

December 28, 1999

SEC Adopts Final Rules and Approves NYSE Rules on Audit Committee Effectiveness

The SEC has adopted final rules and approved proposed NYSE, Amex and Nasdaq rules designed to improve disclosure relating to the functioning of corporate audit committees and to enhance the reliability and credibility of financial statements of public companies. The final rules repudiate the more extreme recommendations of the so-called “Blue Ribbon Committee.” See our memos “The SEC and NYSE Propose Rules Implementing the Blue Ribbon Committee’s Recommendations on Improving the Effectiveness of Corporate Audit Committees” (October 15, 1999) and “Audit Committees – Some Observations” (October 18, 1999).

I. Summary of Final Rules

A. The SEC’s final rules:

- require independent auditors to review interim financial statements before a company files its Form 10-Q
- require the proxy statement to include a report from the audit committee stating
 - (1) whether the audit committee has
 - (a) reviewed and discussed the audited financial statements with management
 - (b) discussed with the independent auditors the matters required to be discussed by Statement on Auditing Standards No. 61¹
 - (c) received disclosures from the auditors regarding the auditors’ independence required by Independence Standards Board Standard No. 1,² and discussed with the auditors the auditors’ independence

¹ SAS No. 61 requires an independent auditor to communicate to the audit committee matters related to the conduct of the audit such as the selection of and changes in significant accounting policies, the methods used to account for significant unusual transactions, the effect of significant accounting policies in controversial or emerging areas, the process used by management in formulating particularly sensitive accounting estimates and the basis for the auditor’s conclusions regarding the reasonableness of those estimates, significant adjustments arising from the audit, and disagreements with management over the application of accounting principles, the basis for management’s accounting estimates and the disclosures in the financial statements.

² Under ISB Standard No. 1, at least annually, an auditor must (1) disclose to the audit committee, in writing, all relationships between the auditor and its related entities and the company and its related entities that in the auditor’s professional judgment may reasonably be thought to bear on independence; (2) confirm in the letter that, in its professional judgment, it is independent of the company within the meaning of the Securities Acts; and (3) discuss the auditor’s independence with the audit committee.

(2) whether, based upon such review and discussion, the audit committee recommended to the Board of Directors that the audited financial statements be included in the company's Form 10-K

- require a company to disclose in its proxy statement whether the Board of Directors has adopted a written charter for the audit committee, and if so, to include a copy of the charter as an appendix to the company's proxy statement at least once every three years
- require a company to disclose in its proxy statement whether audit committee members are "independent" as defined by the relevant securities exchange or Nasdaq, and disclose certain information regarding any director on the audit committee who is not "independent"
- provide a "safe harbor" for the new proxy statement disclosures to protect companies and their directors from certain liabilities under the federal securities laws

B. The NYSE rules require:

- the board to adopt a formal written charter for the audit committee, with the audit committee to review and reassess annually the adequacy of such charter; companies must have charters adopted by June 14, 2000

such charter to specify:

- the scope of the audit committee's responsibilities and how they are being carried out
 - the ultimate accountability of the outside auditor to the board and audit committee
 - the responsibility of the audit committee and board for selection, evaluation and replacement of the outside auditor
 - the responsibility of the audit committee for ensuring the outside auditor submits a formal written statement delineating all relationships with the company, reviewing any disclosed relationships that may impact the objectivity and independence of the auditor, and recommending that the board take appropriate action in response to the outside auditors' report to satisfy itself of the auditors' independence
- the audit committee to consist of at least three directors, all of whom have no relationship to the company that may interfere with the exercise of their independence from management and the company
 - audit committee membership to conform to the following independence restrictions:

- an employee of the company or its affiliates may not serve on the audit committee until three years following termination of such employment, subject to the board’s override³
- a director who (1) is a partner, controlling shareholder or executive officer of an organization that has a business relationship with the company or (2) has a direct business relationship with the company (e.g., a consultant), cannot serve on the audit committee until three years after the termination of such relationship, unless the company’s board determines in its business judgment that the relationship does not interfere with the director’s exercise of independent judgment, taking into account, among other things, the materiality of the relationship to the company, the director and such organization
- a director who is employed as an executive of another corporation where any of the company’s executives serves on that corporation’s compensation committee may not serve on the audit committee
- a director who is an immediate family member of an individual who is an executive officer of the company or any of its affiliates cannot serve on the audit committee until three years following the termination of such employment relationship, subject to the board’s override³
- each audit committee member to be “financially literate,” as the company’s board interprets such qualification in its business judgment, or to attain such status within a reasonable period after appointment
- at least one audit committee member to have “accounting or related financial management expertise,” as the company’s board interprets such qualification in its business judgment
- the company to provide the NYSE annual written confirmation regarding:
 - any determination that the company’s board has made regarding the independence of directors
 - the financial literacy of audit committee members
 - the determination that at least one of the audit committee members has accounting or related financial management expertise
 - the annual review and reassessment of the adequacy of the audit committee charter

³ Under “exceptional and limited circumstances,” the board may appoint one director who is a former employee or an immediate family member of a former executive officer, but who is otherwise not eligible due to the three-year bar, to serve on the audit committee if it determines in its business judgment that such service is required in the best interests of the corporation and its shareholders, provided it discloses in the next annual proxy statement the nature of the relationship and the reasons for the override.

II. Analysis of Final Rules

A. Audit Committee Statement

In the Adopting Release, the SEC noted that “the concern most frequently expressed [by commentators] was that as a result of the new requirements to provide certain disclosures in a report, audit committees may be exposed to additional liability, and that consequently it may be difficult for companies to find qualified people to serve on audit committees.” As a result of these liability concerns, the SEC withdrew its proposal that the audit committee provide negative assurances that nothing has come to its attention that would lead it to believe there were material misstatements or omissions in the company’s audited financial statements.

Instead, the final rules require only that the audit committee state whether, based on the review and discussion with management and auditors, it recommended to the Board of Directors that the financial statements be included in the annual report on Form 10-K for the last fiscal year for filing with the SEC. The Release notes the SEC’s view that such recommendation “already is implicit in, and is consistent with, board members signing the company’s 10-K.” In a related change, the Auditing Standards Board has proposed an amendment to SAS No. 61 to require the auditor to discuss with the audit committee certain information relating to the auditor’s judgment about the quality, not just the acceptability, of the company’s financial statements.

B. Audit Committee Charter

The NYSE amended its proposed rules to require the board, rather than the audit committee, to adopt the audit committee charter, and to require current listed companies to adopt a formal written charter within six months, rather than eighteen months, of the effective date of the rule change. In addition, the NYSE rules were modified to delete the requirement that the board “ensure” the independence of the auditor, and substitute a requirement that the board take such action as is necessary to satisfy itself as to the independence of the auditor. We have attached a model audit committee charter that is designed to meet the final SEC and NYSE rules while seeking to minimize the potential liability exposure that could arise from the charter requirement.

C. Safe Harbor

The form of the audit committee disclosures safe harbor adopted by the SEC tracks the treatment of compensation committee reports under the proxy rules. Such required information would not be deemed to be “soliciting material” or to be “filed” with the SEC, or subject to Regulation 14A or to the liabilities under Section 18 of the Exchange Act, except to the extent the company specifically incorporates such information by reference in other filings.

Although many commentators recommended that the SEC provide stronger safe harbor protection, the SEC did not find such an expansion of the safe harbor to be necessary since it did not believe that the new disclosure requirements would result in increased exposure

to liability. We believe the limited safe harbor will not protect audit committee members from an increase in lawsuits arising from the audit committee rules.

III. Transition Period and Compliance Dates

The SEC provides a transition period for compliance with its new audit committee rules. Companies must obtain reviews of interim financial information by their independent auditors starting with their Forms 10-Q filed for fiscal quarters ending on or after March 15, 2000. Companies must comply with the new proxy disclosure requirements for all proxy statements relating to votes of shareholders occurring after December 15, 2000.

The NYSE transition period grandfathers all public company audit committee members qualified under current NYSE rules until they are re-elected or replaced, although proxy disclosure would be required in 2001 to the extent audit committee members did not meet the independence standards of the new rule. It also gives companies that have fewer than three members on the audit committees eighteen months from the date of SEC approval (i.e., by June 14, 2001) to recruit the requisite members. As noted above, NYSE companies must adopt a written audit committee charter within six months of the effective date (i.e., by June 14, 2000).

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MODEL AUDIT COMMITTEE CHARTER*
(NYSE Listed Company)

The Audit Committee is appointed by the Board to assist the Board in monitoring (1) the integrity of the financial statements of the Company, (2) the compliance by the Company with legal and regulatory requirements and (3) the independence and performance of the Company's internal and external auditors.

The members of the Audit Committee shall meet the independence and experience requirements of the New York Stock Exchange. The members of the Audit Committee shall be appointed by the Board on the recommendation of the [Nominating and Governance Committee].

The Audit Committee shall have the authority to retain special legal, accounting or other consultants to advise the Committee. The Audit Committee may request any officer or employee of the Company or the Company's outside counsel or independent auditor to attend a meeting of the Committee or to meet with any members of, or consultants to, the Committee.

The Audit Committee shall make regular reports to the Board.

The Audit Committee shall:

1. Review and reassess the adequacy of this Charter annually and recommend any proposed changes to the Board for approval.
2. Review the annual audited financial statements with management, including major issues regarding accounting and auditing principles and practices as well as the adequacy of internal controls that could significantly affect the Company's financial statements.
3. Review an analysis prepared by management and the independent auditor of significant financial reporting issues and judgments made in connection with the preparation of the Company's financial statements.
4. Review with management and the independent auditor the Company's quarterly financial statements prior to the release of quarterly earnings.
5. Meet periodically with management to review the Company's major financial risk exposures and the steps management has taken to monitor and control such exposures.
6. Review major changes to the Company's auditing and accounting principles and practices as suggested by the independent auditor, internal auditors or management.
7. Recommend to the Board the appointment of the independent auditor, which firm is ultimately accountable to the Audit Committee and the Board.

* Charter must be adopted by the Board.

8. Approve the fees to be paid to the independent auditor.
9. Receive periodic reports from the independent auditor regarding the auditor's independence, discuss such reports with the auditor, and if so determined by the Audit Committee, recommend that the Board take appropriate action to satisfy itself of the independence of the auditor.
10. Evaluate together with the Board the performance of the independent auditor and, if so determined by the Audit Committee, recommend that the Board replace the independent auditor.
11. Review the appointment and replacement of the senior internal auditing executive.
12. Review the significant reports to management prepared by the internal auditing department and management's responses.
13. Meet with the independent auditor prior to the audit to review the planning and staffing of the audit.
14. Obtain from the independent auditor assurance that Section 10A of the Private Securities Litigation Reform Act of 1995 has not been implicated.
15. Obtain reports from management, the Company's senior internal auditing executive and the independent auditor that the Company's subsidiary/foreign affiliated entities are in conformity with applicable legal requirements and the Company's Code of Conduct.
16. Discuss with the independent auditor the matters required to be discussed by Statement on Auditing Standards No. 61 relating to the conduct of the audit.
17. Review with the independent auditor any problems or difficulties the auditor may have encountered and any management letter provided by the auditor and the Company's response to that letter. Such review should include:
 - (a) Any difficulties encountered in the course of the audit work, including any restrictions on the scope of activities or access to required information.
 - (b) Any changes required in the planned scope of the internal audit.
 - (c) The internal audit department responsibilities, budget and staffing.
18. Prepare the report required by the rules of the Securities and Exchange Commission to be included in the Company's annual proxy statement.
19. Advise the Board with respect to the Company's policies and procedures regarding compliance with applicable laws and regulations and with the Company's Code of Conduct.

20. Review with the Company's General Counsel legal matters that may have a material impact on the financial statements, the Company's compliance policies and any material reports or inquiries received from regulators or governmental agencies.
21. Meet at least annually with the chief financial officer, the senior internal auditing executive and the independent auditor in separate executive sessions.

While the Audit Committee has the responsibilities and powers set forth in this Charter, it is not the duty of the Audit Committee to plan or conduct audits or to determine that the Company's financial statements are complete and accurate and are in accordance with generally accepted accounting principles. This is the responsibility of management and the independent auditor. Nor is it the duty of the Audit Committee to conduct investigations, to resolve disagreements, if any, between management and the independent auditor or to assure compliance with laws and regulations and the Company's Code of Conduct.