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MEMORANDUM

August 1, 2003

TO: Clients and Friends
FROM: Graubard Miller
SUBJECT: New SEC Rule on Standards for Listed Company Audit Committees

General

In Spring 2003, the SEC adopted final rules directing the national securities exchanges and national securities associations (self-regulatory organizations or “SROs”) to prohibit the listing of securities of issuers not in compliance with the audit committee requirements of the Sarbanes-Oxley Act of 2002. Listed domestic issuers must comply with the new requirements by the date of their first annual shareholders meeting after January 15, 2004, but no later than October 31, 2004. Foreign private issuers and small business issuers must comply by July 31, 2005.

The new rule implements the requirements of Section 10A(m)(1) of the Securities Exchange Act of 1934 (“Exchange Act”), as added by Section 301 of the Sarbanes-Oxley Act.

Audit Committee Requirements

SROs will be prohibited from listing any security of an issuer that is not in compliance with the following requirements:

- Each member of the issuer’s audit committee must be independent according to specified criteria.
- The audit committee must be directly responsible for the appointment, compensation, retention and oversight of the work of the issuer’s outside auditors.
- The audit committee must establish procedures for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters, including procedures for the confidential, anonymous

submission by employees of concerns regarding questionable accounting or auditing matters.

- The audit committee must have the authority to engage independent counsel and other advisors, as it determines necessary to carry out its duties.
- The issuer must provide appropriate funding for the audit committee.

Independence

The new rules mandate that listed company audit committees be comprised solely of independent directors.

Fees. In order to maintain independence, audit committee members may not accept any compensation from the issuer other than fees earned for the director's actual service on the board and board committees (including the audit committee). Allowable fees can take a wide range of forms, including cash retainers, meeting fees, stock options and restricted stock grants. It should be noted that a former officer or employee of the issuer who has retired and is drawing a fixed amount of compensation under the issuer's retirement plan would not be disqualified from serving as a member of the issuer's audit committee by virtue of his or her receipt of payments under such plan.

A member would not be independent if he or she is receiving payments as an officer or employee of the issuer or its affiliates. The independence requirement also precludes indirect payments to the audit committee member, such as payments to the member's own family members (such as spouses, minor children or stepchildren or children or stepchildren sharing a home with the member), or payments to affiliated entities providing advisory services to the issuer (such as law firms, consulting firms, and investment banks of which the member is a partner or holds a similar position). The foregoing prohibition does not cover payments for nonadvisory financial services, such as lending relationships, customer account maintenance or brokerage services.

Non-affiliation. Audit committee members may not be "affiliates" of the issuer (apart from their capacity as board members). An executive officer of an affiliate, a director who also is an employee of an affiliate, and a general partner or managing member of an affiliate of the issuer would all be precluded from serving as a member of the audit committee. The SEC has adopted a safe harbor in which a person will not be deemed an affiliate of the issuer if the person is not (i) an executive officer or (ii) beneficial owner of more than 10% of any class of voting equity securities of the issuer. The independence of a shareholder owning more than 10% of the securities of the issuer will depend on a fact-based analysis of control.

This non-affiliation requirement provides for two exemptions that are available to both domestic and foreign listed issuers:

- ***IPO Issuers.*** New issuers are required to have at least one independent audit committee member at the time of listing, a majority of independent members within 90 days and a fully independent audit committee within one year of listing.
- ***Overlapping Board Relationships.*** An audit committee member who sits on the board of directors of an issuer and an affiliate of the issuer is exempt from the “affiliated person” prohibition if, except for being a director on each board, the member otherwise meets the independence requirements with respect to both entities.

Entire Board May be Deemed to be the Audit Committee. If the board of directors does not establish an audit committee, the entire board is deemed to constitute the audit committee. Accordingly, if an issuer is a listed company and does not establish an audit committee, all members of its board of directors would have to be independent to satisfy the audit committee independence requirements.

Applicability to Foreign Private Issuers

The new rule applies to domestic and foreign listed issuers. The rule contains several provisions applicable only to foreign private issuers that seek to address the special circumstances of particular foreign jurisdictions. These provisions include (i) allowing non-management employees to serve as audit committee members; (ii) allowing shareholders to select or ratify the selection of auditors; (iii) allowing alternative structures such as boards of auditors to perform auditor oversight functions where such structures are provided for under local law; and (iv) addressing the issue of foreign government shareholder representation on audit committees.

Disclosure Requirements

The final rule requires:

- Disclosure in proxy statements and annual reports of the use of any exemption to Rule 10A-3 (an issuer availing itself of an exemption must disclose its reliance on such exemption and its assessment of whether, and if so how such reliance will materially adversely affect the ability of the audit committee to act independently and to satisfy the other requirements of the rule);
- Identification of the audit committee in proxy statements and annual reports; for issuers that have not separately designated an audit committee, the rule requires the issuer to disclose that its entire board of directors is acting as the audit committee; and
- Corresponding updates to the audit committee independence disclosure in proxy statements.

Responsibilities Relating to Auditors

The new rules mandate that the audit committee be responsible for hiring, firing, compensation and oversight of the issuer's independent auditors. The auditors are obligated to report directly to the audit committee. As a result, it may prove advisable for issuers to arrange several regular meetings between the audit committee and the auditors (without management present) for the purpose of receiving reports and status updates discussing issues. Audit committee membership will require active participation and issuers candidly should evaluate their audit committee members to ensure they can meet their obligations.

Employee Complaint Procedures

The audit committee must develop procedures for the receipt, retention and treatment of complaints and concerns relating to accounting, internal controls and auditing matters, as well as complaint procedures relating to business and operating ethics. These procedures must include a mechanism for maintaining anonymity of employees submitting such complaints (if such employees desire anonymity). The SEC did not mandate the form or substance of such procedures and leaves it to the issuers to develop procedures that meet their specific needs. Graubard Miller regularly assists its clients in designing such procedures, typically in connection with the creation of audit committee charters and codes of ethics, as well as stand-alone company guidelines.

Additional SRO Rules

The final rule applies to all SROs. These entities, to the extent that their listing standards do not already comply with the final rule, will be required to issue new rules or modify their existing rules, subject to SEC review, to conform their listing standards. SROs are not precluded from adopting additional listing standards regarding audit committees, as long as they are consistent with Exchange Act Rule 10A-3.

The SROs are responsible for enforcing compliance with the rule. The rule directs SROs to adopt a self-reporting mechanism that would require a listed issuer to notify the SRO promptly after an executive officer of the issuer becomes aware of any material non-compliance with the rule.

To facilitate timely implementation of the final rule, each SRO has provided the SEC with proposed rules or rules amendments that comply with the foregoing requirements. The SEC must approve these final rules or rules amendments no later than December 1, 2003.

Additional Information

If you have any questions, please call Brian Ross at (212) 818-8610 or Marci J. Frankenthaler at (212) 818-8892. We intend to provide updates to this memorandum and our previous memoranda regarding the implementation of the provisions of the Sarbanes-Oxley Act of 2002 as warranted at our website www.graubard.com. When visiting our website for updates, please review the section entitled "Articles."