Critical Issues in the Sarbanes-Oxley Act:
AUDIT COMMITTEE

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Thomas O. Gorman

2009

Filed Through:
RELEASE NO. 2, JUNE 2009

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ISBN: 978-1-4224-2977-8

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Mr. Gorman would like to thank David Fischer who prepared an earlier edition of the booklet which served as a predicate for this work.

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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

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[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).

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

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[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.

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 Oxley[14] 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

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[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

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

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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).

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 Act[21] 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

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[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).

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

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[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).

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-

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[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).

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.

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[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 exceptive 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).

[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

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[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

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

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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).

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

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[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).