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HRO Alert

The Sarbanes-Oxley Act of 2002

Final Rules:

LISTED COMPANY AUDIT COMMITTEES

On April 9, 2003, the SEC released final rules which strengthen its requirements regarding the audit committees of listed public companies. Among other things, these rules could impact the composition of your company's audit committee, how your audit committee interacts with your auditor, how your company handles complaints about its accounting and audit process and your company's disclosure regarding its audit committee.¹

These rules, issued under the Sarbanes-Oxley Act of 2002 (the "SO Act"), finalize and, in some cases, revise the SEC's proposed rules relating to audit committee standards for listed companies, which were released on January 8, 2003.

This HRO Alert summarizes the main provisions of the final rules. For listed companies other than foreign private issuers and small business issuers, the deadline for compliance with the new rules is the earlier of **the first annual shareholders meeting after January 15, 2004 or October 31, 2004**. Foreign private issuers and small business issuers that are listed companies must be in compliance with the new rules by **July 31, 2005**.

BACKGROUND

Section 301 of the SO Act directs the SEC to adopt rules that require the national securities exchanges and national securities associations (the "SROs") to prohibit the initial or continued listing of any company that fails to meet the audit committee requirements of the SO Act and the final rules. It should be noted that the final rules apply only to companies listed on a national securities exchange or Nasdaq; they do not apply to companies whose securities are traded on the OTC Bulletin Board or by Pink Sheets or Yellow Sheets.

The subject matter of the requirements specified in Section 301 and implemented by the final rules relate to:

- the independence of audit committee members;
- the audit committee's responsibility to select and oversee the company's auditor;
- procedures for handling complaints regarding the company's accounting practices;
- the authority of the audit committee to engage advisors; and
- funding for the company's auditor and outside advisors engaged by the audit committee.

Under the final rules, the SROs must provide the SEC with proposed rules or rule amendments that comply with the requirements of the final rules no later than July 15, 2003. The SRO rules must be approved by the SEC no later than December 1, 2003. **Once the final rules and the SRO rules are effective, a company that fails to comply with the standards set forth in the final rules is subject to de-listing by the applicable SRO.**

¹ The terms "auditor," "accountant" and "accounting firm" are intended to mean a registered public accounting firm, certified public accountant or public accountant. References to the accountant include any accounting firm with which the certified public accountant or public accountant is affiliated.

INDEPENDENCE OF AUDIT COMMITTEE MEMBERS

General

Pursuant to Section 205 of the SO Act, the term “audit committee” means a committee established by, and comprised of members of, the board of directors of a company for the purpose of overseeing the accounting and financial reporting process of the company and audits of the financial statements of the company. If no committee is established, Section 205 provides that the entire board of directors constitutes the audit committee.

Under the final rules, the individuals that sit on the audit committee of a listed company, whether it be a formally established committee or the entire board if no audit committee is established, must be members of the board of directors and independent. For a member of an audit committee to be considered independent, such member may not:

- accept directly or indirectly any consulting, advisory or other compensatory fee from the company or any of its subsidiaries; or
- be an affiliated person of the company or any of its subsidiaries.

Compensatory Fees

Under the final rules, an audit committee member is not deemed independent if such member, directly or indirectly, accepts any consulting, advisory or other compensatory fee from the listed company. The prohibition on receipt of compensatory fees does not extend to the receipt of (i) compensation in the ordinary-course for serving as a member of a company's board of directors, or (ii) fixed amounts of compensation for prior service with a company (i.e., retirement benefits), provided that such compensation is not contingent on future service.

For purposes of the final rules, indirect acceptance of a consulting, advisory or other compensatory fee by a member of an audit committee includes acceptance of such a fee:

- by a spouse, a minor child or stepchild or a child or stepchild sharing a home with the member; or
- by an entity (i) in which the member is a partner, member, an officer such as a managing director occupying a comparable position or executive officer, or occupies a similar position and (ii) which provides accounting, consulting, legal, investment banking or financial advisory services to the company or any of its subsidiaries.

The SEC received a number of comments arguing that an individual that holds a passive ownership interest, such as a limited partner in a limited partnership, should not lose their status as independent simply because the entity in which they hold such passive ownership interest receives a compensatory fee for providing accounting, consulting, legal, investment banking or financial advisory services to the listed company or its subsidiaries. In response to such comments, the SEC specifically carved out of the concept of indirect acceptance receipt of compensatory fees by entities in which the member only holds a passive ownership interest and has no active role in management.

Affiliates

The second criteria for independence under the final rules is that the member of the audit committee may not be an affiliate of the listed company or any of its subsidiaries. Under the final rules, a member is deemed an “affiliate” of, or a person “affiliated” with, a listed company or its subsidiaries if that member, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under

common control with, the listed company or its subsidiaries. There is a safe harbor from the definition of affiliate which provides that a person is not deemed to be an affiliate of a listed company if:

- they are not the beneficial owner, directly or indirectly, of more than 10% of any class of voting securities of the listed company or its subsidiaries; and
- they are not an executive officer of the listed company or its subsidiaries.

Responding to concerns voiced by numerous commenters, the SEC included a provision in the final rules that specifically states that exceeding the 10% interest specified in the safe harbor does not create the presumption that a person is an affiliate. In the release accompanying the final rules, the SEC also explained that whether a person is an affiliate of another requires a “facts and circumstances” analysis, and that the analysis may determine that a person exceeding the 10% ownership interest is not an affiliate.

Exemptions

The final rules include a number of exemptions from the requirement that each member of a listed company's audit committee be independent. Most notably, the SEC included an exemption for companies coming to market for the first time. Under the final rules, a company coming to market for the first time must have one independent director on its audit committee at the time of the company's initial public offering. Thereafter, within 90 days from the date of its initial public offering, the company's audit committee must be comprised of a majority of independent directors, and within one year from the date of its initial public offering, the company's entire audit committee must be comprised of independent directors.

Another notable exemption included in the final rules addresses the situation where an individual director may sit on the audit committee of a listed company and the company's affiliates. Under the final rules, an individual will be considered independent and can sit simultaneously on the audit committees of a listed company and one or more of its affiliates, provided that, other than being a director of the affiliate(s), such individual satisfies the other independence criteria with respect to the listed company and the relevant affiliate(s).

In addition, the final rules include certain exemptions that are applicable to foreign private issuers.

RESPONSIBILITY OF AUDIT COMMITTEE TO SELECT AND OVERSEE AUDITOR

The final rules also require that certain responsibilities and authority relating to a listed company's auditor be vested in the company's audit committee. Specifically, the final rules provide that a listed company's audit committee must be responsible for appointing, compensating, retaining or terminating and overseeing the work of the company's auditor. This authority includes resolution of any disagreements between management of the company and the auditor regarding the financial statements of the company. According to the SEC, this rule will address the situation of auditors feeling beholden to company's management, rather than its board of directors or audit committee. The SEC also expressed the hope that this rule will boost investor confidence by making clear to the public that the company's auditor is independent.

PROCEDURES FOR HANDLING COMPLAINTS ABOUT COMPANY'S ACCOUNTING

Under the final rules, the audit committee for each listed company must establish procedures for receiving from employees, on an anonymous basis, complaints or concerns about questionable accounting or auditing matters. The audit committees of listed companies also must develop procedures for reten-

tion and treatment of such complaints or concerns. Noting the wide variety of listed companies, the SEC did not mandate specific procedures that audit committees must establish to satisfy this rule. Instead, the SEC instructed companies to develop a system that works best with their individual circumstances and corporate structure.

AUTHORITY TO ENGAGE OUTSIDE ADVISORS

To help assure the effectiveness of the audit committees of listed companies, the final rules provide that each audit committee must have the authority to retain outside counsel and other advisors, as the audit committee deems necessary to carry out its responsibilities. This authority, the SEC noted, was particularly important in instances where a possible conflict of interest with management exists.

FUNDING

Finally, the SEC noted that an audit committee's effectiveness may be compromised in instances where the audit committee is dependent on the management's discretion to compensate the company's auditor or pay other costs incurred by the audit committee. Accordingly, the final rules provide that each listed company must provide funding to its audit committee sufficient to:

- compensate any accounting firm engaged for the purpose of issuing or preparing an audit report or performing other audit, review or attest services for the listed company;
- compensate any advisor retained by the audit committee pursuant to its authority granted under the final rules; and
- pay any ordinary administrative expenses of the audit committee that are necessary or appropriate for carrying out its duties.

Under the final rules, the amount of funds required by the audit committee is to be determined by the audit committee.

DISCLOSURE RELATING TO FINAL RULES

The final rules include new disclosure requirements relating to listed companies' audit committees. Specifically, listed companies must include, or incorporate by reference, the following disclosures in their annual reports filed with the SEC (whether such report is filed on Form 10-K, Form 10-KSB, Form 40-F or Form 20-F):

- the identity of the members of its audit committee (with the exception of companies filing an annual report on Form 20-F, as this disclosure is already required in such form);
- if no audit committee has been designated by the board of directors, a statement that the entire board of directors is acting as its audit committee; and
- if the company is relying on an exemption from the independence requirements of the final rules, a statement that it is relying on an exemption and an assessment of whether, and if so, how much, such reliance will materially adversely affect the ability of the company's audit committee to act independently and satisfy the other requirements of the final rules.

The disclosure regarding whether the listed company is relying on an exemption also must be included in any proxy statement or information statement subject to the proxy rules for shareholders' meetings at which election of directors is to occur.

SRO RULES

Under the final rules, the SROs must provide the SEC with proposed rules or rule amendments that

comply with the requirements of the final rules no later than July 15, 2003. The SRO rules must be approved by the SEC no later than December 1, 2003. It should be noted that the final rules represent the minimum standards that the SROs will have to comply with when adopting their own standards. In the release accompanying the final rules, the SEC strongly encouraged the SROs to go beyond the standards set forth in the final rules. For example, the provisions of the final rules prohibiting certain relationships between audit committee members and related persons is only applicable to *current* relationships. In the accompany release, however, the SEC indicated that it expects the SROs to include a historical, or “look back,” approach to relationships between audit committee members and related parties for independence determination purposes. Furthermore, it is important to note that SROs such as the New York Stock Exchange and Nasdaq already have standards in place, or have proposed standards, that, in some instances, are more stringent than the final rules. When making decisions regarding audit committee composition and governance, companies will need to carefully review the applicable SRO rules approved by the SEC as a result of the final rules.

HOW HRO CAN HELP

The final rules and the SRO rules could have a significant impact on your company’s audit committee. If you would like to discuss the final rules or the SRO rules applicable to your company and how they may affect your company, we encourage you to contact any of the persons listed in the margin of the first page of this HRO Alert.

This HRO Alert is a periodic publication of Holme Roberts & Owen LLP and should not be construed as legal advice or legal opinion on any specific facts or circumstances. Nor is it intended to address specific compliance issues that may arise in particular circumstances or all of the provisions included in the newly adopted rules. The contents are intended for general informational purposes only, and you are urged to consult counsel concerning your own situation and any specific legal questions you may have. For further information regarding the rules described herein, please contact any of the persons listed in the margin of the first page of this HRO Alert.

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