SEC PROPOSES AUDIT COMMITTEE RULES PURSUANT TO SARBANES-OXLEY

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On January 9, 2003, the Securities and Exchange Commission released proposed rules under the Sarbanes-Oxley Act of 2002 (the "Act") to strengthen the independence and authority of the audit committees of listed companies.[1] The proposed rules seek to ensure that listed companies have strong, competent and vigilant audit committees by requiring all audit committee members to be independent and by mandating that all audit committees be granted specific responsibilities and authority designed to restrict the ability of management to improperly influence the independent audit process.

The SEC has recently adopted final rules regarding several other provisions of the Act.[2] We are preparing separate memoranda regarding these other important developments (including a separate memorandum for registered investment companies), each of which will be distributed to our clients and also will be available upon request or at our web site at *www.simpsonthacher.com*.

EXECUTIVE SUMMARY

The SEC's proposed rules under Section 301 of the Act (the "Proposed 301 Rules") would prohibit any national securities exchange and national securities association (the "self-

[1] SEC Release Nos. 33-8173 and 34-47137 (January 9, 2003) (the "Release").

[2] This memorandum supplements our earlier memoranda regarding the Act, which are available upon request or at our website: *www.simpsonthacher.com*.

regulatory organizations" or the "SROs") from listing any security of an issuer that does not comply with all of the following standards:

- Each member of the audit committee must be independent, which requires that the member satisfy the following two-prong test:
  - the member may not receive, directly or indirectly, any consulting, advisory or other compensatory fee from the issuer (other than ordinary course director's fees); and
  - the member may not be an "affiliated person" of the issuer (there is a proposed safe harbor for this requirement providing that a member would not be an "affiliated person" so long as the member does not own greater than 10% of the issuer's common stock and is not a director or executive officer of the issuer).
- The audit committee must be directly responsible for the appointment, compensation, oversight and termination of the issuer's independent auditors.
- The audit committee must establish procedures for handling complaints regarding accounting, internal accounting controls or auditing matters.
- The audit committee must have the authority to engage its own outside advisers and determine the appropriate funding necessary to compensate these advisers as well as the independent auditors.

The Proposed 301 Rules contain some limited exceptions to these requirements, the most notable of which include:

- A 90-day grace period from the independence requirements for companies going public for the first time.
- An exemption from the "affiliated person" prong of the independence test for majority-owned subsidiaries, which would allow directors serving on the board of a parent company to be on the audit committee of the parent's listed subsidiary (and vice versa).
- Several exceptions for foreign private issuers subject to competing home country legal or listing requirements, including the following exceptions that are each available upon satisfying certain criteria:
  - Non-management employees may be members of the audit committee;
  - A controlling shareholder may designate one non-voting member to the audit committee;

- One member of the audit committee may be a foreign governmental representative; and
- If home country law provides for auditor oversight through a board of auditors (or similar body) or group of statutory auditors, the foreign private issuer need not establish a separate audit committee consisting of independent board members.

- An exemption for subsidiaries that list debt and non-convertible, non-participating preferred securities (so long as the parent company lists an equity security and is thereby subject to the Proposed 301 Rules).

In addition to providing these limited exceptions, the Proposed 301 Rules contain other exemptions that apply to particular types of issuers (*e.g.*, investment companies) and types of listed securities (*e.g.*, futures products and standardized options). This memorandum, after setting out the baseline audit committee independence standards and required responsibilities, discusses in detail the exceptions which may be available to foreign private issuers and the impact of the Proposed 301 Rules on these other types of issuers and securities that are afforded special treatment.

The SEC has requested comment on the Proposed 301 Rules by February 18, 2003. The Act requires the SEC to issue final rules under Section 301 by April 26, 2003. Moreover, as these rules may require issuers to reconfigure their audit committees (or to establish an audit committee for the first time) and to recruit independent directors, the SEC has proposed a transition period. Under the Proposed 301 Rules, the self-regulatory organizations will have one year from the publication of the final rules before having to implement the requisite audit committee standards.

STATUTORY BACKGROUND AND REGULATORY OVERLAY

Statutory Background

Prior to the Act, none of the Securities Act of 1933, the Securities Exchange Act of 1934 or any SEC rule required a company to have an audit committee.[3] Section 301 of the Act, enacted

[3] Largely with the SEC's encouragement, however, the most prominent SROs—the New York Stock Exchange and The Nasdaq Stock Market, Inc.—have for some time now required U.S. companies listed with them to maintain audit committees comprised of independent directors. Further, the SEC's proxy rules require a U.S. registrant to disclose in its proxy statement whether it has an audit committee, and if so, the proxy rules require the registrant to disclose specified information with respect to the committee

in the wake of the recent spate of corporate scandals, changes this landscape. Section 301 of the Act amended the Exchange Act to require that the SEC by rule direct the SROs to prohibit the listing of any security of an issuer that does not comply with the following standards:

- Each member of the audit committee of a listed company must be independent according to specified criteria.

- The audit committee of each listed company must: (i) be directly responsible for the appointment, compensation and oversight of the company's independent auditors; (ii) establish procedures for the receipt, retention and treatment of complaints regarding financial matters; (iii) have the authority to engage independent counsel and other advisers; and (iv) be provided with appropriate funding from the issuer to compensate the independent auditors and advisers.

The Proposed 301 Rules would satisfy this mandate primarily by implementing new Rule 10A-3 of the Exchange Act ("Rule 10A-3"), captioned "Listing standards relating to audit committees". Because the Proposed 301 Rules also would require some changes to issuers' disclosure obligations, the SEC has also proposed amendments to certain items of Regulation S-K and to certain of its forms.

Overlay with Proposed NYSE and Nasdaq Audit Committee Standards

Companies listed on the NYSE or quoted on Nasdaq likely are aware that each of these SROs recently proposed new corporate governance listing standards. Both sets of proposed standards contain requirements regarding the independence of audit committee members and the responsibilities of audit committees. Although there is considerable overlap among the Proposed 301 Rules and the proposed NYSE and Nasdaq listing standards, there are areas of divergence as well. Some of the most meaningful differences among the multiple sets of audit committee rules being proposed include the following:

- **Additional NYSE and Nasdaq independence standards**. Each of the proposed NYSE and Nasdaq listing standards regarding audit committee member independence contain prohibitions on some types of relationships not otherwise covered by the Proposed 301 Rules. For example, each of the proposed NYSE and Nasdaq listing standards bar directors from being considered independent if family members of the director are employed by (or have other prohibited relationships with) the listed company. The Release confirms that the Proposed 301 Rules would

(*e.g.*, names of members, whether the members are independent under NYSE or Nasdaq rules, if applicable, and whether the committee has adopted a written charter).

allow the SROs to adopt additional requirements such as those currently proposed by the NYSE and Nasdaq.

- **Additional responsibilities for a NYSE-listed company's audit committee**. The proposed NYSE standards would impose several responsibilities on the audit committee beyond those contained in the Proposed 301 Rules (*e.g.*, the audit committee would have to discuss policies with respect to risk assessment and risk management and meet separately, periodically, with management, internal auditors and the independent auditor). The proposed Nasdaq standards regarding audit committee responsibilities, on the other hand, simply make reference to the Act and expected SEC rulemaking such that the responsibilities are co-extensive with those required by the Act and the SEC's rules.

- **Impact on foreign private issuers**. Each of the proposed NYSE and Nasdaq listing standards would continue to permit listed foreign private issuers to adhere to the corporate governance requirements of their home country in lieu of the proposed governance standards, although these issuers would have to disclose any significant ways in which their corporate governance practices differ from the applicable SRO's proposed standards. The Proposed 301 Rules, however, do not provide a general exemption from the audit committee requirements and instead provide only specified, limited exceptions for these issuers.

The proposed NYSE standards and proposed Nasdaq standards remain subject to SEC approval and may be revised prior to final approval. In fact, the SEC has publicly stated that it intends to work towards harmonizing the proposed NYSE standards and proposed Nasdaq standards. Although this memorandum does not discuss in any significant detail the NYSE or Nasdaq's proposals relating to audit committees,[4] attached as Appendix A is a chart comparing differences between the audit committee standards contained in each of the Proposed 301 Rules, the proposed NYSE standards and the proposed Nasdaq standards.

[4] For a full discussion of the proposed NYSE listing standards, as well as a comparison of the NYSE and Nasdaq proposals, see our memorandum dated August 23, 2002, "*NYSE Board of Directors Approves New Corporate Governance and Disclosure Standards*," which is available upon request or at our website: *www.simpsonthacher.com*.

AUDIT COMMITTEE MEMBER INDEPENDENCE

One of the cornerstones of the Proposed 301 Rules is that listed companies subject to the new rules must have an audit committee composed entirely of independent directors. Independent directors, according to the Release, are the group best suited to assess objectively the quality of the issuer's financial statements and system of internal controls. The SEC expressed its view that these directors should be less susceptible to market pressures and other short-term, performance-related pressures that could affect the judgment of inside directors. The Proposed 301 Rules would enhance audit committee independence by elaborating on the two criteria enumerated by the Act:

1. Members of a listed company's audit committee may not receive compensation from the listed company other than ordinary director's fees; and
2. Members of a listed company's audit committee may not be an "affiliated person" of the listed company or any of its subsidiaries.

Audit Committee Members May Not Receive Any Compensation Other Than Director's Fees

Under the Proposed 301 Rules, audit committee members would generally be barred from receiving any consulting, advisory or other compensatory fees from the issuer, other than compensation paid to them for service on the board of directors and any board committee. Disallowed fees would include payments made both directly and indirectly to the audit committee member, and the Proposed 301 Rules would define the "indirect" acceptance of fees to include the receipt of the following payments:

- Payments to a committee member's spouse, minor child or minor stepchild (or child or stepchild sharing a home with the committee member); and
- Payments to an entity in which the committee member is a partner, member or principal (or occupies a similar position) and which provides accounting, consulting, legal, investment banking, financial or other advisory services to the issuer.

Notably, the Proposed 301 Rules make no mention of a dollar threshold, meaning that audit committee members would be barred from receiving even a de minimis amount of prohibited fees (although the SEC has requested comment regarding whether there should be a de minimis exception). The SEC did clarify, however, that the Proposed 301 Rules would not preclude independence based on payments made pursuant to an ordinary course business transaction between the issuer and an entity with which the audit committee member has a relationship. Similarly, payments made pursuant to most retirement or similar plans in which a former officer or employee of the issuer participates would appear to be permissible under the Proposed 301 Rules, although the Release did not explicitly address the permissibility (or

impermissibility) of these types of payments.[5] In that connection, the SEC requested comment as to whether it should better define the contours of "compensatory fees", including whether the final rules should expressly address retirement payments.

Audit Committee Members May Not Be "Affiliated" with Issuer or Its Subsidiaries

The second prong of the independence requirement stipulates that the audit committee member may not be an "affiliated person" of the issuer or any subsidiary of the issuer, apart from in his or her capacity as a member of the board or any board committee. The Act defines "affiliated person" by reference to the definition contained in the Investment Company Act of 1940, as amended, which included a 5% ownership threshold that raised significant interpretive issues. The SEC, however, recognizing the unsuitability of that definition in the context of assessing audit committee member independence, has proposed to rely upon the definition of "affiliate" contained in the Securities Act and Exchange Act rules (*e.g.*, Securities Act Rule 144 and Exchange Act Rule 12b-2), which is premised solely on whether there is a control relationship.

Definition of "Affiliated Person". Under the Proposed 301 Rules, an affiliated person would 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. The term "control" would then be defined in a manner consistent with Exchange Act Rule 12b-2 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." As noted in the Release, this definition would require issuers to make a determination based on a consideration of all relevant facts and circumstances, subject to the exception for relationships falling within the safe harbor provision.

Safe Harbor. The SEC noted that it often can be difficult to make a conclusive assessment regarding affiliation. The Proposed 301 Rules therefore would create a safe harbor provision. Under the proposed safe harbor, a person who is not an executive officer, director or 10% shareholder of the issuer would be deemed not to control the issuer (the SEC has requested comment on whether 10% is the appropriate threshold). This test is similar to that used for determining insider status under Section 16 of the Exchange Act. Importantly, this test merely creates a safe harbor and does not preclude a determination (based on a facts-and-circumstances analysis) that an audit committee member is not an affiliated person even if that member does not qualify for the safe harbor.

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[5] In its proposed corporate governance listing standards, the NYSE expressly recognized non-contingent deferred compensation and pension payments as exceptions to its general requirement that director's fees are the only form of compensation that an audit committee member may receive from the issuer.

Impact on Designees of Significant Shareholders. The SEC specifically noted that the proposed "affiliated person" definition would mean that a director, executive officer, partner, member, principal or designee of an affiliate would also be deemed an affiliate. This point carries with it particular importance for significant shareholders of listed companies. An individual, group or entity owning a significant percentage of the listed company's shares (*i.e.*, more than the 10% safe harbor limit) would be foreclosed from designating a member of the listed company's audit committee if that individual, group or entity is deemed to control the listed company. In that connection, the listed company would have to analyze all of the facts and circumstances surrounding the relationship with the shareholder, and such matters as contractual veto and other shareholder rights would impact the analysis.

Test for Investment Companies. The general applicability of the Proposed 301 Rules to various types of investment companies is discussed further below under the heading "*Impact on Specified Types of Issuers and Specified Types of Listed Securities*". For those investment companies to which the Proposed 301 Rules do apply, the test for impermissible affiliation with the issuer is slightly different than for other issuers subject to the standard. An audit committee member of an issuer that is an investment company may not be an "interested person" of the investment company, as defined in Section 2(a)(19) of the Investment Company Act. The Release notes that this definition is being proposed for investment companies because it is "tailored to capture the broad range of affiliations with investment advisers, principal underwriters and others that are relevant to the "independence" in the case of investment companies."

Exemptions from Independence Requirements

Companies Going Public for the First Time (exemption from both no-compensation and affiliated person tests). The Proposed 301 Rules would exempt one member (of a non-investment company) of an issuer's audit committee from the independence requirements for 90 days from the effective date of the issuer's initial registration statement. When discussing this proposed exemption, the SEC noted that companies coming to market for the first time often have difficulty recruiting qualified independent directors prior to the initial public offering. The proposed exemption, though it only provides for a 90-day recruitment window, provides some measure of relief for these companies in an effort not to discourage companies from accessing the public markets. Interestingly, the NYSE listing standards, as currently proposed, would grant a two-year transition period for companies listing in conjunction with an initial public offering. The SEC has requested comment as to the appropriate length of the exemption period, and it is possible that the proposed 90-day period will be lengthened.

Majority-Owned Subsidiary (exemption from affiliated person test only). The SEC has proposed to exempt from the "affiliated person" requirement a committee member that sits on the board of both a parent and a direct or indirect consolidated majority-owned subsidiary. In order to qualify for this exemption, however, the audit committee member must otherwise meet the independence requirements in respect of both the parent and subsidiary, including the receipt from the issuer of only ordinary course compensation for serving as a member of the

board and the audit committee. According to the Release, this exemption recognizes that entities with holding company structures often have common boards, and simply serving on the board of a consolidated subsidiary should not adversely affect the board member's independence in respect of the parent. This exemption, in particular, should provide needed relief to financial institutions, utilities and other types of institutions that typically operate with a holding company structure.

General Exemptive Authority. In the Release, the SEC notes that it does not propose to entertain exemptions or waivers for particular relationships on a case-by-case basis. Nonetheless, the Proposed 301 Rules would contain a provision permitting the SEC to exempt from the independence requirements a particular relationship "as the Commission determines appropriate in light of the circumstances."

Required Disclosure. If any listed company chooses to rely on one of the above exemptions from the independence requirements, it would have to disclose its reliance and its assessment of whether, and if so, how, such reliance would materially adversely affect the ability of its audit committee to act independently and to satisfy its obligations under the Proposed 301 Rules. The disclosure would need to appear in, or be incorporated by reference into, annual reports filed with the SEC and in proxy statements for shareholders' meetings at which elections for directors are held.[6]

AUDIT COMMITTEE RESPONSIBILITIES

Responsibilities Regarding Independent Auditors

Historically, one of the audit committee's primary functions has been to reinforce the independence of an issuer's outside auditor. As the SEC noted, the independence of the auditing process may be compromised when an issuer's auditor views its primary responsibility as serving management. To address this concern and help assure investors that independent auditors are conducting objective reviews and are truly independent, the Proposed 301 Rules impose two requirements:

- **The audit committee must be directly responsible for the appointment, compensation, retention and oversight of the work of the independent auditors engaged for the purpose of preparing or issuing an audit report or related work**.

[6] This disclosure is proposed to be included in Part III of Form 10-K and Form 10-KSB (through an addition to Item 401 in Regulations S-K and S-B, as applicable). With respect to Forms 10-K and 10-KSB, Part III permits an issuer, under certain circumstances, to incorporate the disclosure by reference from its definitive proxy or information statement.

This requirement includes the responsibility to resolve any disagreements between management and the auditor regarding financial reporting. Moreover, this responsibility also applies to any work that the independent auditor performs for the issuer in respect of other audit, review or attest services, such as services related to the issuance of comfort letters.[7] Finally, the Proposed 301 Rules clarify that the audit committee, as part of discharging its oversight role, has the power to terminate the auditor as well as the ultimate authority to approve all audit engagement fees and terms and all significant non-audit engagements of the auditor.

- **The independent auditor must report directly to the audit committee**. This requirement reinforces the concept that the independent auditors report to a corporate body that is independent of the management whose financial results are being audited.

The SEC expressly noted that the above requirements relate to the assignment of responsibility to oversee the auditor's work as between the audit committee and management. In this regard, the Release points out that the proposed rules should not be read to conflict with any requirement under an issuer's governing law, organizational documents or other home country requirements providing that shareholders must elect, approve or ratify the selection of the issuer's independent auditors. In such an instance, however, if the issuer recommends or nominates an auditor for its shareholders, the audit committee must be responsible for making the recommendation or nomination.

In addition, the SEC has proposed to exempt investment companies from the requirement that the audit committee be responsible for selecting the independent auditor. Noting that the Investment Company Act already requires auditors of investment companies to be selected by a majority vote of disinterested directors, the SEC considers it unnecessary to subject these companies to the audit committee selection requirement set forth in the Proposed 301 Rules.

Establishing Procedures for Handling Complaints Regarding Accounting Matters

The Proposed 301 Rules would require audit committees to establish procedures for receiving and handling complaints about questionable accounting, internal accounting controls and auditing matters. According to the Release, by requiring issuers to establish formal

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[7] By broadening the scope of the independent auditor's work for which the audit committee is responsible, the Proposed 301 Rules work together with the recently adopted rules regarding auditor independence (*see* SEC Release Nos. 33-8183 and 34-47265 (January 28, 2003)). The auditor independence rules impose several requirements on the conduct of the auditor (and the auditor's employees) if its engagement is within the scope of "audit, review or attest services," which is defined as being broader than simply those services required to perform an audit pursuant to generally accepted auditing standards.

procedures (often referred to as "whistleblower procedures"), the SEC is hopeful that potential problems relating to an issuer's financial condition will surface more quickly than they have in the past, which could help prevent serious adverse consequences to employees and investors alike.[8] Specifically, the Proposed 301 Rules require 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 employees of the issuer of concerns regarding questionable accounting or auditing matters.

The SEC, in drafting the Proposed 301 Rules, consciously avoided mandating specific procedures that an audit committee must adopt. Rather, as noted in the Release, the SEC chose to provide companies with the flexibility to develop procedures appropriate for their own unique circumstances. We would expect, however, that although each issuer subject to the Proposed 301 Rules is free to adopt procedures of its choosing, most issuers' procedures will have certain common characteristics. Some items that issuers should consider when designing their whistleblower procedures include:

- Providing alternative avenues for employees to submit complaints (*e.g.*, provide a toll-free "hotline" number, assign a specific person to receive complaints and/or provide for complaints directly to the audit committee);

- Establishing procedures for assigning the appropriate person or corporate body to review and investigate the complaint (*e.g.*, issuers could grant the audit committee the discretion to determine whether it, management or some other person or group of persons will investigate a complaint); and

- Formalizing a records policy (*e.g.*, clearly establish to what extent the audit committee will document the review and investigatory process and for how long the documentation will be maintained).

We have attached as Annex I to this memorandum sample whistleblower procedures designed to satisfy the Proposed 301 Rules.[9] The attached procedures provide examples of how issuers

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[8] In addition to requiring the adoption of formal procedures, the Act provides protections for employees who provide evidence of wrongdoing. For example, Section 806 of the Act adds a new provision to the U.S. Criminal Code to provide a private right of action for "whistleblowers."

[9] The attached sample procedures are for illustrative purposes, and listed companies will need to carefully tailor their procedures to fit their particular business and circumstances, including their corporate culture.

could address each of the above considerations and highlight additional matters that issuers will need to reflect on when putting their procedures in place.

Authority To Engage Advisers and Funding

In an effort to further augment the audit committee's independence and effectiveness, the Proposed 301 Rules would require listed companies to adhere to two additional requirements regarding their audit committees.

Authority To Engage Independent Advisers. Because an audit committee likely is not equipped to self-advise on all accounting, financial reporting or legal matters, the audit committee must have the ability to retain its own outside advisers. As pointed out in the Release, outside advisers not only can provide a critical eye and draw on their own experiences when it comes to assessing the listed company's disclosure and other compliance obligations, these advisers can also help avoid potential conflicts of interest with management by independently investigating questions regarding financial reporting and compliance with securities laws. The Proposed 301 Rules, accordingly, would include a provision in proposed Rule 10A-3 stating that "[e]ach audit committee must have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties."

Authority To Determine Appropriate Funding. In furtherance of the above requirement, as well as the audit committee's responsibility to appoint, compensate, retain and oversee the listed company's independent auditor, the audit committee needs to be provided with appropriate funding of its own determination. Without the ability to determine and receive the necessary funding for these purposes, the audit committee's effectiveness could be compromised (in fact or in appearance) to the extent it would be reliant on management's discretion to compensate the independent auditors or advisers. The Proposed 301 Rules would therefore include the following provision as part of proposed Rule 10A-3: "Each listed issuer must provide for appropriate funding, as determined by the audit committee, in its capacity as a committee of the board of directors, for payment of compensation: (i) to 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 listed issuer; and (ii) to any advisers employed by the audit committee …."

The procedures also may need to be modified depending on the form of the final rules that the SEC adopts following the comment period.

IMPACT ON FOREIGN PRIVATE ISSUERS

As required by the Act, foreign private issuers will generally be subject to the Proposed 301 Rules. Acknowledging the concerns of several foreign issuers, however, the SEC has proposed exemptions from certain provisions of the Proposed 301 Rules. The exemptions, which are outlined below, seek to address specific areas in which foreign corporate governance arrangements and home country requirements differ significantly from the general practices among domestic issuers. In addition, the SEC has asked for comments as to whether additional exemptions should be included in the final rules, suggesting that further accommodations for foreign private issuers are possible.

Overview of Exemptions

Non-Management Employee May Be Member of Audit Committee. Some foreign private issuers, such as German companies, are subject to legal or listing requirements stipulating that a non-management employee serve on the board of directors or audit committee.[10] Absent an exemption, such an employee would fail the "no compensation" prong of the independence test and therefore not be considered independent for audit committee purposes. Accordingly, the Proposed 301 Rules provide an exemption from the independence requirements for an employee of a foreign private issuer who (i) is not an executive officer of the issuer and (ii) is elected or named to the board of directors or audit committee of the issuer pursuant to home country legal or listing requirements.

Controlling Shareholder May Designate One Non-Voting Member to Audit Committee. The Release notes that controlling shareholders and shareholder groups are more prevalent among foreign issuers than in the United States, and in jurisdictions providing for audit committees, these controlling shareholders or shareholder groups commonly have a representative on the issuer's audit committee. Such a representative would be considered an "affiliated person" and would ordinarily be prohibited from serving on the audit committee. The Proposed 301 Rules, however, provide that one member of the audit committee of a foreign private issuer may be exempt from the "affiliated person" prong of the independence test (but not the "no compensation" prong of the test) so long as the member:

(i) is the beneficial owner of more than 50% of the voting common equity of the foreign private issuer or is a representative or designee of a greater than 50% owner or group of owners;

[10] With respect to foreign private issuers that have a two-tiered board structure comprised of a management board and a supervisory or non-management board, the Proposed 301 Rules would define "board of directors" to mean the supervisory or non-management board, which the SEC has indicated would be the body "best equipped" to comply with the proposed requirements.

(ii) has only observer status and is not a voting member or chair of the committee; and

(iii) is not an executive officer of the issuer.

One Member of Audit Committee May Be Foreign Governmental Representative. In a similar vein to the above exemption, the Release notes that foreign governments may have significant shareholdings or may own special shares in some foreign private issuers and, in such cases, often have a representative on the audit committee of the issuer. Again, because of its shareholdings or special rights, governmental designees could run afoul of the "affiliated person" test. Another limited exemption, however, is contained in the Proposed 301 Rules that would permit one member of the audit committee of a foreign private issuer to be exempt from the "affiliated person" prong of the independence test (but not the "no compensation" prong of the test) so long as the member:

(i) is the representative or designee of a foreign government or foreign governmental entity that is an affiliate of the foreign private issuer; and

(ii) is not an executive officer of the issuer.

Alternative Structures To Having Audit Committee May Be Available. Several foreign jurisdictions (*e.g.*, Japan) require or provide for auditor oversight through a board of auditors or similar body, or group of statutory auditors, that is separate from the board of directors (an "Alternative Oversight Body"). In the Release, the SEC notes that the members of an Alternative Oversight Body may not in all cases satisfy the independence requirements set forth in the Proposed 301 Rules. Moreover, the SEC acknowledged that an Alternative Oversight Body may not maintain all of the responsibilities that the Proposed 301 Rules assign to a listed company's audit committee. Accordingly, the Proposed 301 Rules would exempt foreign private issuers from the independence requirements and auditor oversight requirements of the proposed rules so long as the following six standards are satisfied:

(i) the securities of the foreign private issuer are also listed or quoted on an exchange or quotation system outside of the United States;

(ii) the foreign private issuer has an Alternative Oversight Body established and selected pursuant to home country legal or listing provisions;

(iii) members of the Alternative Oversight Body are not elected by management and no executive officer of the foreign private issuer is a member of the Alternative Oversight Body;

(iv) home country legal or listing requirements set forth standards for the independence of the Alternative Oversight Body from the issuer or management of the issuer;

(v) the Alternative Oversight Body is directly responsible for the oversight of the work of the independent auditor; and

(vi) the Alternative Oversight Body is responsible, to the extent permitted by law, for the appointment and retention of the independent auditors.

Notably, this exemption does not cover the other audit committee responsibilities required by the Proposed 301 Rules: handling of complaints and the ability to hire advisers and obtain necessary funding. These requirements would continue to apply to foreign private issuers, except that the requirements would apply to the Alternative Oversight Body instead of an audit committee.

Disclosure Required If Exemption Relied Upon

Under the Proposed 301 Rules, any foreign private issuer relying on one of the above-described exemptions would have to comply with the following disclosure obligations:

- **Disclose reliance on exemption and assessment of impact**. The foreign private issuer would have to disclose its reliance on the exemption and an assessment of whether, and if so, how, such reliance would materially adversely affect the ability of its audit committee to act independently and to satisfy the other requirements of the Proposed 301 Rules regarding audit committees. This disclosure would have to appear in the foreign private issuer's annual report on Form 20-F or Form 40-F, as applicable.[11]

- **File exhibit stating reliance on Alternative Oversight Body exemption**. Foreign private issuers relying on the exemption permitting an Alternative Oversight Body would have to make a statement regarding such reliance in an exhibit filed with their annual report on Form 20-F.[12] As noted in the Release, the SEC feels that the presence of exhibits can be easily identified in electronic filings and this requirement therefore will facilitate investors' ability to monitor the use of this exemption.

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[11] This disclosure requirement would be codified in new Item 15(f) to Form 20-F and new General Instruction B.(11) to Form 40-F.

[12] This disclosure requirement would be codified in new paragraph (11) to the Instructions as to Exhibits to Form 20-F.

IMPACT ON SPECIFIED TYPES OF ISSUERS AND SPECIFIED TYPES OF LISTED SECURITIES

In addition to providing certain exemptions for foreign private issuers, the SEC has drafted into the Proposed 301 Rules other exceptions that apply to specified types of issuers and specific types of listed securities.

Application of Proposed 301 Rules on Specified Types of Issuers

Small Businesses: Rules Apply. The Proposed 301 Rules would apply to listed issuers of all sizes, including small business issuers. According to the Release, the SEC believes that current minimum listing standards (*e.g.*, market capitalization requirements) will serve to limit the size of the issuers that will be affected by the Proposed 301 Rules. The SEC did, however, request comment on whether an exemption for small businesses would be appropriate after acknowledging that smaller issuers and SROs specializing in listing the securities of such issuers could be negatively impacted.

Investment Companies: Application of Rules Depends on Type of Investment Company. As previously discussed, in a couple of instances the application of the Proposed 301 Rules differs with respect to investment companies (*i.e.*, investment companies use the "interested person" test rather than the "affiliated person" test and investment companies do not have to assign their audit committee the responsibility of hiring the independent auditors). In addition to these exceptions, the Proposed 301 Rules would exempt exchange-traded unit investment trusts entirely. Closed-end investment companies and exchange-traded open-end investment companies would have to comply with the Proposed 301 Rules, subject to the specific exceptions noted above.

Asset-Backed Issuers: Rules Do Not Apply. The Proposed 301 Rules contain an exemption excluding asset-backed issuers from all of the rules' requirements.

Issuers Without An Audit Committee: Rules Apply to Entire Board. The Act defines "audit committee" as "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 . . . *if no such committee exists with respect to an issuer, the entire board of directors …*" (emphasis added). The Proposed 301 Rules therefore permit an issuer either to have a separately designated audit committee composed of members of its board, or to have its entire board of directors deemed to constitute the audit committee. Issuers choosing not to designate a separate committee therefore would have to maintain a board of directors on which all directors serving comply with the independence standards.

Application of Proposed 301 Rules to Specified Types of Listed Securities

The Act made no distinction regarding the type of securities to be covered, prohibiting the listing of "any security" of an issuer not in compliance with the audit committee standards. The Proposed 301 Rules therefore apply not only to voting equity securities but also to any other listed security, including debt, preferred, derivative and other types of securities. The Proposed 301 Rules, however, do provide a general exemption from its requirements in two situations.

Exemption for Multiple Listings. For companies issuing multiple classes of securities through various ownership structures, being subjected to multiple layers of compliance would add little value. Accordingly, the SEC has drafted the Proposed 301 Rules to include exemptions for the following situations:

- **Listings by majority-owned subsidiary**. Any time an issuer has a class of common equity listed on a national securities exchange or association, the listing of other classes of *non-equity* securities (or non-convertible, non-participating preferred securities) by a consolidated majority-owned subsidiary of the issuer would not be subject to the Proposed 301 Rules. For example, if a parent company has a class of equity securities listed on the NYSE, then any listed debt securities issued by its subsidiaries would not subject the subsidiary to the Proposed 301 Rules.[13] Financing subsidiaries would therefore be exempt from the requirements of the Proposed 301 Rules. This exemption would not apply, however, if the security being listed by the subsidiary was an equity security of the subsidiary (other than non-convertible, non-participating preferred securities, including trust-preferred and similar securities).

- **Additional listings of securities**. Any time an issuer has a class of common equity listed on a national securities exchange or association, the listing of additional classes of securities of that issuer (*e.g.*, class of debt or preferred securities), on the same or on different markets, would not be subject to the Proposed 301 Rules. In proposing this exemption, the Release indicates the SEC was mindful that the benefit of having multiple SROs monitoring compliance likely does not outweigh the potential duplicative and administrative burdens that would be imposed on issuers and SROs absent such an exemption. Importantly, this exemption is conditioned on the issuer having a listed class of common equity securities—those issuers that only list debt or

[13] Notably, this exemption does not provide relief for 50/50 (or otherwise unconsolidated) joint ventures. As currently proposed, if a joint venture that lists debt securities were equally controlled by two parents, then that joint venture must comply with the audit committee standards, even if one or more of the venture's parents lists an equity security and has a compliant audit committee. The SEC has requested comment as to whether this exemption should be limited to wholly owned subsidiaries or some other specified level of ownership (and, in fact, to date the SEC has received a comment requesting that the exemption be modified to accommodate unconsolidated joint ventures).

other non-common equity securities would be subject to the requirements of the Proposed 301 Rules in each affected market where its securities were listed.

Exemption for Security Futures Products and Standardized Options. Recognizing the fundamental differences in the way they are issued, the SEC would not have the Proposed 301 Rules apply to the listing of (i) a securities futures product cleared by a clearing agency that is registered pursuant to Section 17A of the Securities Act, or (ii) a standardized option issued by a clearing agency registered pursuant to Section 17A of the Securities Act.

IMPACT ON SELF-REGULATORY ORGANIZATIONS: IMPLEMENTATION AND COMPLIANCE MONITORING

Implementation

General. All national securities exchanges and national securities associations are subject to the Act and the Proposed 301 Rules. These SROs, therefore, must issue or modify their listing standards to the extent they do not already comply with the audit committee requirements discussed in this memorandum.[14] Under the Proposed 301 Rules, the SROs would need to have compliant listing standards operative no later than the first anniversary of the publication of the final rules in the Federal Register. As the Act requires the SEC to issue final rules implementing Section 301 no later than April 26, 2003, the SROs likely will have to have their audit committee standards effective by mid- to late-April 2004. Moreover, this timing could have the effect of accelerating the other transition periods initially proposed by the NYSE and Nasdaq, which in some cases were as long as two years (*e.g.*, NYSE proposed requirement for majority-independent board).

Exclusion for OTC Bulletin Board, Pink Sheets and Yellow Sheets. Issuers with securities quoted on the OTC Bulletin Board, the Pink Sheets or the Yellow Sheets would not be subject to the Proposed 301 Rules, so long as they do not otherwise have a security listed or quoted on an SRO. According to the Release, each of these three quotation systems are fundamentally different in the sense that they do not allow issuers to "list" their securities, but are instead a quotation medium for the over-the-counter securities market that collects and distributes market maker quotes to subscribers. Moreover, issuers whose securities are quoted on these systems do not have any filing or reporting requirements with the system and do not have a listing agreement or arrangement with the system.

[14] The SEC notes that an SRO could satisfy the Proposed 301 Rules simply by requiring that a listed issuer comply with new Rule 10A-3.

Compliance Monitoring

The Proposed 301 Rules would put the onus of monitoring compliance on the SROs. Each SRO would have to require its listed issuers to notify the SRO promptly after an executive officer of the listed issuer becomes aware of any material noncompliance with the audit committee standards set out in the Proposed 301 Rules. The use of the modifier "material" appears designed to provide deliberate flexibility.

In addition to monitoring compliance, the SROs must establish appropriate procedures for an issuer to have an opportunity to cure any defects that would be the basis for delisting. The Release notes that these procedures could not include an extended exemption or waiver of the requirements apart from those contained in the Proposed 301 Rules, thereby preventing the SROs from establishing their own set of exceptions. The Release goes on to point out that the SEC believes that the SROs' existing delisting procedures likely would satisfy the Proposed 301 Rules. The SROs' procedures typically provide issuers with notice, an opportunity for a hearing, an opportunity for an appeal and an opportunity to cure any defects before their securities are delisted. However, the Release goes on to state, the SEC expects the SROs' procedures to provide for definite procedures and time periods for compliance to the extent they do not already do so.

DISCLOSURE REQUIREMENTS

In addition to the disclosure requirements discussed above that apply to issuers availing themselves of an exemption from full compliance with the Proposed 301 Rules, the SEC has proposed some additional changes to listed companies' disclosure obligations.

- **Identification of the audit committee in annual reports**. The Proposed 301 Rules would require disclosure of the members of an issuer's audit committee to be included in its annual report (*e.g.*, Form 10-K, 10-KSB, 20-F or 40-F). Additionally, a listed issuer that has not separately designated an audit committee would have to disclose in its annual report that the entire board of directors is acting as the issuer's audit committee.[15]

[15] This disclosure is proposed to be included in Part III of Form 10-K and Form 10-KSB (through an addition to Item 401 in Regulations S-K and S-B, as applicable); Item 6(c) to Form 20-F and new General Instruction B.(11) to Form 40-F. With respect to Forms 10-K and 10-KSB, Part III permits an issuer, under certain circumstances, to incorporate the disclosure by reference from its definitive proxy or information statement.

- **Update to proxy and information statement disclosure**. Issuers subject to the proxy rules currently are required to disclose specified information regarding their audit committees in their proxy statement or information statement, if action is to be taken with respect to the election of directors. The Proposed 301 Rules would update the existing disclosure obligations to conform them to the requirements of new Rule 10A-3 (*e.g.*, the specification to the independence standards of the NYSE, Nasdaq and AMEX in current Item 7(d)(iv) is no longer necessary since the Proposed 301 Rules would require all SROs to have independence standards). The modifications to the disclosure obligations also will affect non-listed issuers. Under the current proxy rules (Item 7(d)(3)(iv)(B)), a non-listed issuer with an audit committee must disclose whether the committee members are independent by reference to the NYSE, Nasdaq or AMEX standards. Under the Proposed 301 Rules, this concept would be extended, such that non-listed issuers could make their independence assessment by reference to any set of SRO rules that the SEC has approved.

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This memorandum is for general informational purposes and should not be regarded as legal advice. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as additional memoranda regarding recent corporate governance developments, can be obtained from our website, www.simpsonthacher.com.

SIMPSON THACHER & BARTLETT LLP

APPENDIX A

COMPARISON OF PROPOSED AUDIT COMMITTEE STANDARDS

	PROPOSED 301 RULES	PROPOSED NYSE LISTING STANDARDS	PROPOSED NASDAQ LISTING STANDARDS
I. Audit Committee Composition			
Independence of audit committee members	Each member must be independent (*see* Part II below), subject to certain limited exceptions	Same as Proposed 301 Rules	Same as Proposed 301 Rules
Size of audit committee	No requirements as to size	Audit committee must have at least 3 members	Audit committee must have at least 3 members
Financial expertise of audit committee members	No requirement in Proposed 301 Rules; however, under the SEC's rules implementing § 407 of the Act, the issuer must disclose whether or not it has an "audit committee financial expert," and, if not, the reasons therefor	All members must be financially literate (or become financially literate within a reasonable period of time) At least one member must have accounting or related financial management expertise	All members must be able to read and understand fundamental financial statements At least one member must be a financial expert, determined by reference to § 407(b) of the Act and the SEC's rules thereunder
Restriction on simultaneous service	No such restriction	If member serves on the audit committee of more than 3 public companies (and the issuer does not self-impose a limit), the issuer's board must determine that the simultaneous service would not impair the effectiveness of the member	No such restriction

	PROPOSED 301 RULES	PROPOSED NYSE LISTING STANDARDS	PROPOSED NASDAQ LISTING STANDARDS
II. Audit Committee Member Independence			
Restriction on audit committee member's receipt of compensation	Audit committee member may not receive, directly or indirectly, any consulting, advisory or other compensatory fees from the issuer (other than ordinary director's fees), subject to certain limited exceptions	Director's fees must be the sole compensation an audit committee member receives from the issuer	Same as Proposed 301 Rules
Restriction on audit committee member's "affiliation" with issuer	Audit committee member may not be an "affiliated person" of the issuer (subject to certain limited exceptions), which is premised solely on whether there is a control relationship between the member and the issuer Safe harbor providing that a member would not be deemed to "control" the issuer so long as the member does not own greater than 10% of the issuer's common stock and is not a director or executive officer of the issuer	In order for director to be "independent" and thereby be eligible to be a member of the audit committee: • Board must determine that director has no material relationship with the issuer (either directly or as partner, shareholder or officer of an organization that has a relationship with the issuer); and • Required 5-year "cooling-off" period for (i) former employees of the issuer or its independent auditor; (ii) former employees of any other company whose compensation committee includes an executive officer of the issuer; and (iii) immediate family members in any of the foregoing categories	In order for director to be "independent" and thereby be eligible to be a member of the audit committee: • Director may not have a relationship that, in the opinion of the issuer's board, "would interfere with the exercise of independent judgment in carrying out the responsibilities of a director"; • Required 3-year "cooling-off" period for (i) former employees of the issuer or its independent auditor; (ii) directors who have a family member employed by the issuer as an executive officer; (iii) directors (or family members) who have received any payments in excess of $60,000 from the issuer, other than compensation for board service, benefits under a tax-qualified retirement or non-discretionary compensation plan; and (iv) former executive officers of any other company whose compensation committee includes an executive officer of the issuer;

	PROPOSED 301 RULES	PROPOSED NYSE LISTING STANDARDS	PROPOSED NASDAQ LISTING STANDARDS
			• Director may not be a partner in, or controlling shareholder or executive officer of, an entity to which the issuer made (or from which the issuer received) payments exceeding 5% of the recipient's consolidated gross revenues or $200,000 (whichever is more), in the current fiscal year or any of the past 3 fiscal years; and • Director may not own or control greater than 20% of the issuer's voting securities

	PROPOSED 301 RULES	PROPOSED NYSE LISTING STANDARDS	PROPOSED NASDAQ LISTING STANDARDS
III. Required Audit Committee Responsibilities and Authorities			
Responsibility as to independent auditors	The audit committee must be directly responsible for the appointment, compensation, retention and oversight of the issuer's independent auditors In addition, pursuant to the rules adopted by the SEC under § 202 of the Act, the audit committee must "pre-approve" all permissible non-audit services provided by the independent auditors	Same as Proposed 301 Rules In addition, the audit committee is expressly required to (i) approve all significant non-audit engagements with the independent auditors; (ii) have periodic meetings with the auditors; and (iii) obtain a report from the auditors describing, among other things, the auditing firm's internal quality-control procedures and any material issues raised by the most recent internal quality-control review, or peer review, of the auditing firm (and, to assess the auditor's independence, all relationships between the auditors and the issuer)	Same as Proposed 301 Rules In addition, the proposed Nasdaq listing standards require audit committee approval of all permissible non-audit services as set forth in § 202 of the Act and SEC rules promulgated thereunder
Handling complaints	The audit committee must establish procedures for handling complaints regarding accounting, internal accounting controls or auditing matters	No such express requirement in the proposed NYSE listing standards	Same as Proposed 301 Rules
Authority to engage outside advisers	The audit committee must have the authority to engage its own outside advisers	Same as Proposed 301 Rules	Same as Proposed 301 Rules
Authority to determine funding	The audit committee must have the authority to determine the appropriate funding necessary to compensate its outside advisers as well as the independent auditors	No express discussion of ability to determine funding for outside advisers (other than the independent auditors)	Same as Proposed 301 Rules

	PROPOSED 301 RULES	PROPOSED NYSE LISTING STANDARDS	PROPOSED NASDAQ LISTING STANDARDS
Responsibility to meet with management and/or internal auditors	No such express requirement in the Proposed 301 Rules	Periodic meetings with management (and the internal auditors) expressly required—both generally and as to specifically identified items (*e.g.*, major issues regarding accounting principles)	No such express requirement in the proposed Nasdaq listing standards
Responsibility with respect to risk assessment and risk management	No such express requirement in the Proposed 301 Rules	Audit committee must discuss guidelines and policies that govern the process by which risk assessment and management is undertaken	No such express requirement in the proposed Nasdaq listing standards
Discuss earnings press releases	No such express requirement in the Proposed 301 Rules	Audit committee must discuss earnings press releases, as well as financial and earnings guidance provided to analysts and rating agencies	No such express requirement in the proposed Nasdaq listing standards
Set hiring policies for employees or former employees of issuer's independent auditors	No such express requirement in the Proposed 301 Rules; however, under the SEC's rules implementing § 206 of the Act, an accounting firm will not be considered "independent" should the issuer hire recent audit engagement team members in a "financial reporting oversight role"	Audit committee must set hiring policies for employees or former employees of the issuer's independent auditors	No such express requirement in the proposed Nasdaq listing standards

ANNEX I
ST&B Form: ***February 11, 2003***

We are providing these sample whistleblower procedures only as a guideline. Audit committees should tailor these procedures to fit their particular business and circumstances.[1]

WHISTLEBLOWER PROCEDURES

A. Responsibilities of Audit Committee With Respect to Specified Complaints

1. The Audit Committee shall receive, retain, investigate and act on complaints and concerns of employees [and shareholders][2] ("Reports") regarding:

(a) questionable accounting, internal accounting controls and auditing matters, including those regarding the circumvention or attempted circumvention of internal accounting controls or that would otherwise constitute a violation of the Company's accounting policies (an "Accounting Allegation");

(b) compliance with legal and regulatory requirements (a "Legal Allegation");[3] and

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[1] For example, a company's code of ethics or employee handbook may contain procedures for reporting illegal or unethical conduct that may be useful to the audit committee in developing the whistleblower procedures required by § 301 of the Sarbanes-Oxley Act. Additionally, the model procedures may need to be modified in response to any modified requirements that may arise when the SEC adopts final rules. Finally, we have drafted these procedures contemplating that they would be included in resolutions that are adopted by the audit committee. The audit committee can, alternatively, choose to include them as part of the audit committee's charter. If the audit committee chooses the latter alternative, the whistleblower procedures would become publicly available when the company posts its audit committee charter on its website.

[2] The Sarbanes-Oxley Act does not require the audit committee to have procedures to receive complaints from individuals other than employees. The proposed new corporate governance listing standards of the New York Stock Exchange, however, require listed companies to provide shareholders with a method of communicating directly with non-management directors. To the extent such communications involve allegations of accounting irregularities, we recommend that companies investigate such allegations using the same procedures as would be applicable to similar allegations made by an employee.

[3] The proposed new listing standards of the NYSE, filed with the SEC on August 16, 2002, specify that one of the purposes of the audit committee of NYSE-listed companies is to assist board oversight of compliance

(c) retaliation against employees who make Accounting Allegations or Legal Allegations (a "Retaliatory Act").[4]

2. In the discretion of the Audit Committee, responsibilities of the Audit Committee created by these procedures may be delegated to the Chair of the Audit Committee [or to a subcommittee of the Audit Committee].

B. Procedures for Receiving Reports[5]

1. Any Report that is made directly to management, whether openly, confidentially or anonymously, shall be promptly reported to the Audit Committee.

2. Each Report forwarded to the Audit Committee by management and each Report that is made directly to the Audit Committee, whether openly, confidentially or anonymously, shall be reviewed by the Audit Committee, who may, in their discretion, consult with any member of management who is not the subject of the allegation and who may have appropriate expertise to assist the Audit Committee. The Audit Committee shall determine whether the Audit Committee or management should investigate the Report, taking into account the considerations set forth in Section C below.

(a) If the Audit Committee determines that management should investigate the Report, the Audit Committee will notify the General Counsel in writing of that conclusion. Management shall thereafter promptly investigate the Report and shall report the results of its investigation, in writing, to the Audit Committee. Management shall be free in its discretion to engage outside auditors, counsel or other experts to assist in the investigation and in the analysis of results.

(b) If the Audit Committee determines that it should investigate the Report, the Audit Committee shall promptly determine what professional assistance, if any, it needs in order to conduct the investigation. The Audit Committee shall be free in its discretion to engage outside auditors, counsel or other experts to assist in the investigation and in the analysis of results.

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with legal and regulatory requirements. Accordingly, although the Sarbanes-Oxley Act does not have similar requirements, NYSE-listed companies should consider including within their whistleblower procedures a process to deal with allegations of non-compliance with legal and regulatory requirements.

[4] The Sarbanes-Oxley Act does not require audit committees to have procedures to receive or investigate claims of retaliation. We recommend that companies adopt such procedures, however, because the Sarbanes-Oxley Act created new criminal and civil penalties for retaliation against whistleblowers.

[5] The Sarbanes-Oxley Act expressly requires audit committees to adopt procedures for receiving Accounting Allegations.

C. Considerations Relative To Whether the Audit Committee or Management Should Investigate a Report

In determining whether management or the Audit Committee should investigate a Report, the Audit Committee shall consider, among any other factors that are appropriate under the circumstances, the following:

1. Who is the alleged wrongdoer? If an executive officer, senior financial officer or other high management official is alleged to have engaged in wrongdoing, that factor alone may militate in favor of the Audit Committee conducting the investigation.

2. How serious is the alleged wrongdoing? The more serious the alleged wrongdoing, the more appropriate that the Audit Committee should undertake the investigation. If the alleged wrongdoing would constitute a crime involving the integrity of the financial statements of the Company, that factor alone may militate in favor of the Audit Committee conducting the investigation.

3. How credible is the allegation of wrongdoing? The more credible the allegation, the more appropriate that the Audit Committee should undertake the investigation. In assessing credibility, the Audit Committee should consider all facts surrounding the allegation, including but not limited to whether similar allegations have been made in the press or by analysts.

D. Protection of Whistleblowers[6]

Consistent with the policies of the Company, the Audit Committee shall not retaliate, and shall not tolerate any retaliation by management or any other person or group, directly or indirectly, against anyone who, in good faith, makes an Accounting Allegation or Legal Allegation, reports a Retaliatory Act or provides assistance to the Audit Committee, management or any other person or group, including any governmental, regulatory or law enforcement body, investigating a Report. The Audit Committee shall not, unless compelled by judicial or other legal process, reveal the identity of any person who makes an Accounting Allegation or Legal Allegation or reports a Retaliatory Act and who asks that his or her identity as the person who made such Report remain confidential and shall not make any effort, or tolerate any effort made by any other person or group, to ascertain the identity of any person who makes a Report anonymously.

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[6] In light of the new civil and criminal penalties for retaliation against whistleblowers, if no similar provisions exist in the Company's ethics code or other policies, this provision should be expanded to include management's obligation not to retaliate.

E. Records[7]

The Audit Committee shall retain for a period of [seven] years all records relating to any Accounting Allegation or Legal Allegation or report of a Retaliatory Act and to the investigation of any such Report.

F. Procedures for Making Complaints[8]

In addition to any other avenue available to an employee, any employee [or shareholder] may report to the Audit Committee openly, confidentially or anonymously any Accounting Allegation or Legal Allegation or report of a Retaliatory Act. Accounting Allegations, Legal Allegations and reports of a Retaliatory Act can be made orally or in writing to _____. Such Reports can also be made directly to management either (a) confidentially by contacting the [General Counsel] in writing or in person at _____ or (b) if made by an employee, anonymously, by calling the Ethics Hotline at 1- 800-____ at any time. The toll-free line is managed by an outside, independent service provider and allows anyone to make a Report without divulging his or her name. The hotline service provider is required to share the information provided in the Report to management or, if requested by the individual making the Report, the Audit Committee as promptly as practicable.

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[7] The Sarbanes-Oxley Act requires the audit committee to have procedures for retaining reports of Accounting Allegations. At a minimum, we recommend that the Audit Committee and management maintain records of all steps taken in connection with any investigation of an Accounting Allegation. We also recommend that the Audit Committee and management fully document the results of any investigation, including investigations of Reports that are found to be unsubstantiated.

[8] If the Company has similar procedures laid out in its ethics code or other office manuals, it need not repeat the procedure here. Please note, however, that pursuant to the Sarbanes-Oxley Act, the Company must provide an avenue for employees to bring Accounting Allegations to the attention of the Audit Committee anonymously.