Securities Law Developments

COMMISSION REQUIRES NEW DISCLOSURE REGARDING AUDIT COMMITTEES AND AUDITOR REVIEW OF QUARTERLY FINANCIAL REPORTS

On December 15, 1999, the SEC adopted new rules designed to enhance the reliability of financial statements and to improve disclosure about audit committees.[1] The new rules are based largely on the recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, with certain exceptions noted below.[2] The new rules will require that all companies:[3]

- have their interim financial statements reviewed by an independent auditor before they are filed with the SEC;
- include in their proxy statements a report from their audit committee;
- disclose in their proxy statements whether their audit committee has a charter and include a copy of that charter as an appendix to the proxy statement every three years; and

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1 *See* Exchange Act Release No. 42266 (Dec. 22, 1999) (Final Rule: Audit Committee Disclosure), which may be found at <http:/www.sec.gov/rules/final/34-42266.htm>.

2 *See* Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (1999), which may be found at <http://www.nasd.com> and <http://www.nyse.com>. *See also* Exchange Act Release No. 41987 (Oct. 7, 1999) (the "Proposing Release" for the new rules), which may be found at <http://www.sec.gov/rules/proposed/34-41987.htm>. The Blue Ribbon Committee also recommended to the accounting profession and to the New York Stock Exchange ("NYSE"), Nasdaq Stock Market ("Nasdaq") and American Stock Exchange ("AMEX") a number of broader, more systematic proposals to improve the financial reporting process, which recommendations were subsequently adopted by those organizations. The actions of the NYSE, Nasdaq, AMEX and the accounting profession will operate in concert with and complement the SEC's new rules. See discussion below in Sections C (Audit Committee Charters) and D (Independence of Audit Committee Members).

3 Since foreign private issuers are not currently required to file quarterly reports on 10-Q, are exempt from the proxy rules, and are subject to different corporate governance regimes in their home countries, the SEC does not feel it is appropriate, at present, to subject foreign private issuers to the new rules. In addition, since companies whose reporting obligations arise solely under Section 15(d) of the Exchange Act are not required to file proxy statements, and because the new disclosure rules are most relevant to voting decisions based upon proxy statement disclosures, the SEC has decided, at present, not to subject Section 15(d) companies to the proxy statement disclosure requirements.

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- provide disclosure in their proxy statements regarding the independence of their audit committee members.

In order to afford companies an opportunity to revise their procedures, if necessary, and otherwise prepare to implement these rules, the SEC is providing the following transition periods for compliance with the new rules: the rule requiring independent audit or review of interim financial statements takes effect for quarters ending after March 15, 2000; and the remaining rules requiring new proxy and information statement disclosure take effect on December 15, 2000. This newsletter summarizes each of the new rules in turn, focusing on the practical requirements and impact of the new rules following the transition period.

Pre-Filing Review of Quarterly Financials.

The new rules require each issuer to have its interim financial statements reviewed by an independent public accountant before the issuer files its quarterly report with the SEC.[4] The review required is that described in Statement on Auditing Standards ("SAS") No. 71. A SAS 71 review is limited to inquiries and analytical procedures concerning significant accounting matters and is designed to provide the accountant with a basis for reporting whether the interim financial information under review must be materially modified in order to conform with Generally Accepted Accounting Principles. Although an issuer is not required to disclose that its quarterly financial statements have been reviewed by independent auditors, if an issuer does disclose that a review was completed, it must file a copy of the auditor's report.

The pre-filing review requirement applies to Form 10-Qs for all quarters that end after March 15, 2000, so it will apply to the next Form 10-Q for all issuers with quarters ending March 31.

The new rules also require almost all companies to disclose in their annual reports selected quarterly financial data for the prior two fiscal years. This expands a requirement that currently applies only to larger, more widely-held companies that meet certain tests (including stock price, market capitalization and number of security holders). In addition, all issuers will be required to reconcile and describe in their annual reports any adjustments to the quarterly information previously reported in a Form 10-Q.

The expanded obligation to provide quarterly data does not take effect until December 15, 2000, so will not apply to most issuers who are not covered by the current rule until their annual report for the year ended December 31, 2000.

Audit Committee Report.

The new audit committee report must be included in proxy statements relating to an annual meeting of shareholders at which directors are to be elected (or a special meeting for that purpose, or written consents in lieu of such meeting).[5] If the company has no audit committee, then the board committee tasked with similar responsibilities, or the full board of directors, must make the disclosures required by the report. The report must state whether the audit committee has:

- reviewed and discussed the audited financial statements with management;

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4 *See* amendments to Rule 10-01(d) of Reg. S-X and Item 310(b) of Reg. S-B.

5 *See* new Item 306 of Reg. S-K and Reg. S-B, and Item 7(e)(3) of Schedule 14A.

- discussed with the independent auditors the matters required to be discussed by SAS No. 61, including:

  - the methods used to account for significant transactions;
  - the effect of significant accounting policies in controversial or emerging areas for which there is lack of authoritative guidance or consensus;
  - 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; and
  - disagreements with management over the application of accounting principles, the basis for management's accounting estimates, and the disclosures in the financial statements.

- received written disclosures from the auditors regarding their independence as required by Independence Standards Board Standard No. 1, and discussed the auditors' independence with the auditors; and

- based on the foregoing, recommended to the board of directors that the audited financial statements be included in the company's annual report for the last fiscal year for filing with the SEC.

The new rules do not require audit committees to disclose the substance of their discussions with management and the company's independent auditors, only whether the discussions occurred. Moreover, the new rules do not require that the audit committee hold these discussions, but merely that it disclose whether such discussions have taken place. Nevertheless, the rules clearly reflect an expectation that these discussions will occur, and we expect most issuers will insure that they do.

The SEC adopted the requirement to disclose whether the committee recommended inclusion of the financial statements in the annual report after its original proposal was criticized as creating new liabilities for audit committee members. The Commission had originally proposed that audit committees disclose whether anything had come to their attention to cause them to believe that the audited financial statements included in the company's annual report contain an untrue statement of material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances in which they were made, not misleading. Many commenters expressed concern that requiring such disclosure would subject audit committee members to liability and that, consequently, it would be difficult to both retain and attract qualified people to serve on audit committees. The Commission asserts that requiring the revised disclosure from the audit committee is consistent with board members signing the company's annual report on Form 10-K, and with general state corporation law that permits board members to rely on the representations of management and the opinions of experts retained by the company to help reach business decisions.

Nevertheless, to further address liability concerns, the SEC also adopted "safe harbors" for the new disclosures as recommended in the Blue Ribbon Committee Report.[6] The safe harbors provide that the new disclosures will not be considered "soliciting material" or to be "filed" with the SEC or

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[6] The safe harbor provision for the Audit Committee Report is set forth in paragraph (c) in new Item 306 of Reg. S-K and Reg. S-B. An identical safe harbor provision for the new disclosures about audit committee charters and the independence of audit committee members is set forth in new Item 7(e)(3)(v) of Schedule 14A. Both of these safe harbors track the treatment of compensation committee reports under Item 402 of Reg. S-K.

subject to Regulation 14A or 14C (and thus, not subject to the anti-fraud provision of Rules 14a-9 or 14c-6) or to the liabilities of Section 18 of the Exchange Act, unless the company specifically requests that it be treated as such, or specifically incorporates it by reference into a document filed under the Securities Act or the Exchange Act.

Neither the revised, limited disclosure nor the safe harbors eliminate the risk of added liability. Creative plaintiffs attorneys may assert that Audit Committee members are liable for disclosures provided in response to the new requirements if the financial statements are found to be misleading. As a result, it is possible that some issuers may see premiums increase for director and officer liability insurance, and it may be more difficult to find members willing to sit on audit committees. There is no evidence of either so far but this may develop as the rules take effect.

The disclosure requirement for audit committee reports takes effect for proxy statements relating to votes occurring after December 15, 2000, so they will not affect proxy statements for annual meetings in 2000 for most issuers.

Audit Committee Charters.

The proxy statement for annual meetings must also disclose whether the Board of Directors has adopted a written charter for its audit committee. If a charter does exist, it must be included as an appendix to the company's proxy statement at least once every three years.[7] The new rules do not require companies to adopt an audit committee charter, and do not dictate the content of such a charter if adopted. However, each of the revised listing standards for the NYSE, Nasdaq and AMEX provide that audit committees must:

- adopt a formal written charter approved by the full board of directors which specifies the scope of the committee's responsibilities and how it carries out those responsibilities; and

- review and reassess the adequacy of their charter on an annual basis.

The disclosure requirement for charters takes effect for proxy statements relating to votes occurring after December 15, 2000. However, companies will generally have only six months following the date of SEC approval of the revised listing standards for the NYSE, Nasdaq and AMEX (on December 14, 1999) to adopt a formal written audit committee charter.

Independence of Audit Committee Members.

Under the new SEC rules, companies whose securities are quoted on Nasdaq or listed on AMEX or NYSE must disclose in their proxy statements:[8]

- whether their audit committee members are "independent" as defined in the applicable listing standards;[9] and

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7 *See* new Item 7(e)(3) of Schedule 14A.

8 *See* new Item 7(e)(3)(iv) of Schedule 14A.

9 As a result of the Blue Ribbon Committee's recommendations to Nasdaq and NYSE to improve audit committee disclosure, both Nasdaq and NYSE proposed, and the SEC approved, changes to their listing standards. The AMEX also

- with respect to any director on the committee who is not "independent,"[10] the nature of the relationship that makes that individual not independent and the reason for the board's decision to appoint that individual to the audit committee.[11]

Companies whose securities are not quoted on Nasdaq or listed on AMEX or NYSE must disclose in their proxy statements whether, if they have an audit committee, the members are independent as defined in either the Nasdaq, AMEX or NYSE listing standard, and which definition was used. Such companies can choose which of the Nasdaq, AMEX or NYSE definitions of independence it wants to apply, but must apply such definition consistently to all members of the audit committee.

The new Nasdaq and AMEX definitions of independence are substantially similar and apply to all directors, not just those serving on audit committees. The new Nasdaq and AMEX rules provide that directors with any of the following five relationships will not be considered independent:[12]

- employment by the corporation or any of its affiliates for the current year or any of the past three years;

- acceptance of any compensation from the corporation or any of its affiliates in excess of $60,000 during the previous fiscal year, other than compensation for board service, benefits under a tax-qualified retirement plan, or non-discretionary compensation;

- member of the immediate family of an individual who is, or has been in any of the past three years, employed by the corporation or any of its affiliates as an executive officer;

- partnership in, or a controlling shareholder or an executive officer of, any for-profit business organization to which the corporation made, or from which the corporation received, payments (other than those arising solely from investments in the corporation's securities) that exceed five percent of the corporation's or business organization's consolidated gross revenues for that year, or $200,000, whichever is more, in any of the past three years; or

- employment as an executive of another entity where any of the company's executives serve on that entity's compensation committee.

The new NYSE definition of independence imposes the following four restrictions on audit committee members:

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proposed, and the SEC approved, changes to AMEX's listing standards. *See* Exchange Act Release Nos. 42231, 42232 and 42233.

10 The revised listing standards of the Nasdaq, NYSE and AMEX generally allow companies to appoint to their audit committee one director who is not independent "under exceptional limited circumstances" if the board determines that such person's membership on the committee is required by the best interests of the company and the shareholders, and the company discloses in the next annual proxy statement the nature of the relationship and the reasons for that determination.

11 The Nasdaq's and AMEX's revised listing standards require that small business issuers have at least two members of their audit committee, a majority of whom must be independent. Accordingly, small business issuers can disclose that the Nasdaq and AMEX listing standards do not require that all audit committee members be independent, and need not make any disclosure regarding non-independent directors on the committee.

12 *See* Exchange Act Release Nos. 42231 and 42232.

- employees (including non-employee executives) of the company or its affiliates may not serve on the audit committee until three years following the termination of employment; however, if the relationship is with a former parent or predecessor of the company, the three-year bar applies to the time period following the severance of the relationship between the company and the former parent or predecessor;

- a director who is a partner, controlling shareholder, or executive officer of an organization that has a business relationship with the company, or who has a direct business relationship with the company (e.g. a consultant), may serve on the audit committee only if the company's board determines in its business judgment that the relationship does not interfere with the director's exercise of independent judgment;

- a director who is employed as an executive officer of another corporation where any of the company's executives serve on that corporation's compensation committee may not serve on the audit committee; and

- a director who is an immediate family member of any 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.

The disclosure requirement regarding independence takes effect for proxy statements relating to votes occurring after December 15, 2000, even though the new NYSE, Nasdaq and AMEX requirements do not take effect until eighteen months after December 14, 1999, the date the SEC approved the revised listing standards.

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If you have any questions or need additional information, please contact Thomas White (202) 663-6224, Meredith Cross (202) 663-6644, Roger Patterson (202) 663-6246 or Kevin Carroll (410) 986-2890.

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