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MEMORANDUM

January 21, 2003

To Our Clients and Friends

Re: Audit Committee Standards

The Securities and Exchange Commission (“SEC”) has issued a proposed rule requiring national securities exchanges and national securities associations (“SROs”) to prohibit the listing of any security of any issuer that is not in compliance with the audit committee standards established by the Sarbanes-Oxley Act of 2002. Comments are requested by February 18. Under the provisions of the Sarbanes-Oxley Act the rule must become effective by April 26. The SROs must have operative procedures for this rule within one year of the final rule’s publication in the *Federal Register*.

AUDIT COMMITTEE STANDARDS¹

The rules of each SRO must prohibit the initial and continued listing of any security of an issuer² that is not in compliance with the following standards.

Audit Committee Member Independence – Each member of the audit committee³ must be a member of the board of directors of an issuer and must be independent according to the following criteria.

- A member cannot accept, directly or indirectly, any consulting, advisory or other compensatory fee from the issuer or an affiliate of the issuer,

¹ This memorandum describes requirements for companies other than investment companies.

² Issuers of asset-backed securities and exchange-traded unit investment trusts are excluded from these standards.

³ Under the Sarbanes-Oxley Act an audit committee is defined as a committee (or equivalent body) established by 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; if no such committee exists with respect to an issuer, the entire board of directors of the issuer is the audit committee.

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other than in the capacity as member of the board of directors or of a board committee. This includes payments made to:

- spouses, minor children, stepchildren or children or stepchildren sharing a home with a member; and
- an entity in which an audit committee member is a partner, member or principal and which provides accounting, consulting, legal, investment banking, financial or other advisory services to the issuer.
- A member may not be an affiliated⁴ person of the issuer or any subsidiary of the issuer.
- Limited exceptions from the independence requirement are provided for foreign issuers.

Responsibilities - An audit committee must be directly responsible for the appointment, compensation, retention and oversight of the work of the public accounting firm engaged for the purpose of preparing or issuing an audit report or related work or performing other audit, review or attest service for the issuer. The public accounting firm must report directly to the audit committee. The audit committee must have the authority to retain and terminate the outside auditor, to approve all audit engagement fees and terms, as well as all significant non-audit engagements of the accounting firm.

Procedures for Handling Complaints – An audit committee must 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 employees of the issuer of concerns regarding questionable accounting or auditing matters.

Authority to Engage Advisors – A audit committee must have the authority to engage outside advisors, including counsel, as it determines necessary.

Funding – The issuer must provide for appropriate funding, as determined by the audit committee for payment of compensation to:

⁴ An “affiliate” of or a person “affiliated” with means 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 SEC is proposing a safe harbor that deems a person who is not an executive officer, director or 10% shareholder of the issuer to not control the issuer. However, a director, executive officer, partner, member, principal or designee of an affiliate would be deemed to be an affiliate.

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

COMPLIANCE

Rules adopted by SROs must require a listed issuer to notify the SRO promptly after an executive officer of the issuer becomes aware of any material non-compliance by the issuer with the proposed requirements. The SROs would also be required to establish procedures to permit an issuer to cure a defect before the SRO prohibits the listing of, or delists a security of, the issuer.

DISCLOSURE

Disclosure regarding exemptions – Issuers must disclose their reliance on exemptions and their assessment of the affect of the exemption on the ability of the audit committee to act independently and to satisfy the other standards of the proposed rule. Such disclosure must appear, or be incorporated by reference, in annual reports and proxy statements. Foreign private investors are also required to file an exhibit to their annual report disclosing their use of an exemption.

Identification of Audit Committee in Annual Reports – Issuers must disclose the members of the audit committee in their annual report. If the issuer has not separately designated an audit committee, it must disclose that the entire board of directors is acting as the audit committee.

Updates to Existing Audit Committee Disclosures – Listed insurers would be required, as they currently are, to disclose if their audit committee members are independent but would need to use the new standards for determining independence. If a listed issuer does not have a separately designated audit committee, it must disclose the independence of all the members of its board of directors.

EXEMPTIONS

Subsidiaries – A committee member that sits on the board of directors of both a parent and a director or indirect consolidated majority-owned subsidiary, is exempt from the “affiliated person” requirement provided the person meets the other independence requirements for both the parent and the subsidiary.

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Multiple Listings – If a company lists a common equity security and thus becomes subject to these auditing standards, additional listings of securities at the same time by the company are exempted from these standards. A similar exemption is proposed for listing 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 auditing standards as a result of listing an equity security.

Foreign Issuers – Foreign issuers are not subject to the required standards if they meet several conditions, including:

- the securities of the foreign issuer are also listed or quoted on a securities exchange or inter-dealer quotation system outside the United States;
- the foreign issuer has a board of auditors, or statutory auditors, separate from the board of directors that are established and selected in accordance with home country legal or listing provisions;
- the board of auditors or statutory auditors are not elected by management of the issuer, and no executive officer of the issuer is a member of the board of auditors or a statutory auditor; and
- home country legal or listing provisions set forth standards for the independence of the board of auditors, or statutory auditors, from the management of the foreign issuer.

The proposed rule can be found at www.schwartzandballen.com/WhatsNew.htm.

If you have any questions concerning the proposed rule, please call Gilbert Schwartz, Robert Ballen or Tom Fox at (202) 776-0700.