

January 10, 2003

SEC Proposes Rules Regarding Audit Committee Independence

In connection with the implementation of Section 301 of the Sarbanes-Oxley Act of 2002 (the "Act"), the SEC has proposed new rules that would prohibit the listing in the United States of any security of an issuer not complying with the audit committee requirements set out in Section 301 of the Act.

The proposed rules relate to, among other things:

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

For companies without a separate audit committee, the board of directors would be deemed to constitute the audit committee and the requirements of the proposed rules would apply to the board of directors as a whole.

The proposed rules also call for changes to the existing disclosure requirements regarding audit committees and would require additional audit committee disclosure in annual reports and proxy statements.

The proposed rules would apply to foreign private issuers as well as domestic issuers. However, to avoid conflict with legal requirements, corporate governance standards and the methods for providing auditor oversight in the home jurisdiction of some foreign private issuers, the proposed rules provide specific limited accommodations to foreign private issuers. These accommodations are described in more detail in Section III below.

The proposed rules are subject to a 30-day comment period. The Act requires the SEC to adopt final rules no later than April 26, 2003. Under the SEC's proposal, the new rules would become operative no later than the first anniversary of the publication of the SEC's final rules. The proposed rules also require that each U.S. securities market, no later than 60 days after publication of the final rules, propose listing standards that comply with the provisions of the final rules.

1285 Avenue of the Americas
New York, New York 10019-6064
(212) 373-3000

1615 L Street, NW
Washington, DC 20036-5694
(202) 223-7300

Alder Castle, 10 Noble Street
London EC2V 7JU England
(44-20) 7367 1600

2, rue du Faubourg Saint-Honoré
75008 Paris, France
(33-1) 53.43.14.14

Fukoku Seimei Building 2nd Floor
2-2, Uchisawaicho 2-chome
Chiyoda-ku, Tokyo 100, Japan
(81-3) 3597-8120

2918 China World Tower II
No. 1, Jianguomenwai Dajie
Beijing 100004, People's Republic of China
(86-10) 6505-6822

12th Fl., Hong Kong Club Building
3A Chater Road, Central
Hong Kong
(852) 2536-9933

I. Audit Committee Independence

The Act requires that each member of the audit committee of a listed company be independent. The proposed rules implement the two basic criteria for determining independence set forth in Section 301 of the Act:

- audit committee members would be barred from accepting any consulting, advisory or other compensatory fee from the issuer or an affiliate of the issuer, other than in the member's capacity as a member of the board of directors and any board committee; and
- audit committee members may not be an affiliate of the issuer or any subsidiary of the issuer other than in his or her capacity as a member of the board and any board committee.

A. "No Compensation" Requirement

The "no compensation" requirement would preclude payments to an audit committee member for service as an officer or employee, as well as other compensatory payments. Disallowed payments would include payments made either directly or indirectly. Under the proposed rules, indirect compensatory payments would include payments to:

- spouses;
- minor children or stepchildren;
- children or stepchildren sharing a home with the audit committee member; and
- an entity in which the audit committee member is a partner, member or principal or occupies a similar position and which provides accounting, consulting, legal, investment banking, financial or other advisory services or any similar services to the issuer.

In its proposal, the SEC recognized that the listing standards of some securities markets (notably the NYSE and Nasdaq) currently restrict additional business or personal relationships, and that these markets are seeking to add to these requirements. Nevertheless, the SEC stated that its mandate under Section 301 of the Act is limited to determining independence by reference to payments of compensatory fees. The SEC's proposal would not, for example, preclude independence on the basis of ordinary course commercial business relationships between an issuer and an entity with which a director had a relationship. The SEC's proposal also would not extend to the broad categories of family members that may be reached by NYSE and Nasdaq listing standards. The SEC pointed out that its proposal would allow U.S. securities markets to adopt further requirements of these sorts, but they would do so within the more flexible environment of listing standards.

B. Affiliated Persons

The proposed rules would define an “affiliate” of, or a person “affiliated” with, a specified person, to mean a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified. The term “control” would be defined as the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise. A director, executive officer, partner, member, principal or designee of an affiliate would also be deemed to be an affiliate.

The determination of whether or not a person is an affiliate would require a factual determination based on a consideration of all relevant facts and circumstances. However, because the SEC recognizes that it can be difficult to determine whether someone controls an issuer, the proposed rules would create a safe harbor from this aspect of the proposed definition of “affiliated person.” Under the proposed safe harbor, a person who is not an executive officer, director or 10% beneficial owner of an issuer would be deemed not to control the issuer. The safe harbor would not be exclusive. Those who would be ineligible to rely on the safe harbor, but believe that they do not control an issuer, still could rely on a facts and circumstances analysis.

C. Exemptions from the Independence Requirement

Recognizing that companies coming to market for the first time may face particular difficulty in recruiting members that meet the proposed independence requirements, the proposed rules would exempt one member of an issuer’s audit committee from the independence requirements for a period of 90 days from the effective date of the company’s initial listing or the effective date of the company’s registration statement under the Securities Act covering an initial public offering of the company’s securities, where the issuer was not previously a reporting company.

Further, the proposed rules would exempt from the “affiliated person” requirement an audit committee member that sits on the board of both a listed company and its direct or indirect consolidated majority-owned subsidiary (or that sits on the board of both a listed company and its parent, if the listed company is a direct or indirect consolidated majority-owned subsidiary of the parent), if the committee member, except for sitting on both boards, otherwise meets the independence requirements for both the parent and the subsidiary, including the receipt of only ordinary-course compensation for serving as a member of the board of directors, audit committee or any other board committee of the parent or subsidiary.

As discussed below, any issuer availing itself of either of these exceptions would have to disclose that fact. Apart from the two limited exemptions discussed above and the accommodations for foreign private issuers discussed below, the SEC did not propose to exempt any other particular relationships from the independence requirements at this time. The Act does not, and therefore the proposed rules do not, contain any exemptions based on exceptional and limited circumstances similar to those that exist currently under stock exchange and Nasdaq rules. Moreover, although the proposed rules include a provision permitting the SEC to exempt particular relationships with respect

to audit committee members from the independence provisions of the proposed rules, the proposing release indicates that the SEC does not currently intend to entertain requests for exemptions, waivers or “no-action” letters for particular relationships on a case-by-case basis.

II. Functions of the Audit Committee

A. Auditor Oversight

The proposed rules would require that:

- the audit committee of each listed company would have to be directly responsible for the appointment, compensation, retention and oversight of the work of the independent auditor engaged (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work or performing other audit, review or attest services for the issuer; and
- each such independent auditor would have to report directly to the audit committee.

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

The proposed rules include an instruction that the requirement that the audit committee (or a board of auditors or statutory auditors, as described below), be responsible for the selection of an issuer’s independent auditors does not conflict with, and does not affect the application of, any requirement under the issuer’s governing law or documents or other home country requirements that requires shareholders to ultimately elect, approve or ratify the selection of the issuer’s auditor. The requirement instead relates to the assignment of responsibility to oversee the auditor’s work as between the audit committee and management. In such an instance, however, if the issuer provides a recommendation or nomination of an auditor to its shareholders, the audit committee of the issuer, or body performing similar functions, must be responsible for making the recommendation or nomination.

B. Receipt and Handling of Complaints

Under the proposed rules, the audit committee of each listed company would be required to establish procedures for:

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

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

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

C. Authority to Engage Advisors/Funding

The proposed rules would require each listed company's audit committee to have the authority to engage outside advisors, including counsel, as it determines necessary to carry out its duties. In addition, the proposed rules would also require listed companies to provide for appropriate funding, as determined by the audit committee, in its capacity as a committee of the board of directors, for payment of compensation:

- to any independent auditors engaged for the purpose of rendering or issuing an audit report or related work or performing other audit, review or attest services for the listed issuer; and
- to any advisors employed by the audit committee.

III. Foreign Issuer Accommodations

As indicated above, the proposed rules would apply to both domestic and foreign issuers that have securities listed in the United States. However, several exceptions in the proposed rules would address the special circumstances of foreign private issuers. These provisions would include the following:

- a non-executive employee of a foreign private issuer is exempt from the independence requirements of the proposed rules if the employee is elected or named to the board of directors or audit committee of the foreign private issuer pursuant to home country legal or listing requirements;
- one member of the audit committee may be a shareholder, or representative of a shareholder or group, owning more than 50% of the voting common equity of the foreign private issuer, if:
 - the "no compensation" portion of the independence requirements is satisfied;
 - the member has only observer status on, and is not a voting member or chair of, the audit committee; and
 - the member is not an executive officer of the issuer;

- one member of an audit committee may be a representative or designee of a foreign government or foreign governmental entity that is an affiliate of the foreign private issuer if:
 - the “no compensation” portion of the independence requirements is satisfied; and
 - the member is not an executive officer of the issuer; and
- a foreign private issuer will be exempt from the requirements regarding the independence of audit committee members and the audit committee’s responsibility to oversee the work of the independent auditors if:
 - the securities of the foreign private issuer are also listed or quoted on an exchange outside the United States;
 - the foreign private issuer has a board of auditors (or similar body), or has statutory auditors, separate from the board of directors, that is established and selected pursuant to home country legal or listing provisions requiring or permitting such a board or similar body;
 - the board or body, or statutory auditors, are not elected by management and no executive officer of the issuer is a member of such board or body, or statutory auditors;
 - home country legal or listing provisions set forth standards for the independence of such board or body, or statutory auditors, from the issuer and management;
 - such board or body, or statutory auditors, are directly responsible, in accordance with standards prescribed by home country legal or listing provisions, for the oversight of the work of any independent auditor engaged (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work or performing other audit, review or attest services for the issuer; and
 - such board or body, or statutory auditors, are responsible, to the extent permitted by law, for the appointment and retention of any independent auditor engaged by the issuer.

One example of such a foreign statutory requirement is that large Japanese companies must maintain, pursuant to current Japanese law, a board of corporate statutory auditors, a legally separate and independent body from the company’s board of directors that is elected by shareholders.

The requirement that the audit committee or a board of auditors or statutory auditors be responsible for the selection of an issuer's independent auditors does not conflict with any requirement in a company's home jurisdiction that prohibits the full board of directors from delegating the responsibility to select the company's auditor. In that case, the audit committee, or body performing similar functions, must be granted advisory and other powers with respect to such matters to the extent permitted by law, including submitting nominations or recommendations to the full board.

In the past, U.S. securities exchanges and Nasdaq have granted waivers from certain corporate governance related listing standards to foreign private issuers. As proposed, there would be no ability to exempt or waive the proposed rules' requirements for foreign private issuers. This would not affect the exchanges' ability to provide an exemption or waiver from other exchange listing requirements.

IV. Securities Covered

The proposed audit committee rules would apply only to issuers with securities listed in the United States on a national securities exchange (such as the NYSE) or listed in an automated inter-dealer quotation system of a national securities association (such as Nasdaq). None of the requirements would apply to other reporting companies under Section 13(a) or 15(d) of the Exchange Act or to issuers of securities quoted on an interdealer quotation system (such as the OTC Bulletin Board (OTCBB) or the Pink Sheets), unless their securities also are listed on an exchange or Nasdaq. In addition, issuers of asset-backed securities would not be subject to the proposed rules.

The Act prohibits the listing of "any security" of an issuer that does not meet the new standards for audit committees. Accordingly, the proposed rules would apply not just to voting equity securities, but to any listed security, regardless of its type, including debt securities, derivative securities and other types of listed securities.

The proposed rules include an exemption for additional listings of securities by a company if that company is already subject to the proposed rules as a result of the listing of a class of common equity or similar securities. The additional listings could be on the same stock market or on different markets. Companies that do not have a class of common equity or similar securities listed would be subject to the proposed requirements of each market where its securities are listed.

The proposed rules also include an exemption for listings of non-equity securities by a direct or indirect consolidated majority-owned subsidiary of a parent company, if the parent company is subject to the proposed rules as a result of the listing of a class of its equity securities. However, if the subsidiary were to list its own equity securities (other than non-convertible, non-participating preferred securities, including trust-preferred and similar securities) the subsidiary would be required to meet the proposed requirements to protect its own public shareholders.

V. Disclosure Changes Regarding Audit Committees

A. Disclosure Regarding Exemptions

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

- their reliance on the exemption; and
- their assessment of whether, and if so, how, such reliance would materially adversely affect the ability of their audit committee to act independently and to satisfy the other requirements of the proposed rules.

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

Foreign private issuers availing themselves of the board of auditors accommodation outlined above would be required to file an exhibit to their annual reports stating that they are doing so.

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

B. Identification of Audit Committee in Annual Reports

A domestic issuer subject to the proxy rules of Section 14 of the Exchange Act is currently required to disclose in its proxy statement or information statement, if action is to be taken with respect to the election of directors, whether the issuer has a standing audit committee, the names of each committee member, the number of committee meetings held by the audit committee during the last fiscal year and the functions performed by the committee. The proposed rules would require disclosure of the members of the audit committee to be included or incorporated by reference in each listed issuer's annual report on Form 10-K, 20-F or 40-F, as applicable.

Because the Exchange Act now provides that in the absence of an audit committee the entire board of directors will be considered to be the audit committee, the proposed rules would require a listed issuer that has not separately designated or has chosen not to separately designate an audit committee to disclose that the entire board of directors is acting as the issuer's audit committee.

C. Additional Changes to Audit Committee Disclosure Requirements

A domestic issuer subject to the proxy rules, whether listed or not, is currently required to disclose additional information about its audit committee in its proxy statement or information

statement, if action is to be taken with respect to the election of directors. This disclosure includes, among other things, whether the members of the audit committee are independent. Under the existing requirements, issuers whose securities are not listed on the NYSE or AMEX or quoted on the Nasdaq, may choose which definition of independence to use from any of the NYSE, AMEX or Nasdaq listing standards.

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

* * *

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

Mark S. Bergman	(44 20) 7367-1601	John C. Kennedy	(212) 373-3025
Richard S. Borisoff	(212) 373-3153	Edwin S. Maynard	(212) 373-3034
Andrew J. Foley	(212) 373-3078	Raphael M. Russo	(212) 373-3309
Paul D. Ginsberg	(212) 373-3131	Ian G. Putnam	(212) 373-3040

PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP

©2003 Paul, Weiss, Rifkind, Wharton & Garrison LLP
1285 Avenue of the Americas, New York, NY 10019-6064