The SEC has adopted a final rule to implement the audit committee requirements of Section 301 of the Sarbanes-Oxley Act of 2002 (Sarbanes). The new Securities Exchange Act rule, Rule 10A-3, directs NYSE, Nasdaq and other national securities exchanges or associations (Exchanges) to require listed issuers to comply with audit committee requirements relating to:

- independence of audit committee members;
- selection and oversight of the issuer's independent accountant;
- engagement of advisors;
- funding for the independent accountant and advisors; and
- whistleblower procedures for accounting and auditing matters.

In addition, the SEC has adopted changes to current disclosure requirements regarding audit committees.

When to Comply?

Although Rule 10A-3 itself is effective as of April 25, 2003, issuers will not need to comply until 2004. Rule 10A-3 directs each Exchange (including NYSE and Nasdaq) to provide to the SEC, no later than July 15, 2003, proposed listing rules or amendments that comply with the requirements of the new rule. The SEC must approve these new Exchange listing rules by December 1, 2003. Issuers must comply with the new Exchange listing rules by the earlier of their first annual shareholders meeting after January 15, 2004 or October 31, 2004. Listed foreign private issuers and small business issuers have until July 31, 2005 to comply with the new listing rules.

Practical Tip: NYSE Companies May Need to Accelerate Their Plans.

Rule 10A-3's 2004 compliance deadline tracks closely with Nasdaq's pending listing rule changes, which included a compliance deadline of the first annual meeting after January 1, 2004. NYSE's original proposed listing rule changes included a compliance deadline of 24 months after SEC approval of the listing rule changes. NYSE issuers who hoped to have a longer phase-in period will have less time than they originally expected to comply with the Rule 10A-3 audit committee requirements.

What Issuers Are Subject to Rule 10A-3?

Rule 10A-3 applies to all issuers whose securities are traded on a national securities exchange or Nasdaq. Issuers quoted only on the OTC Bulletin Board, the Pink Sheets or the Yellow Sheets will not be affected. The SEC excludes certain types of issuers or securities from the requirements of Rule 10A-3 (e.g., security futures products cleared through an appropriate clearing agency, standardized options, foreign governments and asset-backed issuers or similar passive issuers like unit investment trusts). This Update focuses primarily on U.S. issuers, and addresses only a few provisions relating to foreign private issuers. We do not discuss provisions that apply to investment companies.

When There Is No "Audit Committee" – 10A-3 Can Still Apply

Rule 10A-3 provides that if a company does not have a separately designated audit committee, then the company's entire board of directors will constitute the audit committee. The SEC clarifies in its final rule that for an issuer that is a limited partnership or limited liability company but does not have a board of directors or equivalent body, the term "board of directors" may refer to the board of directors of the managing general partner, the managing member or an equivalent body.

Independence Requirements for Audit Committee Members – Two Criteria

Each member of an issuer's audit committee must be independent according to two criteria set forth in Rule 10A-3. These criteria preclude audit committee membership for any director who:

- has received compensation from the issuer or a subsidiary other than for board service, or
- is an "affiliated person" of the issuer or any subsidiary.
No Compensation Other Than for Board Service

Rule 10A-3 bars audit committee members from accepting any direct or indirect consulting, advisory or other compensatory fee from an issuer or any subsidiary, other than in the member's capacity as a member of the board of directors or a board committee. The final rule provides no de minimis exception for compensatory payments, even though several Exchanges currently have such exceptions in their listing standards. Compensatory fees do not include fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with a listed issuer (provided that the compensation is not contingent on continued service).

Indirect Payments Covered by the Rule

Rule 10A-3 precludes indirect compensatory payments, including:

- payments to spouses, minor children or stepchildren or children or stepchildren sharing a home with the director; and
- payments to an entity (1) in which the director is a partner, member or officer, or occupies a similar position, and (2) which provides accounting, consulting, legal, investment banking or financial advisory services to the issuer or any of its subsidiaries.

Payments by a listed company to an entity in which a director is a limited partner or non-managing member (or occupies a similar passive position) would not bar that director from serving on the company's audit committee as long as he or she has no active role in providing services to the company. The final rule does not bar payments to an entity in which an audit committee member is a partner, member or officer where the payments are in connection with commercial relationships outside the areas of accounting, consulting, legal, investment banking or financial advisory services, although the SEC acknowledges that the Exchanges' final rules may be more restrictive.

No Look-Back Required

Rule 10A-3 applies the compensation-related prohibitions only to current relationships with audit committee members and related persons and does not extend prohibitions to “look-back” periods before the appointment of members to the audit committee.

Trap for the Unwary: NYSE's and Nasdaq's Listing Standards Will Typically Be Stricter Than Rule 10A-3. Rule 10A-3 sets forth only the minimum standards for audit committee membership. NYSE's and Nasdaq's listing standards as currently proposed will generally be more stringent than Rule 10A-3's requirements. NYSE and Nasdaq will prohibit a much broader range of compensatory payments to potential audit committee members, and include look-back periods.

No Affiliated Persons; Modified “Safe Harbor”

The second independence criterion under Rule 10A-3 prohibits any director who is an "affiliated person" of an issuer or any subsidiary of the issuer (other than solely in his or her capacity as a member of the board and any board committee of the issuer) from serving on the issuer's audit committee. The SEC adopted the non-affiliate safe harbor contemplated in the proposed rule with minor modifications.

Who Is an "Affiliate" or "Affiliated Person"? What Does "Control" Mean?

The SEC defines "affiliated person" consistently with other "affiliate" and related "control" definitions under federal securities laws, including Exchange Act Rule 12b-2 and Securities Act Rule 144. An "affiliate" or "affiliated person" is defined as "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" is defined as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."

"Safe Harbor" – SEC Adopts the 10% Solution for Determining Non-Affiliate Status

The SEC definition of affiliated person generally requires a factual determination, based on the consideration of all relevant facts and circumstances, of whether a control relationship exists. However, as contemplated in the proposed rule, the final rule creates a safe harbor for determining that a person is deemed not to control an issuer or a subsidiary of the issuer, and therefore is deemed not to be an affiliated person. An audit committee member will qualify for this safe harbor as a non-affiliate only if the person:

- is not an executive officer of the issuer (or a subsidiary of the issuer), and
- is not the beneficial owner of 10% or more of any class of voting equity securities (instead of any class of equity securities) of the issuer or any of its subsidiaries.
In the adopting release, the SEC stressed that the safe harbor is designed to simplify the determination of those who are \textit{not} affiliates, eliminating the need to engage in additional facts and circumstances analysis for any director who qualifies for the safe harbor. Where a director does not satisfy the safe harbor requirements, the issuer must analyze the facts and circumstances relating to whether the director (other than in his or her capacity as a director or member of a board committee) controls, is controlled by or is under common control with the issuer or a subsidiary within the meaning of Rule-10A-3. Rule 10A-3 also clarifies that a person who owns more than 10% of voting equity securities of the issuer or any of its subsidiaries is \textit{not presumed} to be an affiliate.

\textbf{Officers, Directors and Other Persons Associated With Affiliates}

The final rule limits the class of directors who will be deemed to be affiliates of an issuer because of their relationship to an entity (such as a major shareholder) that is an affiliate of the issuer. Under the final rule only executive officers, directors \textit{that are also employees} of an affiliate, general partners and managing members of an affiliate will be deemed to be affiliates. Outside directors of an affiliate are not automatically designated as affiliated persons of the issuer. As contemplated in the proposed rule, the final rule clarifies that passive, non-control positions, such as limited partners and those who do not have policy-making functions, are not covered. While the final rule also removes the term "designee," an affiliate could not evade the prohibitions of the rule simply by designating a third-party representative or agent that it directs to act in its place.

\textbf{Exemptions to Independence Requirements}

Under Securities Exchange Act Section 10A(m)(3)(C), the SEC has the authority to exempt from the independence requirements particular relationships with respect to audit committee members. Rule 10A-3 provides the following exemptions from the independence requirement of the affiliated person restriction:

- \textbf{Newly Listed Public Companies (independence requirement phase-in).}

  In balancing the need for independence and the ability for newly listed issuers to recruit qualified candidates, the SEC adopted a revised exemption that requires at least one fully independent audit committee member at the time of an issuer's initial listing, a majority of independent members within 90 days of initial listing and a fully independent audit committee within one year of initial listing.

- \textbf{Overlapping Board Relationships and Holding Companies.} The SEC has adopted an exemption that addresses overlapping board relationships, i.e., when an audit committee member sits on the boards of directors of both the listed issuer and a majority-owned subsidiary or any other affiliate. The member will not be deemed to be an "affiliated person" if the member would have otherwise met the independence requirements, except for the fact that the member serves as a director on the boards of directors of both the parent and subsidiary. Under this exemption, the audit committee members will still be required to be independent of an issuer and its affiliates, but the exemption will now apply regardless of the source of control. Among other things, the final rule provides accommodations for independent directors who serve on the boards of sibling subsidiaries under common control of a parent, if such directors would be independent other than for the fact of the two sibling subsidiaries being affiliated through the parent.

- \textbf{Foreign Private Issuers.} The final rule applies to listed companies incorporated outside the United States, known as "foreign private issuers." The SEC has provided a number of accommodations for "foreign private issuers"; for example, the Rules provide guidance for compliance when the foreign private issuers' local legal or listing requirements conflict with the provisions of the rule. The SEC also recognizes and provides limited exemptions from 10A-3 for certain governance structures that foreign law or Exchange listing standards require of foreign private issuers. For example, a foreign private issuer may be required to have non-executive employees or government representatives on audit committees, to maintain a two-tier board structure (management and supervisory) or have a board of auditors. 10A-3 provides an accommodation for each of these and similar requirements of local law.

Besides the particular limited exemptions mentioned above, the SEC chose not to provide exemptions from independence requirements for other relationships at this time.

\textbf{No Exemption for "Exceptional and Limited Circumstances"}

Consistent with the proposed rule, the final rule does not contain an exemption for "exceptional and limited circumstances," despite the existence of this type of exemption in the current rules of some Exchanges. The SEC acknowledged that Exchanges may still provide an exemption for "exceptional and limited circumstances" when Exchanges have imposed additional, more stringent requirements for audit committee membership.

\textbf{No Case-by-Case Waivers}

Under the final rule, the SEC states that it will not entertain exemptions or waivers for particular relationships on a case-by-case basis. The SEC recognizes its expansive authority to do so (as granted by Sarbanes) and states that it will remain sensitive to evolving standards of corporate governance, including changes in U.S. or foreign law, to address unanticipated new conflicts.

\textit{SEC Supports Additional Exchange Listing Standards Regarding Audit Committees}
The final rule allows NYSE, Nasdaq and other Exchanges the flexibility to adopt and administer additional independence requirements in connection with their implementation of listing standards. The SEC encourages Exchanges to adopt rigorous standards designed to ensure appropriate levels of independence and authority for audit committees. We expect that NYSE and Nasdaq will continue to submit updated versions of their proposed listing rules and amendments to the SEC in the coming months. Perkins Coie has and will continue to publish Updates covering these NYSE and Nasdaq listing standards and amendments as they mature, available on our website.

Audit Committee Responsibility Relating to Independent Accountant

Rule 10A-3 directs NYSE, Nasdaq and other Exchanges to incorporate the following requirements into their listing rules:

- Audit committees of each issuer must be directly responsible for the appointment, compensation, retention and oversight of the work of any registered public accounting firm engaged (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or performing any other audit, review or attest services for the issuer; and
- The independent auditor must directly report to the audit committee.

These audit committee oversight responsibilities include:

- the authority to retain an outside auditor, which includes the power not to retain (or to terminate) an outside auditor; and
- the authority to approve all audit engagement fees and terms.

The final rule does not mandate that the Exchanges' rules require audit committees to be responsible for oversight of issuers' internal auditors or to have other responsibilities not listed in Section 301 of Sarbanes. The Exchanges may impose additional responsibilities, and indeed both Nasdaq's and NYSE's pending proposals specify a number of additional responsibilities for the audit committee.

Audit Committee Authority to Engage Advisors

Rule 10A-3 directs Exchanges to adopt listing rules that specifically require a listed issuer's audit committee to have the authority to engage outside advisors, including its own counsel and other advisors, as it determines necessary to carry out its duties. The rationale is that in order to be effective, audit committees must have the necessary resources and authority to fulfill their function and the "advice of outside advisors may be necessary to identify potential conflicts of interest and assess the company's disclosure and other compliance obligations with an independent and critical eye."

Audit Committee Funding

Rule 10A-3 directs Exchanges to adopt listing rules requiring each issuer to provide appropriate funding, as determined by its audit committee, to:

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

The final rule does not set funding limits. It also provides that, in addition to funding for the independent accountant and advisors to the audit committee, an issuer must provide appropriate funding for the audit committee to ensure its effectiveness and independence from management.

Whistleblower Procedures for Accounting and Auditing Matters (for handling complaints regarding the issuer's accounting practices)

Rule 10A-3 directs Exchanges to adopt listing rules that require audit committees to establish formal procedures for complaints relating to accounting and auditing matters. The rule requires audit committees 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, anonymous submission by an issuer's employees of concerns regarding questionable accounting or auditing matters.

Although portions of the rule referring to confidential, anonymous submissions of concerns are directed at the issuer's employees, the final rule defines the scope of the requirements to include complaints received by a listed issuer regardless of source. Rule 10A-3 does not mandate an issuer to establish a specific set of procedures. Instead of adopting a "one-size-fits-all" approach, the SEC provides companies the flexibility for audit committees to adopt procedures that are the most appropriate "fit" for each company's circumstances.
Practical Tip: An Effective Whistleblower Policy Must Be Consistent With Company's Ethics Program. Make sure your company's whistleblower procedures are consistent with your company's ethics program, including the code of ethics mandated by Sarbanes, code of conduct mandated by Nasdaq or code of business conduct and ethics mandated by NYSE.

Remember, companies have until the 2004 proxy season to implement their audit committee whistleblower procedures. For more details and practical considerations, see our Update on the Whistleblower Provisions available soon on our website.

Opportunity to Cure Defects

Rule 10A-3 requires a listed issuer to notify NYSE or Nasdaq or the appropriate Exchange promptly after an executive officer of the issuer becomes aware of any material noncompliance with the Exchange's Rule 10A-3 related listing requirements. The final rule does not specify how Exchanges may ensure compliance with standards on an ongoing basis, but recognizes that periodic confirmations can be part of an effective overall system for monitoring compliance with listing rules. Although the final rule does not mandate specific time periods for the opportunity to cure defects, the SEC has indicated that it expects NYSE, Nasdaq and other Exchange rules to provide for definite procedures and time periods for compliance, to the extent that they do not already do so.

Exchange listing standards may provide for a transition period if a member of an audit committee ceases to be independent for reasons outside the company's control. With notice to the Exchange, the director may remain an audit committee member of the listed company until the earlier of the next annual meeting of the listed issuer or one year from the occurrence of the event that caused the member to be no longer independent.

Exemptions for Issuers With Multiple Listings and for Non-Equity Securities of Certain Subsidiaries

Consistent with the proposed rule, the SEC adopted exemptions for issuers with multiple listings and for certain subsidiaries with listed non-equity securities:

- Issuers with multiple classes of listed securities may only need to comply with the Rule 10A-3 related listing requirements of one Exchange.

  Exchanges may exempt from their Rule 10A-3 related listing requirements the securities of any issuer that is subject to the Rule 10A-3 related listing requirements of another Exchange. The final rule dropped the proposed requirement that the exemption would only apply if the issuer had a class of common equity or similar securities listed on an Exchange subject to Rule 10A-3.

- Controlled and other subsidiaries. If the common equity securities of a parent company are subject to the Rule 10A-3 related listing requirements of one Exchange, then Exchanges may exempt from their Rule 10A-3 related listing requirements the non-equity securities (including non-convertible, non-participating preferred securities) of any direct or indirect subsidiary that is consolidated or at least 50% beneficially owned.

Current Disclosure Requirements and Changes

The SEC adopted several changes to current disclosure requirements regarding audit committees.

Disclosure on Exemptions

The final rule generally requires issuers relying on an exemption from the Rule 10A-3 requirements to disclose their reliance on the exemption and their assessment whether and, if so, how that reliance will materially affect the ability of their audit committee to act independently and to satisfy the other requirements of Rule 10A-3. This disclosure will need to appear in, or be incorporated by reference into, annual reports filed with the SEC (i.e., 10-K, 10-KSB, 20-F, 40-F). The disclosure also will need to appear in the issuer's proxy statements or information statements for shareholder meetings at which directors are elected. This disclosure is not required if the issuer is relying on the independence exemption afforded to overlapping board relationships and holding company structures or the exemptions provided to companies with securities listed on multiple Exchanges and controlled or other subsidiaries with non-equity securities.

Identification of an Audit Committee in Annual Reports

Currently, an issuer subject to the proxy rules of Exchange Act Section 14 must disclose in its proxy statement any action regarding the election of directors, whether the issuer has a separate audit committee, the number of committee meetings held by the audit committee during the last fiscal year and the functions performed by the committee. The SEC has adopted changes to Item 401 of Regulations S-K and S-B that require a company subject to the proxy rules also to disclose the identity of its audit committee members (or, if there is no separately designated audit committee, the full board) in its annual report, either by including it or by incorporating it by reference from the listed company's proxy statement filed with the SEC.

Updates to Existing Audit Committee Disclosure.
Listed issuers will still be required, under the proxy rules, to disclose whether its audit committee members are independent. Disclosure should reflect the new Rule 10A-3 related Exchange rules to be adopted. Thus, a listed issuer must use the definition of independence for audit committee members included in the listing standards by NYSE, Nasdaq or those applicable to the listed issuer.

Text of Final Rule

This Update is intended only as a summary of the SEC's final rule. You can find the full text of the final rule at www.sec.gov/rules/final/33-8220.htm. You can also find further discussion of the Sarbanes-Oxley Act and of other recent laws, regulations and rule proposals of interest to public companies on our website.

CONTACTS

Eric A. DeJong
Partner
Seattle
D +1.206.359.3793

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