REQUIREMENTS.—

“(1) IN GENERAL.—

“(A) AUDIT COMMITTEE ACTION.— All auditing services (which may entail providing comfort letters in connection with securities underwritings or statutory audits required for insurance companies for purposes of State law) and non-audit services, other than as provided in subparagraph (B), provided to an issuer by the auditor of the issuer shall be preapproved by the audit committee of the issuer.

“(B) DE MINIMUS EXCEPTION.— The preapproval requirement under subparagraph (A) is waived with respect to the provision of non-audit services for an issuer, if—

“(i) the aggregate amount of all such non-audit services provided to the issuer constitutes not more than 5 percent of the total amount of revenues paid by the issuer to its auditor during the fiscal year in which

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the nonaudit services are provided;

“(ii) such services were not recognized by the issuer at the time of the engagement to be non-audit services; and

“(iii) such services are promptly brought to the attention of the audit committee of the issuer and approved prior to the completion of the audit by the audit committee or by 1 or more members of the audit committee who are members of the board of directors to whom authority to grant such approvals has been delegated by the audit committee.

“(2) DISCLOSURE TO INVESTORS.— Approval by an audit committee of an issuer under this subsection of a non-audit service to be performed by the auditor of the issuer shall be disclosed to investors in periodic reports required by section 13(a).

“(3) DELEGATION AUTHORITY.— The audit committee of an issuer may delegate to 1 or more designated members of the audit committee who are independent directors of the board of directors, the authority to grant preapprovals required by this subsection. The decisions of any member to whom authority is delegated under this paragraph to preapprove an activity under this subsection shall be presented to the full audit committee at each of its scheduled meetings.

“(4) APPROVAL OF AUDIT SERVICES FOR OTHER PURPOSES.— In carrying out its duties under subsection (m)(2), if the audit committee of an issuer approves an audit service within the scope of the engagement of the auditor, such audit service shall be deemed to have been preapproved for purposes of this subsection.”.

SEC. 203. AUDIT PARTNER ROTATION.

Section 10A of the Securities Exchange Act of 1934 (15 U.S.C. 78j—1), as amended by this Act, is amended by adding at the end the following:

“(j) AUDIT PARTNER ROTATION.— It shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer.”.

SEC. 204. AUDITOR REPORTS TO AUDIT COMMITTEES.

Section 10A of the Securities Exchange Act of 1934 (15 U.S.C. 78j—1), as amended by this Act, is amended by adding at the end the following:

“(k) REPORTS TO AUDIT COMMITTEES.— Each registered public accounting firm that performs for any issuer any audit required by this title shall timely report to the audit committee of the issuer—

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“(1) all critical accounting policies and practices to be used;

“(2) all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management officials of the issuer, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the registered public accounting firm; and

“(3) other material written communications between the registered public accounting firm and the management of the issuer, such as any management letter or schedule of unadjusted differences.”.

SEC. 205. CONFORMING AMENDMENTS.

(a) DEFINITIONS.— Section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)) is amended by adding at the end the following:

“(58) AUDIT COMMITTEE.— The term ‘audit committee’ means—

“(A) 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

“(B) if no such committee exists with respect to an issuer, the entire board of directors of the issuer.

SEC. 206. CONFLICTS OF INTEREST.

Section 10A of the Securities Exchange Act of 1934 (15 U.S.C. 78j-1), as amended by this Act, is amended by adding at the end the following:

“(1) CONFLICTS OF INTEREST.— It shall be unlawful for a registered public accounting firm to perform for an issuer any audit service required by this title, if a chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for the issuer, was employed by that registered independent public accounting firm and participated in any capacity in the audit of that issuer during the 1-year period preceding the date of the initiation of the audit.”.

SEC. 207. STUDY OF MANDATORY ROTATION OF REGISTERED PUBLIC ACCOUNTING FIRMS.

(a) STUDY AND REVIEW REQUIRED.— The Comptroller General of the United States shall conduct a study and review of the potential effects of requiring the mandatory rotation of registered public accounting firms.

(b) REPORT REQUIRED.— Not later than 1 year after the date of enactment of this Act, the Comptroller General shall submit a report to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives on the results of the study and review required by this section.

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(c) DEFINITION.— For purposes of this section, the term “mandatory rotation” refers to the imposition of a limit on the period of years in which a particular registered public accounting firm may be the auditor of record for a particular issuer.

SEC. 208. COMMISSION AUTHORITY.

(a) COMMISSION REGULATIONS.— Not later than 180 days after the date of enactment of this Act, the Commission shall issue final regulations to carry out each of subsections (g) through (1) of section 10A of the Securities Exchange Act of 1934, as added by this title.

(b) AUDITOR INDEPENDENCE.— It shall be unlawful for any registered public accounting firm (or an associated person thereof, as applicable) to prepare or issue any audit report with respect to any issuer, if the firm or associated person engages in any activity with respect to that issuer prohibited by any of subsections (g) through (1) of section 10A of the Securities Exchange Act of 1934, as added by this title, or any rule or regulation of the Commission or of the Board issued thereunder.

SEC. 209. CONSIDERATIONS BY APPROPRIATE STATE REGULATORY AUTHORITIES.

In supervising nonregistered public accounting firms and their associated persons, appropriate State regulatory authorities should make an independent determination of the proper standards applicable, particularly taking into consideration the size and nature of the business of the accounting firms they supervise and the size and nature of the business of the clients of those firms. The standards applied by the Board under this Act should not be presumed to be applicable for purposes of this section for small and medium sized nonregistered public accounting firms.

TITLE III —CORPORATE RESPONSIBILITY**SEC. 301. PUBLIC COMPANY AUDIT COMMITTEES.**

Section 10A of the Securities Exchange Act of 1934 (15 U.S.C. 78f) is amended by adding at the end the following:]

“(m) STANDARDS RELATING TO AUDIT COMMITTEES.—

“(1) COMMISSION RULES.—

“(A) IN GENERAL.— Effective not later than 270 days after the date of enactment of this subsection, the Commission shall, by rule, 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 requirements of any portion of paragraphs (2) through (6).

“(B) OPPORTUNITY TO CURE DEFECTS.— The rules of the Commission under subparagraph (A) shall provide for appropriate procedures for an issuer to have an opportunity to cure any defects that would be the basis

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for a prohibition under subparagraph (A), before the imposition of such prohibition.

“(2) RESPONSIBILITIES RELATING TO REGISTERED PUBLIC ACCOUNTING FIRMS.— The audit committee of each issuer, in its capacity as a committee of the board of directors, shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer (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, and each such registered public accounting firm shall report directly to the audit committee.

“(3) INDEPENDENCE.—

“(A) IN GENERAL.— Each member of the audit committee of the issuer shall be a member of the board of directors of the issuer, and shall otherwise be independent.

“(B) CRITERIA.— In order to be considered to be independent for purposes of this paragraph, a member of an audit committee of an issuer 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—

“(i) accept any consulting, advisory, or other compensatory fee from the issuer; or

“(ii) be an affiliated person of the issuer or any subsidiary thereof.

“(C) EXEMPTION AUTHORITY.— The Commission may exempt from the requirements of subparagraph (B) a particular relationship with respect to audit committee members, as the Commission determines appropriate in light of the circumstances.

“(4) COMPLAINTS.— Each audit committee shall establish procedures for—

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

“(B) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.

“(5) AUTHORITY TO ENGAGE ADVISERS.— Each audit committee shall have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties.

“(6) FUNDING.— Each issuer shall 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—

“(A) to the registered public accounting firm employed by the issuer for

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the purpose of rendering or issuing an audit report; and

“(B) to any advisers employed by the audit committee under paragraph (5).”.

SEC. 302. CORPORATE RESPONSIBILITY FOR FINANCIAL REPORTS.

(a) REGULATIONS REQUIRED.— The Commission shall, by rule, require, for each company filing periodic reports under section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m, 78o(d)), that the principal executive officer or officers and the principal financial officer or officers, or persons performing similar functions, certify in each annual or quarterly report filed or submitted under either such section of such Act that—

(1) the signing officer has reviewed the report;

(2) based on the officer’s knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading;

(3) based on such officer’s knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report;

(4) the signing officers—

(A) are responsible for establishing and maintaining internal controls;

(B) have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared;

(C) have evaluated the effectiveness of the issuer’s internal controls as of a date within 90 days prior to the report; and

(D) have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date;

(5) the signing officers have disclosed to the issuer’s auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function)—

(A) all significant deficiencies in the design or operation of internal controls which could adversely affect the issuer’s ability to record, process, summarize, and report financial data and have identified for the issuer’s auditors any material weaknesses in internal controls; and

(B) any fraud, whether or not material, that involves management or other

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employees who have a significant role in the issuer's internal controls; and

(6) the signing officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

(b) FOREIGN REINCORPORATIONS HAVE NO EFFECT.— Nothing in this section 302 shall be interpreted or applied in any way to allow any issuer to lessen the legal force of the statement required under this section 302, by an issuer having reincorporated or having engaged in any other transaction that resulted in the transfer of the corporate domicile or offices of the issuer from inside the United States to outside of the United States.

(c) DEADLINE.— The rules required by subsection (a) shall be effective not later than 30 days after the date of enactment of this Act.

SEC. 303. IMPROPER INFLUENCE ON CONDUCT OF AUDITS.

(a) RULES TO PROHIBIT.— It shall be unlawful, in contravention of such rules or regulations as the Commission shall prescribe as necessary and appropriate in the public interest or for the protection of investors, for any officer or director of an issuer, or any other person acting under the direction thereof, to take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading.

(b) ENFORCEMENT.— In any civil proceeding, the Commission shall have exclusive authority to enforce this section and any rule or regulation issued under this section.

(c) No PREEMPTION OF OTHER LAW.— The provisions of subsection (a) shall be in addition to, and shall not supersede or preempt, any other provision of law or any rule or regulation issued thereunder.

(d) DEADLINE FOR RULEMAKING.— The Commission shall—

(1) propose the rules or regulations required by this section, not later than 90 days after the date of enactment of this Act; and

(2) issue final rules or regulations required by this section, not later than 270 days after that date of enactment.

SEC. 304. FORFEITURE OF CERTAIN BONUSES AND PROFITS.

(a) ADDITIONAL COMPENSATION PRIOR TO NONCOMPLIANCE WITH COMMISSION FINANCIAL REPORTING REQUIREMENTS.— If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities

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laws, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for—

(1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and

(2) any profits realized from the sale of securities of the issuer during that 12-month period.

(b) COMMISSION EXEMPTION AUTHORITY.— The Commission may exempt any person from the application of subsection (a), as it deems necessary and appropriate.

SEC. 404. MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS.

(a) RULES REQUIRED.— The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) to contain an internal control report, which shall—

(1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and

(2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

(b) INTERNAL CONTROL EVALUATION AND REPORTING.— With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.

SEC. 405. EXEMPTION.

Nothing in section 401, 402, or 404, the amendments made by those sections, or the rules of the Commission under those sections shall apply to any investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a- 8).

SEC. 406. CODE OF ETHICS FOR SENIOR FINANCIAL OFFICERS.

(a) CODE OF ETHICS DISCLOSURE.— The Commission shall issue rules to require each issuer, together with periodic reports required pursuant to section 13(a) or 15(d) of the Securities Exchange Act of 1934, to disclose whether or not, and if not, the reason therefor, such issuer has adopted a code of ethics for senior

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financial officers, applicable to its principal financial officer and comptroller or principal accounting officer, or persons performing similar functions.

(b) **CHANGES IN CODES OF ETHICS.**— The Commission shall revise its regulations concerning matters requiring prompt disclosure on Form 8-K (or any successor thereto) to require the immediate disclosure, by means of the filing of such form, dissemination by the Internet or by other electronic means, by any issuer of any change in or waiver of the code of ethics for senior financial officers.

(c) **DEFINITION.**— In this section, the term “code of ethics” means such standards as are reasonably necessary to promote—

- (1) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
- (2) full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed by the issuer; and
- (3) compliance with applicable governmental rules and regulations.

(d) **DEADLINE FOR RULEMAKING.**— The Commission shall—

- (1) propose rules to implement this section, not later than 90 days after the date of enactment of this Act; and
- (2) issue final rules to implement this section, not later than 180 days after that date of enactment.

SEC. 407. DISCLOSURE OF AUDIT COMMITTEE FINANCIAL EXPERT.

(a) **RULES DEFINING “FINANCIAL EXPERT”.**— The Commission shall issue rules, as necessary or appropriate in the public interest and consistent with the protection of investors, to require each issuer, together with periodic reports required pursuant to sections 13(a) and 15(d) of the Securities Exchange Act of 1934, to disclose whether or not, and if not, the reasons therefor, the audit committee of that issuer is comprised of at least 1 member who is a financial expert, as such term is defined by the Commission.

(b) **CONSIDERATIONS.**— In defining the term “financial expert” for purposes of subsection (a), the Commission shall consider whether a person has, through education and experience as a public accountant or auditor or a principal financial officer, comptroller, or principal accounting officer of an issuer, or from a position involving the performance of similar functions—

- (1) an understanding of generally accepted accounting principles and financial statements;
- (2) experience in—
 - (A) the preparation or auditing of financial statements of generally comparable issuers; and

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(B) the application of such principles in connection with the accounting for estimates, accruals, and reserves;

(3) experience with internal accounting controls; and

(4) an understanding of audit committee functions.

(c) DEADLINE FOR RULEMAKING.— The Commission shall—

(1) propose rules to implement this section, not later than 90 days after the date of enactment of this Act; and

(2) issue final rules to implement this section, not later than 180 days after that date of enactment.

SEC. 408. ENHANCED REVIEW OF PERIODIC DISCLOSURES BY ISSUERS.

(a) REGULAR AND SYSTEMATIC REVIEW.— The Commission shall review disclosures made by issuers reporting under section 13(a) of the Securities Exchange Act of 1934 (including reports filed on Form 10-K), and which have a class of securities listed on a national securities exchange or traded on an automated quotation facility of a national securities association, on a regular and systematic basis for the protection of investors. Such review shall include a review of an issuer's financial statement.

(b) REVIEW CRITERIA.— For purposes of scheduling the reviews required by subsection (a), the Commission shall consider, among other factors—

(1) issuers that have issued material restatements of financial results;

(2) issuers that experience significant volatility in their stock price as compared to other issuers;

(3) issuers with the largest market capitalization;

(4) emerging companies with disparities in price to earning ratios;

(5) issuers whose operations significantly affect any material sector of the economy; and

(6) any other factors that the Commission may consider relevant.

(c) MINIMUM REVIEW PERIOD.— In no event shall an issuer required to file reports under section 13(a) or 15(d) of the Securities Exchange Act of 1934 be reviewed under this section less frequently than once every 3 years.

Appendix B

NEW YORK STOCK EXCHANGE REQUIREMENTS (Selected Sections)

303A.00

N.Y. STOCK EXCHANGE REQUIREMENTS

**NYSE
LISTED COMPANY MANUAL****303A.00 Corporate Governance Standards****303A.00 Introduction****General Application**

Companies listed on the Exchange must comply with certain standards regarding corporate governance as codified in this Section 303A. Consistent with the NYSE's traditional approach, as well as the requirements of the Sarbanes-Oxley Act of 2002, certain provisions of Section 303 A are applicable to some listed companies but not to others.

Equity Listings

Section 303A applies in full to all companies listing common equity securities, with the following exceptions:

Controlled Companies

A listed company of which more than 50% of the voting power is held by an individual, a group or another company need not comply with the requirements of Sections 303A.01, 303A.04 or 303A.05. A controlled company that chooses to take advantage of any or all of these exemptions must disclose that choice, that it is a controlled company and the basis for the determination in its annual proxy statement or, if the company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC. Controlled companies must comply with the remaining provisions of Section 303A.

Limited Partnerships and Companies in Bankruptcy

Due to their unique attributes, limited partnerships and companies in bankruptcy proceedings need not comply with the requirements of Sections 303A.01, 303A.04 or 303A.05. However, all limited partnerships (at the general partner level) and companies in bankruptcy proceedings must comply with the remaining provisions of Section 303 A.

Closed-End and Open-End Funds

The Exchange considers the significantly expanded standards and requirements provided for in Section 303A to be unnecessary for closed-end and open-end management investment companies that are registered under the Investment Company Act of 1940, given the pervasive federal regulation applicable to them. However, closed-end funds must comply with the requirements of Sections 303A.06, 303A.07(a) and 303A.07(c), and 303A.12. Note, however, that in view of the common practice to utilize the same directors for boards in the same fund complex, closed-end funds will not be required to comply with the disclosure requirement in the second paragraph of the Commentary to 303A.07(a), which calls for disclosure of a board's determination with respect to simultaneous service on more than three public company audit committees. However, the other provisions of that paragraph will apply.

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Business development companies, which are a type of closed-end management investment company defined in Section 2(a)(48) of the Investment Company Act of 1940 that are not registered under that Act, are required to comply with all of the provisions of Section 303 A applicable to domestic issuers other than Sections 303A.02 and 303A.07(b). For purposes of Sections 303A.01, 303A.03, 303A.04, 303A.05, and 303A.09, a director of a business development company shall be considered to be independent if he or she is not an “interested person” of the company, as defined in Section 2 (a)(19) of the Investment Company Act of 1940.

As required by Rule 10A-3 under the Exchange Act, open-end funds (which can be listed as Investment Company Units, more commonly known as Exchange Traded Funds or ETFs) are required to comply with the requirements of Sections 303A.06 and 303A.12(b) and (c).

Rule 10A-3(b)(3)(ii) under the Exchange Act requires that each audit committee must establish procedures for the confidential, anonymous submission by employees of the listed issuer of concerns regarding questionable accounting or auditing matters. In view of the external management structure often employed by closed-end and open-end funds, the Exchange also requires the audit committees of such companies to establish such procedures for the confidential, anonymous submission by employees of the investment adviser, administrator, principal underwriter, or any other provider of accounting related services for the management company, as well as employees of the management company. This responsibility must be addressed in the audit committee charter.

Other Entities

Except as otherwise required by Rule 10A-3 under the Exchange Act (for example, with respect to open-end funds), Section 303A does not apply to passive business organizations in the form of trusts (such as royalty trusts) or to derivatives and special purpose securities (such as those described in Sections 703.16, 703.19, 703.20 and 703.21). To the extent that Rule 10A-3 applies to a passive business organization, listed derivative or special purpose security, such entities are required to comply with Sections 303A.06 and 303A.12(b).

Foreign Private Issuers

Listed companies that are foreign private issuers (as such term is defined in Rule 3b-4 under the Exchange Act) are permitted to follow home country practice in lieu of the provisions of this Section 303A, except that such companies are required to comply with the requirements of Sections 303A.06, 303A.11 and 303A.12(b) and (c).

Preferred and Debt Listings

Section 303A does not generally apply to companies listing only preferred or debt securities on the Exchange. To the extent required by Rule 10A-3 under the Exchange Act, all companies listing only preferred or debt securities on the

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NYSE are required to comply with the requirements of Sections 303A.06 and 303A.12(b) and (c).

Effective Dates/Transition Periods

Except for Section 303A.08, which became effective June 30, 2003, listed companies will have until the earlier of their first annual meeting after January 15, 2004, or October 31, 2004, to comply with the new standards contained in Section 303A, although if a listed company with a classified board would be required (other than by virtue of a requirement under Section 303A.06) to change a director who would not normally stand for election in such annual meeting, the listed company may continue such director in office until the second annual meeting after such date, but no later than December 31, 2005. In addition, foreign private issuers will have until July 31, 2005 to comply with the new audit committee standards set out in Section 303A.06, and will not be required to provide the written affirmations required by Section 303A.12(c) until after that date. As a general matter, the existing audit committee requirements provided for in Section 303 continue to apply to listed companies pending the transition to the new rules. On November 3, 2004, the SEC approved a change to the Section 303A.02(b)(iii) bright line test for director independence relating to audit firms. Companies will have until their first annual meeting after June 30, 2005, to replace a director who was independent under the prior test but who is not independent under the current test.

Companies listing in conjunction with their initial public offering will be permitted to phase in their independent nomination and compensation committees on the same schedule as is permitted pursuant to Rule 10A-3 under the Exchange Act for audit committees, that is, one independent member at the time of listing, a majority of independent members within 90 days of listing and fully independent committees within one year. Such companies will be required to meet the majority independent board requirement within 12 months of listing. For purposes of Section 303 A other than Sections 303 A.06 and 303A.12(b), a company will be considered to be listing in conjunction with an initial public offering if, immediately prior to listing, it does not have a class of common stock registered under the Exchange Act. The Exchange will also permit companies that are emerging from bankruptcy or have ceased to be controlled companies within the meaning of Section 303A to phase in independent nomination and compensation committees and majority independent boards on the same schedule as companies listing in conjunction with an initial public offering. However, for purposes of Sections 303 A.06 and 303A.12(b), a company will be considered to be listing in conjunction with an initial public offering only if it meets the conditions of Rule 10A-3(b)(1)(iv)(A) under the Exchange Act, namely, that the company was not, immediately prior to the effective date of a registration statement, required to file reports with the SEC pursuant to Section 13(a) or 15(d) of the Exchange Act.

Companies listing upon transfer from another market have 12 months from the date of transfer in which to comply with any requirement to the extent the

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market on which they were listed did not have the same requirement. To the extent the other market has a substantially similar requirement but also had a transition period from the effective date of that market's rule, which period had not yet expired, the company will have the same transition period as would have been available to it on the other market. This transition period for companies transferring from another market will not apply to the requirements of Section 303A.06 unless a transition period is available pursuant to Rule 10A-3 under the Exchange Act.

References to Form 10-K

There are provisions in this Section 303A that call for disclosure in a listed company's Form 10-K under certain circumstances. If a listed company subject to such a provision is not a company required to file a Form 10-K, then the provision shall be interpreted to mean the annual periodic disclosure form that the listed company does file with the SEC. For example, for a closed-end management company, the appropriate form would be the annual Form N-CSR. If a listed company is not required to file either an annual proxy statement or an annual periodic report with the SEC, the disclosure shall be made in the annual report required under Section 203.01 of the NYSE Listed Company Manual.

303A.02 Independence Tests

In order to tighten the definition of "independent director" for purposes of these standards:

(a) No director qualifies as "independent" unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company). Companies must identify which directors are independent and disclose the basis for that determination.

Commentary: It is not possible to anticipate, or explicitly to provide for, all circumstances that might signal potential conflicts of interest, or that might bear on the materiality of a director's relationship to a listed company. Accordingly, it is best that boards making "independence" determinations broadly consider all relevant facts and circumstances. In particular, when assessing the materiality of a director's relationship with the listed company, the board should consider the issue not merely from the standpoint of the director, but also from that of persons or organizations with which the director has an affiliation. Material relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others. However, as the concern is independence from management, the Exchange does not view ownership of even a significant amount of stock, by itself, as a bar to an independence finding.

The identity of the independent directors and the basis for a board

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determination that a relationship is not material must be disclosed in the listed company's annual proxy statement or, if the company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC. In this regard, a board may adopt and disclose categorical standards to assist it in making determinations of independence and may make a general disclosure if a director meets these standards. Any determination of independence for a director who does not meet these standards must be specifically explained. A company must disclose any standard it adopts. It may then make the general statement that the independent directors meet the standards set by the board without detailing particular aspects of the immaterial relationships between individual directors and the company. In the event that a director with a business or other relationship that does not fit within the disclosed standards is determined to be independent, a board must disclose the basis for its determination in the manner described above. This approach provides investors with an adequate means of assessing the quality of a board's independence and its independence determinations while avoiding excessive disclosure of immaterial relationships.

(b) In addition, a director is not independent if:

(i) The director is, or has been within the last three years, an employee of the listed company, or an immediate family member is, or has been within the last three years, an executive officer,¹ of the listed company.

Commentary: Employment as an interim Chairman or CEO or other executive officer shall not disqualify a director from being considered independent following that employment.

(ii) The director has received, or has an immediate family member who has received, during any twelve-month period within the last three years, more than \$120,000 in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service).

Commentary: Compensation received by a director for former service as an interim Chairman or CEO or other executive officer need not be considered in determining independence under this test. Compensation received by an immediate family member for service as an employee of the listed company (other than an executive officer) need not be considered in determining independence under this test.

(iii) (A) The director is a current partner or employee of a firm that is the company's internal or external auditor; (B) the director has an immediate family member who is a current partner of such a firm; (C)

¹ For the purposes of Section 303A, the term executive officer has the same meaning specified for the term officer in Rule 16a-1(f) under the Securities Exchange Act of 1934.

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the director has an immediate family member who is a current employee of such a firm and personally works on the listed company's audit; or (D) the director or an immediate family member was within the last three years a partner or employee of such a firm and personally worked on the listed company's audit within that time.

(iv) The director or an immediate family member is, or has been with the last three years, employed as an executive officer of another company where any of the listed company's present executive officers at the same time serves or served on that company's compensation committee.

(v) The director is a current employee, or an immediate family member is a current executive officer, of a company that has made payments to, or received payments from, the listed company for property or services in an amount which, in any of the last three fiscal years, exceeds the greater of \$1 million, or 2% of such other company's consolidated gross revenues.

Commentary: In applying the test in Section 303A.02(b)(v), both the payments and the consolidated gross revenues to be measured shall be those reported in the last completed fiscal year of such other company. The look-back provision for this test applies solely to the financial relationship between the listed company and the director or immediate family member's current employer; a listed company need not consider former employment of the director or immediate family member.

Contributions to tax exempt organizations shall not be considered payments for purposes of Section 303 A.02(b)(v), provided however that a listed company shall disclose in its annual proxy statement, or if the listed company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC, any such contributions made by the listed company to any tax exempt organization in which any independent director serves as an executive officer if, within the preceding three years, contributions in any single fiscal year from the listed company to the organization exceeded the greater of \$1 million, or 2% of such tax exempt organization's consolidated gross revenues. Listed company boards are reminded of their obligations to consider the materiality of any such relationship in accordance with Section 303A.02(a) above.

General Commntary to Section 303A.02(b): An "immediate family member" includes a person's spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, and anyone (other than domestic employees) who shares such person's home. When applying the look-back provisions in Section 303A.02(b), listed companies need not consider individuals who are no longer immediate family members as a result of legal separation or divorce, or those who have died or become incapacitated.

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In addition, references to the “company” would include any parent or subsidiary in a consolidated group with the company.

Transition Rule. Each of the above standards contains a three-year “look-back” provision. In order to facilitate a smooth transition to the new independence standards, the Exchange will phase in the “look-back” provisions by applying only a one-year look-back for the first year after adoption of these new standards. The three-year look-backs provided for in Section 303A.02(b) will begin to apply only from and after November 4, 2004.

As an example, until November 3, 2004, a listed company need look back only one year when testing compensation under Section 303A.02(b)(ii). Beginning November 4, 2004, however, the listed company would need to look back the full three years provided in Section 303A.02(b)(ii).

303A.06 Audit Committee

Listed companies must have an audit committee that satisfies the requirements of Rule 10A-3 under the Exchange Act.

Commentary: The Exchange will apply the requirements of Rule 10A-3 in a manner consistent with the guidance provided by the Securities and Exchange Commission in SEC Release No. 34-47654 (April 1, 2003). Without limiting the generality of the foregoing, the Exchange will provide companies the opportunity to cure defects provided in Rule 10A-3(a)(3) under the Exchange Act.

303A.07 Audit Committee Additional Requirements

(a) The audit committee must have a minimum of three members.

Commentary: Each member of the audit committee must be financially literate, as such qualification is interpreted by the listed company’s board in its business judgment, or must become financially literate within a reasonable period of time after his or her appointment to the audit committee. In addition, at least one member of the audit committee must have accounting or related financial management expertise, as the listed company’s board interprets such qualification in its business judgment. While the Exchange does not require that a listed company’s audit committee include a person who satisfies the definition of audit committee financial expert set out in Item 401(h) of Regulation S-K, a board may presume that such a person has accounting or related financial management expertise.

Because of the audit committee’s demanding role and responsibilities, and the time commitment attendant to committee membership, each prospective audit committee member should evaluate carefully the existing demands on his or her time before accepting this important assignment. Additionally, if an audit committee member simultaneously serves on the audit committees of more than three public companies, and the listed company does not limit the number of

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audit committees on which its audit committee members serve to three or less, then in each case, the board must determine that such simultaneous service would not impair the ability of such member to effectively serve on the listed company's audit committee and disclose such determination in the listed company's annual proxy statement or, if the company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC.

(b) In addition to any requirement of Rule 10A-3(b)(1), all audit committee members must satisfy the requirements for independence set out in Section 303A.02.

(c) The audit committee must have a written charter that addresses:

(i) the committee's purpose - which, at minimum, must be to:

(A) assist board oversight of (1) the integrity of the listed company's financial statements, (2) the listed company's compliance with legal and regulatory requirements, (3) the independent auditor's qualifications and independence, and (4) the performance of the listed company's internal audit function and independent auditors; and

(B) prepare an audit committee report as required by the SEC to be included in the listed company's annual proxy statement;

(ii) an annual performance evaluation of the audit committee; and

(iii) the duties and responsibilities of the audit committee - which, at a minimum, must include those set out in Rule 10A-3(b)(2), (3), (4) and (5) of the Exchange Act, as well as to:

(A) at least annually, obtain and review a report by the independent auditor describing: the firm's internal quality-control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and (to assess the auditor's independence) all relationships between the independent auditor and the listed company;

Commentary: After reviewing the foregoing report and the independent auditor's work throughout the year, the audit committee will be in a position to evaluate the auditor's qualifications, performance and independence. This evaluation should include the review and evaluation of the lead partner of the independent auditor. In making its evaluation, the audit committee should take into account the opinions of management and the listed company's internal auditors (or other personnel responsible for the internal audit function). In addition to assuring the regular rotation of the lead audit partner as required by law, the audit committee should further

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consider whether, in order to assure continuing auditor independence, there should be regular rotation of the audit firm itself. The audit committee should present its conclusions with respect to the independent auditor to the full board.

(B) meet to review and discuss the listed company’s annual audited financial statements and quarterly financial statements with management and the independent auditor, including reviewing the company’s specific disclosures under “Management’s Discussion and Analysis of Financial Condition and Results of Operations”;

(C) discuss the listed company’s earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies;

Commentary: The audit committee’s responsibility to discuss earnings releases, as well as financial information and earnings guidance, may be done generally (i.e., discussion of the types of information to be disclosed and the type of presentation to be made). The audit committee need not discuss in advance each earnings release or each instance in which a listed company may provide earnings guidance.

(D) discuss policies with respect to risk assessment and risk management;

Commentary: While it is the job of the CEO and senior management to assess and manage the listed company’s exposure to risk, the audit committee must discuss guidelines and policies to govern the process by which this is handled. The audit committee should discuss the listed company’s major financial risk exposures and the steps management has taken to monitor and control such exposures. The audit committee is not required to be the sole body responsible for risk assessment and management, but, as stated above, the committee must discuss guidelines and policies to govern the process by which risk assessment and management is undertaken. Many companies, particularly financial companies, manage and assess their risk through mechanisms other than the audit committee. The processes these companies have in place should be reviewed in a general manner by the audit committee, but they need not be replaced by the audit committee.

(E) meet separately, periodically, with management, with internal auditors (or other personnel responsible for the internal audit function) and with independent auditors;

Commentary: To perform its oversight functions most effectively, the audit committee must have the benefit of separate sessions with management, the independent auditors and those responsible for the internal audit function. As noted herein, all listed companies must have an internal audit function. These separate sessions may be more productive than joint

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sessions in surfacing issues warranting committee attention.

(F) review with the independent auditor any audit problems or difficulties and management's response;

Commentary: The audit committee must regularly review with the independent auditor any difficulties the auditor encountered in the course of the audit work, including any restrictions on the scope of the independent auditor's activities or on access to requested information, and any significant disagreements with management. Among the items the audit committee may want to review with the auditor are: any accounting adjustments that were noted or proposed by the auditor but were "passed" (as immaterial or otherwise); any communications between the audit team and the audit firm's national office respecting auditing or accounting issues presented by the engagement; and any "management" or "internal control" letter issued, or proposed to be issued, by the audit firm to the listed company. The review should also include discussion of the responsibilities, budget and staffing of the listed company's internal audit function.

(G) set clear hiring policies for employees or former employees of the independent auditors; and

Commentary: Employees or former employees of the independent auditor are often valuable additions to corporate management. Such individuals' familiarity with the business, and personal rapport with the employees, may be attractive qualities when filling a key opening. However, the audit committee should set hiring policies taking into account the pressures that may exist for auditors consciously or subconsciously seeking a job with the company they audit.

(H) report regularly to the board of directors.

Commentary: The audit committee should review with the full board any issues that arise with respect to the quality or integrity of the listed company's financial statements, the company's compliance with legal or regulatory requirements, the performance and independence of the company's independent auditors, or the performance of the internal audit function.

General Commentary Section 303A.07(c): While the fundamental responsibility for the listed company's financial statements and disclosures rests with management and the independent auditor, the audit committee must review: (A) major issues regarding accounting principles and financial statement presentations, including any significant changes in the company's selection or application of accounting principles, and major issues as to the adequacy of the company's internal controls and any special audit steps adopted in light of material control deficiencies; (B) analyses prepared by management and/or the independent auditor setting forth significant financial reporting issues and judgments made in connection

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with the preparation of the financial statements, including analyses of the effects of alternative GAAP methods on the financial statements; (C) the effect of regulatory and accounting initiatives, as well as off-balance sheet structures, on the financial statements of the listed company; and (D) the type and presentation of information to be included in earnings press releases (paying particular attention to any use of “pro forma,” or “adjusted” non-GAAP, information), as well as review any financial information and earnings guidance provided to analysts and rating agencies.

(d) Each listed company must have an internal audit function.

Commentary: Listed companies must maintain an internal audit function to provide management and the audit committee with ongoing assessments of the company’s risk management processes and system of internal control. A listed company may choose to outsource this function to a third party service provider other than its independent auditor.

General Commentary to Section 303A.07: To avoid any confusion, note that the audit committee functions specified in Section 303A.07 are the sole responsibility of the audit committee and may not be allocated to a different committee.

303A.09 Corporate Governance Guidelines

Listed companies must adopt and disclose corporate governance guidelines.

Commentary: No single set of guidelines would be appropriate for every listed company, but certain key areas of universal importance include director qualifications and responsibilities, responsibilities of key board committees, and director compensation. Given the importance of corporate governance, each listed company’s website must include its corporate governance guidelines and the charters of its most important committees (including at least the audit, and if applicable, compensation and nominating committees). The listed company must state in its annual proxy statement or, if the company does not file an annual proxy statement, in the company’s annual report on Form 10-K filed with the SEC that the foregoing information is available on its website, and that the information is available in print to any shareholder who requests it. Making this information publicly available should promote better investor understanding of the listed company’s policies and procedures, as well as more conscientious adherence to them by directors and management.

The following subjects must be addressed in the corporate governance guidelines:

- **Director qualification standards.** These standards should, at minimum, reflect the independence requirements set forth in Sections 303A.01 and 303A.02. Companies may also address other substantive qualification requirements, including policies limiting the number of boards on which a director may sit, and director tenure, retirement and

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succession.

- **Director responsibilities.** These responsibilities should clearly articulate what is expected from a director, including basic duties and responsibilities with respect to attendance at board meetings and advance review of meeting materials.
- **Director access to management and, as necessary and appropriate, independent advisors.**
- **Director compensation.** Director compensation guidelines should include general principles for determining the form and amount of director compensation (and for reviewing those principles, as appropriate). The board should be aware that questions as to directors' independence may be raised when directors' fees and emoluments exceed what is customary. Similar concerns may be raised when the listed company makes substantial charitable contributions to organizations in which a director is affiliated, or enters into consulting contracts with (or provides other indirect forms of compensation to) a director. The board should critically evaluate each of these matters when determining the form and amount of director compensation, and the independence of a director.
- **Director orientation and continuing education.**
- **Management succession.** Succession planning should include policies and principles for CEO selection and performance review, as well as policies regarding succession in the event of an emergency or the retirement of the CEO.
- **Annual performance evaluation of the board.** The board should conduct a self- evaluation at least annually to determine whether it and its committees are functioning effectively.

303A.10 Code of Business Conduct and Ethics

Listed companies must adopt and disclose a code of business conduct and ethics for directors, officers and employees, and promptly disclose any waivers of the code for directors or executive officers.

Commentary: No code of business conduct and ethics can replace the thoughtful behavior of an ethical director, officer or employee. However, such a code can focus the board and management on areas of ethical risk, provide guidance to personnel to help them recognize and deal with ethical issues, provide mechanisms to report unethical conduct, and help to foster a culture of honesty and accountability.

Each code of business conduct and ethics must require that any waiver of the code for executive officers or directors may be made only by the board or a board committee and must be promptly disclosed to shareholders. This disclosure requirement should inhibit casual and perhaps questionable waivers, and should help assure that, when warranted, a waiver is accompanied by

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appropriate controls designed to protect the listed company. It will also give shareholders the opportunity to evaluate the board's performance in granting waivers.

Each code of business conduct and ethics must also contain compliance standards and procedures that will facilitate the effective operation of the code. These standards should ensure the prompt and consistent action against violations of the code. Each listed company's website must include its code of business conduct and ethics. The listed company must state in its annual proxy statement or, if the company does not file an annual proxy statement, in the company's annual report on Form 10-K, filed with the SEC, that the foregoing information is available on its website and that the information is available in print to any shareholder who requests it.

Each listed company may determine its own policies, but all listed companies should address the most important topics, including the following:

- **Conflicts of interest.** A "conflict of interest" occurs when an individual's private interest interferes in any way - or even appears to interfere - with the interests of the corporation as a whole. A conflict situation can arise when an employee, officer or director takes actions or has interests that may make it difficult to perform his or her company work objectively and effectively. Conflicts of interest also arise when an employee, officer or director, or a member of his or her family, receives improper personal benefits as a result of his or her position in the company. Loans to, or guarantees of obligations of, such persons are of special concern. The listed company should have a policy prohibiting such conflicts of interest, and providing a means for employees, officers and directors to communicate potential conflicts to the listed company.
- **Corporate opportunities.** Employees, officers and directors should be prohibited from (a) taking for themselves personally opportunities that are discovered through the use of corporate property, information or position; (b) using corporate property, information, or position for personal gain; and (c) competing with the company. Employees, officers and directors owe a duty to the company to advance its legitimate interests when the opportunity to do so arises.
- **Confidentiality.** Employees, officers and directors should maintain the confidentiality of information entrusted to them by the listed company or its customers, except when disclosure is authorized or legally mandated. Confidential information includes all non- public information that might be of use to competitors, or harmful to the company or its customers, if disclosed.
- **Fair dealing.** Each employee, officer and director should endeavor to deal fairly with the company's customers, suppliers, competitors and employees. None should take unfair advantage of anyone through

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manipulation, concealment, abuse of privileged information, misrepresentation of material facts, or any other unfair-dealing practice. Listed companies may write their codes in a manner that does not alter existing legal rights and obligations of companies and their employees, such as “at will” employment arrangements.

- **Protection and proper use of company assets.** All employees, officers and directors should protect the company’s assets and ensure their efficient use. Theft, carelessness and waste have a direct impact on the listed company’s profitability. All company assets should be used for legitimate business purposes.
- **Compliance with laws, rules and regulations (including insider trading laws).** The listed company should proactively promote compliance with laws, rules and regulations, including insider trading laws. Insider trading is both unethical and illegal, and should be dealt with decisively.
- **Encouraging the reporting of any illegal or unethical behavior.** The listed company should proactively promote ethical behavior. The company should encourage employees to talk to supervisors, managers or other appropriate personnel when in doubt about the best course of action in a particular situation. Additionally, employees should report violations of laws, rules, regulations or the code of business conduct to appropriate personnel. To encourage employees to report such violations, the listed company must ensure that employees know that the company will not allow retaliation for reports made in good faith.

303A.11 Foreign Private Issuer Disclosure

Listed foreign private issuers must disclose any significant ways in which their corporate governance practices differ from those followed by domestic companies under NYSE listing standards.

Commentary: Foreign private issuers must make their U.S. investors aware of the significant ways in which their corporate governance practices differ from those required of domestic companies under NYSE listing standards. However, foreign private issuers are not required to present a detailed, item-by-item analysis of these differences. Such a disclosure would be long and unnecessarily complicated. Moreover, this requirement is not intended to suggest that one country’s corporate governance practices are better or more effective than another. The Exchange believes that U.S. shareholders should be aware of the significant ways that the governance of a listed foreign private issuer differs from that of a U.S. listed company. The Exchange underscores that what is required is a brief, general summary of the significant differences, not a cumbersome analysis.

Listed foreign private issuers may provide this disclosure either on their web site (provided it is in the English language and accessible from the United

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States) and/or in their annual report as distributed to shareholders in the United States in accordance with Sections 103.00 and 203.01 of the Listed Company Manual (again, in the English language). If the disclosure is only made available on the web site, the annual report shall so state and provide the web address at which the information may be obtained.

303A.12 Certification Requirements

(a) Each listed company CEO must certify to the NYSE each year that he or she is not aware of any violation by the company of NYSE corporate governance listing standards, qualifying the certification to the extent necessary.

Commentary: The CEO's annual certification regarding the NYSE's corporate governance listing standards will focus the CEO and senior management on the listed company's compliance with the listing standards. Both this certification to the NYSE, including any qualifications to that certification, and any CEO/CFO certifications required to be filed with the SEC regarding the quality of the listed company's public disclosure, must be disclosed in the company's annual report to shareholders or, if the company does not prepare an annual report to shareholders, in the company's annual report on Form 10-K filed with the SEC.

(b) Each listed company CEO must promptly notify the NYSE in writing after any executive officer of the listed company becomes aware of any material non-compliance with any applicable provisions of this Section 303A.

(c) Each listed company must submit an executed Written Affirmation annually to the NYSE. In addition, each listed company must submit an interim Written Affirmation each time a change occurs to the board or any of the committees subject to Section 303A. The annual and interim Written Affirmations must be in the form specified by the NYSE.

303A.13 Public Reprimand Letter

The NYSE may issue a public reprimand letter to any listed company that violates a NYSE listing standard.

Commentary: Suspending trading in or delisting a listed company can be harmful to the very shareholders that the NYSE listing standards seek to protect; the NYSE must therefore use these measures sparingly and judiciously. For this reason it is appropriate for the NYSE to have the ability to apply a lesser sanction to deter companies from violating its corporate governance (or other) listing standards. Accordingly, the NYSE may issue a public reprimand letter to any listed company, regardless of type of security listed or country of incorporation, that it determines has violated a NYSE listing standard. For companies that repeatedly or flagrantly violate NYSE listing standards, suspension and delisting remain the ultimate penalties. For clarification, this lesser sanction is not intended for use in the case of companies that fall below

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the financial and other continued listing standards provided in Chapter 8 of the Listed Company Manual or that fail to comply with the audit committee standards set out in Section 303A.06. The processes and procedures provided for in Chapter 8 govern the treatment of companies falling below those standards.

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Appendix C

NASDAQ RULES (Selected Rules)

4200.

NASDAQ RULES

4200. Definitions

(a) For purposes of the Rule 4000 Series, unless the context requires otherwise:

(1) “Act” means the Securities Exchange Act of 1934.

(2) “Best efforts offering” means an offering of securities by members of a selling group under an agreement which imposes no financial commitment on the members of such group to purchase any such securities except as they may elect to do so.

(3) “Cash flow” means cash funds provided from limited partnership operations, including lease payments on net leases from builders and sellers, without deduction for depreciation, but after deducting cash funds used to pay all other expenses, debt payments, capital improvements and replacements.

(4) “Consolidated Quotations Service” (CQS) means the consolidated quotation collection system for securities listed on an exchange other than Nasdaq implementing SEC Rule 602.

(5) “Country of Domicile” means the country under whose laws an issuer is organized or incorporated.

(6) “Covered security” means a security described in Section 18(b) of the Securities Act of 1933.

(7) Reserved

(8) Reserved

(9) Reserved

(10) “Direct Registration Program” means any program by an issuer, directly or through its transfer agent, whereby a shareholder may have securities registered in the shareholder’s name on the books of the issuer or its transfer agent without the need for a physical certificate to evidence ownership.

(11) “Dissenting Limited Partner” means a person who, on the date on which soliciting material is mailed to investors, is a holder of a beneficial interest in a limited partnership that is the subject of a limited partnership rollup transaction, and who casts a vote against the transaction and complies with procedures established by Nasdaq, except that for purposes of an exchange or tender offer, such person shall file an objection in writing under the rules of Nasdaq during the period in which the offer is outstanding. Such objection in writing shall be filed with the party responsible for tabulating the votes or tenders.

(12) “ESOP” means employee stock option plan.

(13) “Firm commitment offering” means an offering of securities by

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participants in a selling syndicate under an agreement that imposes a financial commitment on participants in such syndicate to purchase such securities.

(14) “Family Member” means a person’s spouse, parents, children and siblings, whether by blood, marriage or adoption, or anyone residing in such person’s home.

(15) “Independent director” means a person other than an executive officer or employee of the company or any other individual having a relationship which, in the opinion of the issuer’s board of directors, would interfere with the exercise of independent judgement in carrying out the responsibilities of a director. The following persons shall not be considered independent:

(A) a director who is, or at any time during the past three years was, employed by the company;

(B) a director who accepted or who has a Family Member who accepted any compensation from the company in excess of \$120,000 during any period of twelve consecutive months within the three years preceding the determination of independence, other than the following:

(i) compensation for board or board committee service;

(ii) compensation paid to a Family Member who is an employee (other than an executive officer) of the company; or

(iii) benefits under a tax-qualified retirement plan, or non-discretionary compensation,

Provided, however, that in addition to the requirements contained in this paragraph (B), audit committee members are also subject to additional, more stringent requirements under Rule 4350(d).

(C) a director who is a Family Member of an individual who is, or at any time during the past three years was, employed by the company as an executive officer;

(D) a director who is, or has a Family Member who is, a partner in, or a controlling shareholder or an executive officer of, any organization to which the company made, or from which the company received, payments for property or services in the current or any of the past three fiscal years that exceed 5% of the recipient’s consolidated gross revenues for that year, or \$200,000, whichever is more, other than the following:

(i) payments arising solely from investments in the company’s securities; or

(ii) payments under non-discretionary charitable contribution matching programs.

(E) a director of the issuer who is, or has a Family Member who is, employed as an executive officer of another entity where at any time during

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the past three years any of the executive officers of the issuer serve on the compensation committee of such other entity; or

(F) a director who is, or has a Family Member who is, a current partner of the company's outside auditor, or was a partner or employee of the company's outside auditor who worked on the company's audit at any time during any of the past three years.

(G) in the case of an investment company, in lieu of paragraphs (A)-(F), a director who is an "interested person" of the company as defined in Section 2(a)(19) of the Investment Company Act of 1940, other than in his or her capacity as a member of the board of directors or any board committee.

(16) "Index warrants" means instruments that are direct obligations of the issuing company, either exercisable throughout their life (i.e., American style) or exercisable only on their expiration (i.e., European style), entitling the holder to a cash settlement in U.S. dollars to the extent that the index has declined below (for a put warrant) or increased above (for a call warrant) the pre-stated cash settlement value of the index. Index warrants may be based on either foreign or domestic indexes.

(17) "Limited partner" or "investor in a limited partnership" means the purchaser of an interest in a direct participation program, as defined in Nasdaq Rule 2810, that is a limited partnership who is not involved in the day-to-day management of the limited partnership and bears limited liability.

(18) "Limited partnership" means an unincorporated association that is a direct participation program, as defined in Nasdaq Rule 2810, organized as a limited partnership whose partners are one or more general partners and one or more limited partners, which conforms to the provisions of the Revised Uniform Limited Partnership Act or the applicable statute that regulates the organization of such partnership.

(19) "Limited Partnership Rollup Transaction" means a transaction involving the combination or reorganization of one or more limited partnerships, directly or indirectly, in which:

(A) some or all of the investors in any of such limited partnerships will receive new securities, or securities in another entity, that will be reported under a transaction reporting plan declared effective before January 1, 1991, by the Commission under Section 11A of the Act¹;

(B) any of the investors' limited partnership securities are not, as of the date of the filing, reported under a transaction reporting plan declared effective before January 1, 1991, by the Commission under Section 11A of the Act;

¹ Transaction reporting plans under Section 11A were declared effective prior to January 1, 1991 for the Nasdaq National Market, the New York Stock Exchange, and the American Stock Exchange.

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(C) investors in any of the limited partnerships involved are subject to a significant adverse change with respect to voting rights, the term of existence of the entity, management compensation, or investment objectives; and

(D) any of such investors are not provided an option to receive or retain a security under substantially the same terms and conditions as the original issue. Notwithstanding the foregoing definition, a “limited partnership rollup transaction” does not include:

(i) a transaction that involves only a limited partnership or partnerships having an operating policy or practice of retaining cash available for distribution and reinvesting proceeds from the sale, financing, or refinancing of assets in accordance with such criteria as the Commission determines appropriate;

(ii) a transaction involving only limited partnerships wherein the interests of the limited partners are repurchased, recalled or exchanged pursuant to the terms of the pre-existing limited partnership agreements for securities in an operating company specifically identified at the time of the formation of the original limited partnership;

(iii) a transaction in which the securities to be issued or exchanged are not required to be and are not registered under the Securities Act of 1933;

(iv) a transaction that involves only issuers that are not required to register or report under Section 12 of the Act, both before and after the transaction;

(v) a transaction, except as the Commission may otherwise provide for by rule for the protection of investors, involving the combination or reorganization of one or more limited partnerships in which a non-affiliated party succeeds to the interests of the general partner or sponsor, if:

a. such action is approved by not less than 66-2/3 percent of the outstanding units of each of the participating limited partnerships; and

b. as a result of the transaction, the existing general partners will receive only compensation to which they are entitled as expressly provided for in the pre-existing partnership agreements; or

(vi) a transaction, except as the Commission may otherwise provide for by rule for the protection of investors, in which the securities offered to investors are securities of another entity that are reported under a transaction reporting plan declared effective before January 1, 1991, by the Commission under Section 11A of the Act²; if:

² Transaction reporting plans under Section 11A were declared effective prior to January 1, 1991 for the Nasdaq National Market, the New York Stock Exchange, and the American Stock Exchange.

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a. such other entity was formed, and such class of securities was reported and regularly traded, not less than 12 months before the date on which soliciting material is mailed to investors; and

b. the securities of that entity issued to investors in the transaction do not exceed 20 percent of the total outstanding securities of the entity, exclusive of any securities of such class held by or for the account of the entity or subsidiary of the entity.

(vii) a transaction involving only entities registered under the Investment Company Act of 1940 or any Business Development Company as defined in Section 2(a)(48) of that Act.

(20) “Listed securities” means securities listed on Nasdaq or another national securities exchange.

(21) “Management fee” means a fee paid to the sponsor, general partner (s), their affiliates, or other persons for management and administration of a limited partnership.

(22) “Market Value” means the closing bid price multiplied by the measure to be valued (e.g., an issuer’s market value of public float is equal to the closing bid price multiplied by an issuer’s public float).

(23) “Member” means a broker or dealer admitted to membership in Nasdaq.

(24) “Nasdaq market maker” means a dealer that, with respect to a security, holds itself out (by entering quotations in the Nasdaq Market Center) as being willing to buy and sell such security for its own account on a regular and continuous basis and that is registered as such.

(25) “Nasdaq Global Market” or “NGM” is a distinct tier of Nasdaq comprised of two segments: the Nasdaq Global Market and the Nasdaq Global Select Market. The Nasdaq Global Market is the successor to the Nasdaq National Market.

(26) “Nasdaq Global Market security” or “NGM security” means any security listed on Nasdaq which (1) satisfies all applicable requirements of the Rule 4300 Series and substantially meets the criteria set forth in the Rule 4400 Series; (2) is a right to purchase such security; (3) is a warrant to subscribe to such security; or (4) is an index warrant which substantially meets the criteria set forth in Rule 4420.

(27) “The Nasdaq Capital Market” is a distinct tier of Nasdaq comprised of securities that meet the requirements of and are listed as Nasdaq Capital Market securities.

(28) “Nasdaq Capital Market security” means any security listed on The Nasdaq Capital Market which (1) satisfies all applicable requirements of the Rule 4300 Series but that is not a Nasdaq Global Market security; (2) is a right to purchase such security; or (3) is a warrant to subscribe to such security.

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(29) “Nasdaq Global Select Market” or “NGSM” is a segment of the Nasdaq Global Market comprised of NGM securities that met the requirements for initial inclusion contained in Rules 4425, 4426 and 4427.

(30) “Nasdaq Global Select Market security” or “NGSM security” means any security listed on Nasdaq and included in the Nasdaq Global Select segment of the Nasdaq Global Market.

(31) “Normal unit of trading” means 100 shares of a security unless, with respect to a particular security, Nasdaq determines that a normal unit of trading shall constitute other than 100 shares. If a normal unit of trading is other than 100 shares, a special identifier shall be appended to the issuer’s Nasdaq symbol.

(32) “Public holders” of a security include both beneficial holders and holders of record, but does not include any holder who is, either directly or indirectly, an executive officer, director, or the beneficial holder of more than 10% of the total shares outstanding.

(33) “Round lot holder” means a holder of a normal unit of trading. The number of beneficial holders will be considered in addition to holders of record.

(34) “SEC Rule 100,” “SEC Rule 101,” “SEC Rule 103,” and “SEC Rule 104” means the rules adopted by the Commission under Regulation M, and any amendments thereto.

(35) “Solicitation expenses” means direct marketing expenses incurred by a member in connection with a limited partnership rollup transaction, such as telephone calls, broker/dealer fact sheets, members’ legal and other fees related to the solicitation, as well as direct solicitation compensation to members.

(36) “Stabilizing bid” means the terms “stabilizing” or to “stabilize” as defined in SEC Rule 100.

(37) “Substitution Listing Event” means a reverse stock split, re- incorporation or a change in the issuer’s place of organization, the formation of a holding company that replaces a listed company, reclassification or exchange of an issuer’s listed shares for another security, the listing of a new class of securities in substitution for a previously-listed class of securities, or any technical change whereby the shareholders of the original company receive a share-for-share interest in the new company without any change in their equity position or rights.

(38) “Total holders” of a security include both beneficial holders and holders of record.

(39) “Transaction costs” means costs incurred in connection with a limited partnership rollup transaction, including printing and mailing the proxy, prospectus or other documents; legal fees not related to the solicitation of votes or tenders; financial advisory fees; investment banking fees; appraisal fees; accounting fees; independent committee expenses; travel expenses; and all

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other fees related to the preparatory work of the transaction, but not including costs that would have otherwise been incurred by the subject limited partnerships in the ordinary course of business or solicitation expenses.

(40) “Underwriting Activity Report” is a report provided by the Corporate Financing Department of FINRA in connection with a distribution of securities subject to SEC Rule 101 pursuant to NASD Rule 2710(b)(11) and includes forms that are submitted by members to comply with their notification obligations under Rules 4614, 4619, and 4623.

(b) For purposes of Rules 4614, 4619, and 4623, the following terms shall have the meanings as defined in SEC Rule 100: “affiliated purchaser,” “distribution,” “distribution participant,” “independent bid,” “net purchases,” “passive market maker,” “penalty bid,” “reference security,” “restricted period,” “subject security,” and “syndicate covering transaction.”

(c) All forms and applications relating to listing of securities on Nasdaq referenced in the Rule 4000 Series are available on www.nasdaq.com.

Adopted by SEC Release 34-53128 (Jan. 13, 2006); Amended by SR- NASDAQ-2006-007 eff. May 8, 2006; amended by SR-NASDAQ-2006-021 eff. Oct. 6, 2006; amended by SR-NASDAQ-2006-041 eff. Mar. 13, 2007; amended by SR-NASDAQ-2006-032 eff. Apr 18, 2007; amended by SR-NASDAQ-2008-037 eff. June 17, 2008; amended by SR-NASDAQ-2008- 054 eff. June 13, 2008; amended by SR-NASDAQ-2008-053 eff. August 8, 2008.

4350. Qualitative Listing Requirements for Nasdaq Issuers Except for Limited Partnerships**(a) Applicability**

(1) Foreign Private Issuers. A foreign private issuer may follow its home country practice in lieu of the requirements of Rule 4350, provided, however, that such an issuer shall: comply with Rules 4350(b)(1)(B), 4350(j) and 4350(m), have an audit committee that satisfies Rule 4350 (d)(3), and ensure that such audit committee’s members meet the independence requirement in Rule 4350(d)(2)(A)(ii). In addition, a foreign private issuer must be eligible to participate in a Direct Registration Program, as required by Rule 4350(1), unless prohibited from complying by a law or regulation in its home country. A foreign private issuer that follows a home country practice in lieu of one or more provisions of Rule 4350 shall disclose in its annual reports filed with the Commission or on its website each requirement of Rule 4350 that it does not follow and describe the home country practice followed by the issuer in lieu of such requirements. In addition, a foreign private issuer making its initial public offering or first U.S. listing on Nasdaq shall make the same disclosures in its registration statement or on its website.

(2) Management Investment Companies. Management investment companies (including business development companies) are subject to all the requirements of Rule 4350, except that management investment companies

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registered under the Investment Company Act of 1940 are exempt from the requirements of Rule 4350(c) and (n).

(3) Asset-backed Issuers and Other Passive Issuers. The following are exempt from the requirements of Rule 4350(c), (d) and (n): (a) asset-backed issuers; and (b) issuers, such as unit investment trusts, that are organized as trusts or other unincorporated associations that do not have a board of directors or persons acting in a similar capacity and whose activities are limited to passively owning or holding (as well as administering and distributing amounts in respect of) securities, rights, collateral or other assets on behalf of or for the benefit of the holders of the listed securities.

(4) Cooperatives. Cooperative entities, such as agricultural cooperatives, that are structured to comply with relevant state law and federal tax law and that do not have a publicly traded class of common stock are exempt from Rule 4350(c). However, such entities must comply with all federal securities laws, including without limitation those rules required by Section 10A(m) of the Act and Rule 10A-3 thereunder.

(5) Phase-in Periods.

A company listing in connection with its initial public offering shall be permitted to phase in its compliance with the independent committee requirements set forth in Rule 4350(c) on the same schedule as it is permitted to phase in its compliance with the independent audit committee requirement pursuant to SEC Rule 10A-3(b)(1)(iv)(A). Accordingly, a company listing in connection with its initial public offering shall be permitted to phase in its compliance with the independent committee requirements set forth in Rule 4350(c) as follows: (1) one independent member at the time of listing; (2) a majority of independent members within 90 days of listing; and (3) all independent members within one year of listing. Furthermore, a company listing in connection with its initial public offering shall have twelve months from the date of listing to comply with the majority independent board requirement in Rule 4350(c). It should be noted, however, that pursuant to SEC Rule 10A-3(b)(1)(iii) investment companies are not afforded the exemptions under SEC Rule 10A-3(b)(1)(iv). Issuers may choose not to adopt a compensation or nomination committee and may instead rely upon a majority of the independent directors to discharge responsibilities under Rule 4350(c). For purposes of Rule 4350 other than Rule 4350(d)(2)(A) (ii) and Rule 4350(m), a company shall be considered to be listing in conjunction with an initial public offering if, immediately prior to listing, it does not have a class of common stock registered under the Act. For purposes of Rule 4350(d)(2)(A)(ii) and Rule 4350(m), a company shall be considered to be listing in conjunction with an initial public offering only if it meets the conditions in SEC Rule 10A-3(b)(1)(iv)(A) under the Act, namely, that the company was not, immediately prior to the effective date of a registration statement, required to file reports with the Commission pursuant to Section 13(a) or 15(d) of the Act.

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Companies that are emerging from bankruptcy or have ceased to be Controlled Companies within the meaning of Rule 4350(c)(5) shall be permitted to phase-in independent nomination and compensation committees and majority independent boards on the same schedule as companies listing in conjunction with their initial public offering. It should be noted, however, that a company that has ceased to be a Controlled Company within the meaning of Rule 4350(c)(5) must comply with the audit committee requirements of Rule 4350(d) as of the date it ceased to be a Controlled Company. Furthermore, the executive sessions requirement of Rule 4350(c)(2) applies to Controlled Companies as of the date of listing and continues to apply after it ceases to be controlled.

Companies transferring from other markets with a substantially similar requirement shall be afforded the balance of any grace period afforded by the other market. Companies transferring from other listed markets that do not have a substantially similar requirement shall be afforded one year from the date of listing on Nasdaq. This transition period is not intended to supplant any applicable requirements of Rule 10A-3 under the Act.

(b) Distribution of Annual and Interim Reports

(1) (A) Each issuer shall make available to shareholders of such securities an annual report containing audited financial statements of the company and its subsidiaries, which may be on Form 10-K, 20-F, 40-F or N-CSR. An issuer may comply with this requirement either:

(i) by mailing the report to shareholders; or

(ii) by satisfying the requirements for furnishing an annual report contained in Exchange Act Rule 14a-16; or

(iii) by posting the annual report to shareholders on or through the company's website (or, in the case of an issuer that is an investment company that does not maintain its own website, on a website that the company is allowed to use to satisfy the website posting requirement in Exchange Act Rule 16a-3(k)), along with a prominent undertaking in the English language to provide shareholders, upon request, a hard copy of the company's annual report free of charge. An issuer that chooses to satisfy this requirement pursuant to this paragraph (iii) must, simultaneous with this posting, issue a press release stating that its annual report has been filed with the Commission (or other appropriate regulatory authority). This press release must also state that the annual report is available on the company's website and include the website address and that shareholders may receive a hard copy free of charge upon request. An issuer must provide such hard copies within a reasonable period of time following the request.

(B) An issuer that receives an audit opinion that expresses doubt about the ability of the company to continue as a going concern for a reasonable period

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of time must make a public announcement through the news media disclosing the receipt of such opinion. Prior to the release of the public announcement, the issuer must provide the text of the public announcement to the StockWatch section of Nasdaq's MarketWatch Department ("Nasdaq StockWatch"). The public announcement shall be provided to Nasdaq StockWatch and released to the media not later than seven calendar days following the filing of such audit opinion in a public filing with the Securities and Exchange Commission.

(2) Each issuer which is subject to SEC Rule 13a-13 shall make available copies of quarterly reports including statements of operating results to shareholders either prior to or as soon as practicable following the company's filing of its Form 10-Q with the Commission. If the form of such quarterly report differs from the Form 10-Q, the issuer shall file one copy of the report with Nasdaq in addition to filing its Form 10-Q pursuant to Rule 4310(c)(14). The statement of operations contained in quarterly reports shall disclose, as a minimum, any substantial items of an unusual or nonrecurrent nature and net income before and after estimated federal income taxes or net income and the amount of estimated federal taxes.

(3) Each issuer which is not subject to SEC Rule 13a-13 and which is required to file with the Commission, or another federal or state regulatory authority, interim reports relating primarily to operations and financial position, shall make available to shareholders reports which reflect the information contained in those interim reports. Such reports shall be made available to shareholders either before or as soon as practicable following filing with the appropriate regulatory authority. If the form of the interim report provided to shareholders differs from that filed with the regulatory authority, the issuer shall file one copy of the report to shareholders with Nasdaq in addition to the report to the regulatory authority that is filed with Nasdaq pursuant to Rule 4310(c)(14).

(4) Each foreign private issuer shall publish, in a press release, which would also be submitted on a Form 6-K, an interim balance sheet and income statement as of the end of its second quarter. This information, which must be presented in English but does not have to be reconciled to U.S. GAAP, must be provided not later than six months following the end of the issuer's second quarter.

(c) Independent Directors

(1) A majority of the board of directors must be comprised of independent directors as defined in Rule 4200. The company must disclose in its annual proxy (or, if the issuer does not file a proxy, in its Form 10-K or 20-F) those directors that the board of directors has determined to be independent under Rule 4200. If an issuer fails to comply with this requirement due to one vacancy, or one director ceases to be independent due to circumstances beyond

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their reasonable control, the issuer shall regain compliance with the requirement by the earlier of its next annual shareholders meeting or one year from the occurrence of the event that caused the failure to comply with this requirement. provided, however, that if the annual shareholders meeting occurs no later than 180 days following the event that caused the failure to comply with this requirement, the issuer shall instead have 180 days from such event to regain compliance. An issuer relying on this provision shall provide notice to Nasdaq immediately upon learning of the event or circumstance that caused the non-compliance.

(2) Independent directors must have regularly scheduled meetings at which only independent directors are present (“executive sessions”).

(3) Compensation of Officers

(A) Compensation of the chief executive officer of the company must be determined, or recommended to the Board for determination, either by;

(i) a majority of the independent directors, or

(ii) a compensation committee comprised solely of independent directors.

The chief executive officer may not be present during voting or deliberations.

(B) Compensation of all other executive officers must be determined, or recommended to the Board for determination, either by:

(i) a majority of the independent directors, or

(ii) a compensation committee comprised solely of independent directors.

(C) Notwithstanding paragraphs (3)(A)(ii) and (3)(B)(ii) above, if the compensation committee is comprised of at least three members, one director who is not independent as defined in Rule 4200 and is not a current officer or employee or a Family Member of an officer or employee, may be appointed to the compensation committee if the board, under exceptional and limited circumstances, determines that such individual’s membership on the committee is required by the best interests of the company and its shareholders, and the board discloses, in the proxy statement for the next annual meeting subsequent to such determination (or, if the issuer does not file a proxy, in its Form 10-K or 20-F), the nature of the relationship and the reasons for the determination. A member appointed under this exception may not serve longer than two years.

(4) Nomination of Directors

(A) Director nominees must either be selected, or recommended for the Board’s selection, either by:

(i) a majority of the independent directors, or

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(ii) a nominations committee comprised solely of independent directors.

(B) Each issuer must certify that it has adopted a formal written charter or board resolution, as applicable, addressing the nominations process and such related matters as may be required under the federal securities laws.

(C) Notwithstanding paragraph (4)(A)(ii) above, if the nominations committee is comprised of at least three members, one director, who is not independent as defined in Rule 4200 and is not a current officer or employee or a Family Member of an officer or employee, may be appointed to the nominations committee if the board, under exceptional and limited circumstances, determines that such individual's membership on the committee is required by the best interests of the company and its shareholders, and the board discloses, in the proxy statement for next annual meeting subsequent to such determination (or, if the issuer does not file a proxy, in its Form 10-K or 20-F), the nature of the relationship and the reasons for the determination. A member appointed under this exception may not serve longer than two years.

(D) Independent director oversight of director nominations shall not apply in cases where the right to nominate a director legally belongs to a third party. However, this does not relieve a company's obligation to comply with the committee composition requirements under Rule 4350(c) and (d).

(E) This Rule 4350(c)(4) is not applicable to a company if the company is subject to a binding obligation that requires a director nomination structure inconsistent with this rule and such obligation pre-dates the approval date of this rule.

(5) A Controlled Company is exempt from the requirements of this Rule 4350(c), except for the requirements of subsection (c)(2) which pertain to executive sessions of independent directors. A Controlled Company is a company of which more than 50% of the voting power for the election of directors is held by an individual, a group or another company. A Controlled Company relying upon this exemption must disclose in its annual meeting proxy statement (or, if the issuer does not file a proxy, in its Form 10-K or 20-F) that it is a Controlled Company and the basis for that determination.

(d) Audit Committee

(1) Audit Committee Charter

Each Issuer must certify that it has adopted a formal written audit committee charter and that the audit committee has reviewed and reassessed the adequacy of the formal written charter on an annual basis. The charter must specify:

(A) the scope of the audit committee's responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements;

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(B) the audit committee's responsibility for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the company, consistent with Independence Standards Board Standard 1, and the audit committee's responsibility for actively engaging in a dialogue with the auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the auditor and for taking, or recommending that the full board take, appropriate action to oversee the independence of the outside auditor; and

(C) the committee's purpose of overseeing the accounting and financial reporting processes of the issuer and the audits of the financial statements of the issuer;

(D) the specific audit committee responsibilities and authority set forth in Rule 4350(d)(3).

(2) Audit Committee Composition

(A) Each issuer must have, and certify that it has and will continue to have, an audit committee of at least three members, each of whom must: (i) be independent as defined under Rule 4200(a)(15); (ii) meet the criteria for independence set forth in Rule 10A-3(b)(1) under the Act (subject to the exemptions provided in Rule 10A-3(c)); (iii) not have participated in the preparation of the financial statements of the company or any current subsidiary of the company at any time during the past three years; and (iv) be able to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement. Additionally, each issuer must certify that it has, and will continue to have, at least one member of the audit committee who has past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.

(B) Notwithstanding paragraph (2)(A)(i), one director who: (i) is not independent as defined in Rule 4200; (ii) meets the criteria set forth in Section 10A(m)(3) under the Act and the rules thereunder; and (iii) is not a current officer or employee or a Family Member of such officer or employee, may be appointed to the audit committee, if the board, under exceptional and limited circumstances, determines that membership on the committee by the individual is required by the best interests of the company and its shareholders, and the board discloses, in the next annual proxy statement subsequent to such determination (or, if the issuer does not file a proxy, in its Form 10-K or 20-F), the nature of the relationship and the reasons for that determination. A member appointed under this exception may not serve longer than two years and may not chair the audit committee.

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(3) Audit Committee Responsibilities and Authority

The audit committee must have the specific audit committee responsibilities and authority necessary to comply with Rule 10A-3(b)(2), (3), (4) and (5) under the Act (subject to the exemptions provided in Rule 10A-3(c)), concerning responsibilities relating to: (i) registered public accounting firms, (ii) complaints relating to accounting, internal accounting controls or auditing matters, (iii) authority to engage advisors, and (iv) funding as determined by the audit committee. Audit committees for investment companies must also establish procedures for the confidential, anonymous submission of concerns regarding questionable accounting or auditing matters by employees of the investment adviser, administrator, principal underwriter, or any other provider of accounting related services for the investment company, as well as employees of the investment company.

(4) Cure Periods

(A) If an issuer fails to comply with the audit committee composition requirement under Rule 10A-3(b)(1) under the Act and Rule 4350(d)(2) because an audit committee member ceases to be independent for reasons outside the member's reasonable control, the audit committee member may remain on the audit committee until the earlier of its next annual shareholders meeting or one year from the occurrence of the event that caused the failure to comply with this requirement. An issuer relying on this provision must provide notice to Nasdaq immediately upon learning of the event or circumstance that caused the non-compliance.

(B) If an issuer fails to comply with the audit committee composition requirement under Rule 4350(d)(2)(A) due to one vacancy on the audit committee, and the cure period in paragraph (A) is not otherwise being relied upon for another member, the issuer will have until the earlier of the next annual shareholders meeting or one year from the occurrence of the event that caused the failure to comply with this requirement; provided, however, that if the annual shareholders meeting occurs no later than 180 days following the event that caused the vacancy, the issuer shall instead have 180 days from such event to regain compliance. An issuer relying on this provision must provide notice to Nasdaq immediately upon learning of the event or circumstance that caused the non-compliance.

(5) Exception

At any time when an issuer has a class of common equity securities (or similar securities') that is listed on another national securities exchange or national securities association subject to the requirements of SEC Rule 10A-3 under the Act, the listing of classes of securities of a direct or indirect consolidated subsidiary or an at least 50% beneficially owned subsidiary of the issuer (except classes of equity securities, other than non-convertible, non-participating preferred securities, of such subsidiary) shall not be subject

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to the requirements of this paragraph (d).

(e) Shareholder Meetings

Each issuer listing common stock or voting preferred stock, and their equivalents, shall hold an annual meeting of shareholders no later than one year after the end of the issuer's fiscal year-end.

(f) Quorum

Each issuer shall provide for a quorum as specified in its by-laws for any meeting of the holders of common stock; provided, however, that in no case shall such quorum be less than 33 1/3 % of the outstanding shares of the company's common voting stock.

(g) Solicitation of Proxies

Each issuer shall solicit proxies and provide proxy statements for all meetings of shareholders and shall provide copies of such proxy solicitation to Nasdaq.

(h) Conflicts of Interest

Each issuer shall conduct appropriate review and oversight of all related party transactions for potential conflict of interest situations on an ongoing basis by the company's audit committee or another independent body of the board of directors. For purposes of this rule, the term "related party transaction" shall refer to transactions required to be disclosed pursuant to SEC Regulation S-K, Item 404. However, in the case of small business issuers (as that term is defined in SEC Rule 12b- 2), the term "related party transactions" shall refer to transactions required to be disclosed pursuant to SEC Regulation S-B, Item 404, and in the case of non-U.S. issuers, the term "related party transactions" shall refer to transactions required to be disclosed pursuant to Form 20- F, Item 7.B.

(i) Shareholder Approval

(1) Each issuer shall require shareholder approval or prior to the issuance of securities under subparagraph (A), (B), (C), or (D) below:

(A) when a stock option or purchase plan is to be established or materially amended or other equity compensation arrangement made or materially amended, pursuant to which stock may be acquired by officers, directors, employees, or consultants, except for:

(i) warrants or rights issued generally to all security holders of the company or stock purchase plans available on equal terms to all security holders of the company (such as a typical dividend reinvestment plan); or

(ii) tax qualified, non-discriminatory employee benefit plans (e.g., plans that meet the requirements of Section 401(a) or 423 of the Internal Revenue Code) or parallel nonqualified plans, provided such plans are approved by the issuer's independent compensation committee or a

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majority of the issuer's independent directors; or plans that merely provide a convenient way to purchase shares on the open market or from the issuer at fair market value; or

(iii) plans or arrangements relating to an acquisition or merger as permitted under IM-4350-5; or

(iv) issuances to a person not previously an employee or director of the company, or following a bona fide period of non-employment, as an inducement material to the individual's entering into employment with the company, provided such issuances are approved by either the issuer's independent compensation committee or a majority of the issuer's independent directors. Promptly following an issuance of any employment inducement grant in reliance on this exception, a company must disclose in a press release the material terms of the grant, including the recipient(s) of the grant and the number of shares involved.

(B) when the issuance or potential issuance will result in a change of control of the issuer;

(C) in connection with the acquisition of the stock or assets of another company if:

(i) any director, officer or substantial shareholder of the issuer has a 5% or greater interest (or such persons collectively have a 10% or greater interest), directly or indirectly, in the company or assets to be acquired or in the consideration to be paid in the transaction or series of related transactions and the present or potential issuance of common stock, or securities convertible into or exercisable for common stock, could result in an increase in outstanding common shares or voting power of 5% or more; or

(ii) where, due to the present or potential issuance of common stock, or securities convertible into or exercisable for common stock, other than a public offering for cash:

a. the common stock has or will have upon issuance voting power equal to or in excess of 20% of the voting power outstanding before the issuance of stock or securities convertible into or exercisable for common stock; or

b. the number of shares of common stock to be issued is or will be equal to or in excess of 20% of the number of shares or common stock outstanding before the issuance of the stock or securities; or

(D) in connection with a transaction other than a public offering involving:

(i) the sale, issuance or potential issuance by the issuer of common stock (or securities convertible into or exercisable for common stock) at a price less than the greater of book or market value which together with sales by

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officers, directors or substantial shareholders of the company equals 20% or more of common stock or 20% or more of the voting power outstanding before the issuance; or

(ii) the sale, issuance or potential issuance by the company of common stock (or securities convertible into or exercisable common stock) equal to 20% or more of the common stock or 20% or more of the voting power outstanding before the issuance for less than the greater of book or market value of the stock.

(2) An exception applicable to a specified issuance of securities may be made upon prior written application to Nasdaq's Listing Qualifications Department when:

(A) the delay in securing stockholder approval would seriously jeopardize the financial viability of the enterprise; and

(B) reliance by the company on this exception is expressly approved by the audit committee or a comparable body of the board of directors comprised solely of independent, disinterested directors. The Listing Qualifications Department shall respond to each application for such an exception in writing.

A company that receives such an exception must mail to all shareholders not later than ten days before issuance of the securities a letter alerting them to its omission to seek the shareholder approval that would otherwise be required. Such notification shall disclose the terms of the transaction (including the number of shares of common stock that could be issued and the consideration received), the fact that the issuer is relying on a financial viability exception to the stockholder approval rules, and that the audit committee or a comparable body of the board of directors comprised solely of independent, disinterested directors has expressly approved reliance on the exception. The issuer shall also make a public announcement through the news media disclosing the same information as promptly as possible, but no later than ten days before the issuance of the securities.

(3) Only shares actually issued and outstanding (excluding treasury shares or shares held by a subsidiary) are to be used in making any calculation provided for in this paragraph (i). Unissued shares reserved for issuance upon conversion of securities or upon exercise of options or warrants will not be regarded as outstanding.

(4) Voting power outstanding as used in this Rule refers to the aggregate number of votes which may be cast by holders of those securities outstanding which entitle the holders thereof to vote generally on all matters submitted to the company's security holders for a vote.

(5) An interest consisting of less than either 5% of the number of shares of common stock or 5% of the voting power outstanding of an issuer or party shall

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not be considered a substantial interest or cause the holder of such an interest to be regarded as a substantial security holder.

(6) Where shareholder approval is required, the minimum vote which will constitute shareholder approval shall be a majority of the total votes cast on the proposal. These votes may be cast in person, by proxy at a meeting of shareholders or by written consent in lieu of a special meeting to the extent permitted by applicable state and federal law and rules (including interpretations thereof), including, without limitation, SEC Regulations 14A and 14C. Nothing contained in this Rule 4350(i)(6) shall affect an issuer's obligation to hold an annual meeting of shareholders as required by Rule 4350(e).

(7) Shareholder approval shall not be required for any share issuance if such issuance is part of a court-approved reorganization under the federal bankruptcy laws or comparable foreign laws.

(j) Listing Agreement

Each issuer shall execute a Listing Agreement in the form designated by Nasdaq.

(k) Auditor Registration

Each listed issuer must be audited by an independent public accountant that is registered as a public accounting firm with the Public Company Accounting Oversight Board, as provided for in Section 102 of the Sarbanes-Oxley Act of 2002 [15 U.S.C. 7212].

(I) Direct Registration Program

(1) All securities initially listing on Nasdaq on or after January 1, 2007 must be eligible for a Direct Registration Program operated by a clearing agency registered under Section 17A of the Exchange Act. This provision does not extend to: (i) additional classes of securities of companies which already have securities listed on Nasdaq; (ii) companies which immediately prior to such listing had securities listed on another registered securities exchange in the U.S.; or, (iii) securities which are book-entry only.

(2) (A) Except as indicated in paragraph (2)(B) below, on and after March 31, 2008, all securities listed on Nasdaq (except securities which are book-entry only) must be eligible for a Direct Registration Program operated by a clearing agency registered under Section 17A of the Exchange Act.

(B) Until March 31, 2009, a foreign private issuer may follow its home country practice in lieu of the requirements of this Rule 4350(1), provided, however, that such an issuer must follow the requirements of Rule 4350(a) and IM-4350-6 for doing so. Thereafter, the listed securities of such issuers (except securities which are book-entry only) must be eligible for a Direct Registration Program operated by a clearing agency registered under Section 17A of the Exchange Act unless prohibited from complying by a law or

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regulation in its home country.

(3) If an issuer establishes or maintains a Direct Registration Program for its shareholders, the issuer shall, directly or through its transfer agent, participate in an electronic link with a clearing agency registered under Section 17A of the Exchange Act to facilitate the electronic transfer of securities held pursuant to such program.

(m) Notification of Material Noncompliance

An issuer must provide Nasdaq with prompt notification after an executive officer of the issuer becomes aware of any material noncompliance by the issuer with the requirements of this Rule 4350.

(n) Code of Conduct

Each Issuer shall adopt a code of conduct applicable to all directors, officers and employees, which shall be publicly available. A code of conduct satisfying this rule must comply with the definition of a “code of ethics” set out in Section 406(c) of the Sarbanes-Oxley Act of 2002 (“the Sarbanes-Oxley Act”) and any regulations promulgated thereunder by the Commission. See 17 C.F.R. 228.406 and 17 C.F.R. 229.406. In addition, the code must provide for an enforcement mechanism. Any waivers of the code for directors or executive officers must be approved by the Board. Issuers, other than foreign private issuers, shall disclose such waivers in a Form 8-K within four business days. Foreign private issuers shall disclose such waivers either in a Form 6-K or in the next Form 20-F or 40-F.

Adopted by SEC Release 34-53128 (Jan. 13, 2006); amended by SR- NASDAQ-2006-007 eff. May 8, 2006; amended by SR-NASDAQ-2006-019 eff July 28, 2006; amended by SR-NASDAQ-2006-008 eff. August 8, 2006; amended by SR-NASDAQ-2006-033 eff. Aug. 25, 2006; amended by SR-NASDAQ-2006-011 eff. Sept. 11, 2006; amended by SR-NASDAQ- 2006-021 eff. Oct. 6, 2006; amended by SR-NASDAQ-2007-022 eff. May 29, 2007; amended by SR-NASDAQ-2006-045 eff. Aug. 24, 2007; amended by SR-NASDAQ-2007-101 eff. Dec. 28, 2007; amended by SR- NASDAQ-2008-031 eff. July 9, 2008; amended by SR-NASDAQ-2009-003 eff. January 15, 2009; amended by SR-NASDAQ-2009-009 eff. February 10, 2009.

IM-4350-7. Code of Conduct

Ethical behavior is required and expected of every corporate director, officer and employee whether or not a formal code of conduct exists. The requirement of a publicly available code of conduct applicable to all directors, officers and employees of an issuer is intended to demonstrate to investors that the board and management of Nasdaq issuers have carefully considered the requirement of ethical dealing and have put in place a system to ensure that they become aware of and take prompt action against any questionable behavior. For company personnel, a code of conduct with enforcement provisions provides assurance that reporting of questionable behavior is protected and encouraged, and fosters an atmosphere of self-awareness and prudent conduct.

Rule 4350(n) requires issuers to adopt a code of conduct complying with the

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definition of a “code of ethics” under Section 406(c) of the Sarbanes- Oxley Act of 2002 (“the Sarbanes-Oxley Act”) and any regulations promulgated thereunder by the Commission. See 17 C.F.R. 228.406 and 17 C.F.R. 229.406. Thus, the code must include such standards as are reasonably necessary to promote the ethical handling of conflicts of interest, full and fair disclosure, and compliance with laws, rules and regulations, as specified by the Sarbanes-Oxley Act. However, the code of conduct required by Rule 4350(n) must apply to all directors, officers, and employees. Issuers can satisfy this obligation by adopting one or more codes of conduct, such that all directors, officers and employees are subject to a code that satisfies the definition of a “code of ethics.”

As the Sarbanes-Oxley Act recognizes, investors are harmed when the real or perceived private interest of a director, officer or employee is in conflict with the interests of the company, as when the individual receives improper personal benefits as a result of his or her position with the company, or when the individual has other duties, responsibilities or obligations that run counter to his or her duty to the company. Also, the disclosures an issuer makes to the Commission are the essential source of information about the company for regulators and investors—there can be no question about the duty to make them fairly, accurately and timely. Finally, illegal action must be dealt with swiftly and the violators reported to the appropriate authorities. Each code of conduct must require that any waiver of the code for executive officers or directors may be made only by the board and must be disclosed to shareholders, along with the reasons for the waiver. All issuers, other than foreign private issuers, must disclose such waivers in a Form 8-K within four business days. Foreign private issuers must disclose such waivers either in a Form 6-K or in the next Form 20-F or 40-F. This disclosure requirement provides investors the comfort that waivers are not granted except where they are truly necessary and warranted, and that they are limited and qualified so as to protect the company and its shareholders to the greatest extent possible.

Each code of conduct must also contain an enforcement mechanism that ensures prompt and consistent enforcement of the code, protection for persons reporting questionable behavior, clear and objective standards for compliance, and a fair process by which to determine violations.

Adopted by SEC Release 34-53128 (Jan. 13, 2006).

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