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Via email: rule-comments@sec.gov
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Attention: Jonathan G. Katz, Secretary

Re: File No. S7-02-03; Release Nos. 33-8173; 34-47137
Proposed Rule: Standards Relating to Listed Company Audit Committees

Ladies and Gentlemen:

This letter is submitted on behalf of the Committee on Securities Regulation of the Association of the Bar of the City of New York in response to Release Nos. 33-8173 and 34-47137, dated January 8, 2003 (the "Release"), in which the Securities and Exchange Commission announced a proposed rule requiring the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with several enumerated standards regarding audit committees (the "Proposed Rule" or "Proposal"). Our Committee is composed of lawyers with diverse perspectives on securities issues, including members of law firms, counsel to corporations, investment banks, investors and academics.

Introduction

The Committee supports the Commission's efforts to promote effective oversight of the financial reporting processes of filing companies. Overall, we believe that the Proposal provides a thoughtful discussion and analysis of the methods by which such oversight may be improved. In particular, the Release offers an informative synopsis of the important role that audit committees play in overseeing the accounting and financial reporting process of public companies, which is crucial to the integrity of U.S. securities markets.

In considering the several aspects of the Proposed Rule, we want to emphasize that critical to the concept of the audit committee and its role will be the availability of qualified individuals who are willing to serve on audit committees. We understand that Congress, through the passage of the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act"), intended to emphasize the importance of independence as an eligibility requirement for such service. The Committee agrees with both Congress and the Commission that audit committees should be composed of directors best able to assume the important responsibilities tasked to such bodies and should be free of any actual or potential conflict that calls into question their independent judgment. However, defining the criteria for audit committee membership should also be approached with the understanding that, in view of the responsibilities of audit committee members and the qualifications necessary for their position, the number of persons who will feel qualified and who will be willing to serve on audit committees is limited. Another dynamic is the fact that the audit committee requirement applies to all issuers, regardless of their size, market capitalization, resources, industry or profitability. Attracting qualified candidates for audit committee membership will be more difficult the smaller the issuer. Criteria for "independence" that are too narrow or strict could immeasurably burden the attraction and selection process, particularly for smaller issuers, and ultimately defeat the laudable goals of the audit committee requirement.

The Committee recognizes the complexities involved in establishing standards for audit committees. Listed companies are subject not only to the Commission's rules, but also to

provisions of the Sarbanes-Oxley Act and the corporate governance listing standards to be adopted by the national securities exchanges and national securities associations. The Committee understands that through the Proposed Rule, the Commission appears to have stipulated the minimum "independence" requirements for audit committee membership. We realize that self-regulatory organizations ("SROs") will promulgate additional and more detailed requirements with respect to the qualifications necessary to serve on audit and other board committees. That is, the SROs will build and rely on certain standards of independence required by the Commission's rules, but within the more flexible environment of listing standards.

Given such a regulatory matrix, the Committee believes that the SROs should be primarily charged with interpreting the new independence standards. Inefficiencies will invariably result if issuers are required to seek guidance on such standards from both the SROs and the Commission. Because the SROs have gained valuable experience in establishing workable independence criteria through their current and proposed listing standards, the Committee believes that the SROs are uniquely qualified to analyze and determine the parameters of the independence requirements for audit committee service.

Additionally, the Committee believes that the SROs will be in a better position to analyze independence questions that involve particular facts and circumstances for any person who cannot rely on the Commission's 10% shareholder "safe harbor" in determining whether an audit committee member is an "affiliated person."[1] For example, the SROs, in developing detailed independence criteria, may consider whether a greater than 10% shareholder should be considered not to be independent in a situation where another shareholder or group of shareholders beneficially own a measurably greater percentage of shares of the issuer.

While SROs currently offer such assistance, we believe that, in recognition of their role as the primary interpreters of the new standards, the SROs should publish their interpretations,

[1] As a technical matter, the Committee recommends that subclause (C) of Rule §240.10A-3(e)(1) be eliminated as it appears to conflict with the requirement that audit committee members be directors and that the definition of "affiliate" appearing in Rule §240.10A-3(e)(1) (ii) include trustees.

as, for instance, the Commission staff publishes its significant no-action letters. Such publication by the SROs would promote understanding and consistency of application of the new standards.

The Committee offers the following specific observations and recommendations on the Proposed Rule:

I. Timing of Implementation

We feel it is imperative that the Commission establish a significant time period between the date that new listed company standards relating to independence are published and the date such standards become operative. The Proposed Rule mandates that each national securities exchange or association must provide proposed rules or rule amendments to the Commission within 60 days of publication of the new rule in the Federal Register. Such rules must be effective within 270 days after publication of the Commission's final rules and operative no later than the first anniversary of such publication. Thus under the Proposal, the period between publication of final listing rules and their operation may be as short as 90 days. Given that 1) many companies may be looking for new directors concurrently, 2) companies will require sufficient time to be deliberative when considering potential director candidates and 3) potential candidates are likely to consider carefully whether to accept an invitation to join a board, we believe the period between final effectiveness of SRO rules and the date they become operative should be at least 180 days in order to allow sufficient time to identify and select appropriate director candidates.

To illustrate the foregoing, we note that if the final form of the Proposed Rule is published on or about April 26, 2003, then the listing standards could be published as late as January 21, 2004 and become operative under the Commission's rule by April 26, 2004. In order to allow companies adequate time to comply with new independence standards, in these circumstances, the Committee believes such standards should not become operative for annual reports covering fiscal years ending prior to September 30, 2004.

II. SROs Should Determine "Look-Back" Periods

The Committee supports application of the independence requirements to current relationships of audit committee members and specified related persons. However, the Committee does not believe application of the Commission's independence requirements should extend to a "look-back" period, especially given that 1) SRO listing standards regarding audit committee member independence already apply look-back periods to certain business and personal relationships and 2) Section 301 of the Sarbanes-Oxley Act does not require a "look-back" period. As previously noted, the Proposed Rule provides the minimum independence standards that the SROs must adopt. The SROs, with their history of applying their independence standards, are in a better position to determine what "look-back" periods, if any, are appropriate for their listed companies.

For example, the New York Stock Exchange (the "NYSE") listing standards currently provide, among other things, that 1) a director who is an employee of a listed company or any of its affiliates may not serve on the audit committee of such company until three years following termination of his or her employment and 2) a director who is an immediate family member of an individual who is an executive officer of the listed company or any of its affiliates cannot serve on the audit committee of such company until three years following the termination of such employment relationship. However, the recently proposed NYSE corporate governance rules increase the "look-back" period in each of the above situations to five years.

Further, to the extent the Commission adopts "look-back" periods applicable to independence requirements, the Committee recommends that listed companies be exempt from such periods for 365 days from the effective date of the issuer's initial registration statement in order to allow a suitable transition period from private to public status.

III. Exception to Bar on "Indirect" Payments for Family Members Employed in Non-Officer Capacities and Payments to Family Member Firms

In order to be considered independent under the Proposal, audit committee members would be prohibited from accepting, directly or indirectly, any consulting, advisory or other compensatory fee from an issuer or an affiliate of the issuer, other than in his or her capacity as a member of the board of directors or any board committee.

The Proposed Rule prohibits audit committee members from accepting payments as an officer or employee, as well as other compensatory payments.[2] This prohibition extends to payments made directly or indirectly to the audit committee member, even though the Sarbanes-Oxley Act does not address the concept of direct and indirect payments. For example, under the Proposed Rule indirect acceptance of compensatory payments includes payments to spouses, minor children or stepchildren or children or stepchildren sharing a home with the member.

Overall, we support the Commission's initiatives to enhance audit committee member independence; however, we believe that the inclusion of all indirect compensation as a bar to independence is overly broad. The Commission noted that the Proposal would not preclude independence on the basis of ordinary course commercial business relationships between an issuer and an entity with which a director had a relationship. We believe that this concept should be extended to permit compensation which the Proposed Rule would otherwise label "indirect" but which is unlikely to impact the independence of the audit committee member. We recommend that the Commission add exceptions for compensation received by an audit committee member's family member in the ordinary course of business in a non-officer capacity and for fees to firms of family members below a prescribed amount or percentage of revenue.

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[2] The Committee recommends that the Proposal clarify that retirement payments to a director by an issuer or an affiliate of the issuer do not constitute "compensation" so as to prevent a finding of independence and, thus, preclude service on the audit committee. This, we believe, should be the case regardless of whether the retirement benefit is fixed or variable based on market performance of a portfolio or other index.

These exceptions are appropriate because:

- The types of payments contemplated should not compromise the audit committee member's judgment.

- The Proposed Rule without these exceptions would impose an undue burden on audit committee members by unnecessarily restricting the activities of their spouses and covered family members. It would also impose an undue administrative burden on audit committee members to track all compensation received by their spouses and covered family members, even inconsequential amounts, if such persons are in the business of rendering consulting, legal, investment banking, financial or other advice.

These exceptions will promote practical application of the Proposed Rule while still effectuating the intent of the Sarbanes-Oxley Act. In addition, without these exceptions, otherwise qualified directors may be reluctant to accept positions on audit committees. Indirect compensation falling within the exceptions would not result in a significant threat to audit committee member independence. For example, if an audit committee member's child holds a summer job or the spouse of an audit committee member serves in a non-executive capacity for the listed company, compensation for such positions should not bar the director from serving on the audit committee.

IV. Exception to Bar on Payments to Firms of Audit Committee Members for Types of Fees which are Unlikely to Impair Independence

As a corollary to the above comment regarding exceptions for some indirect compensation to an audit committee member's family member, the Committee believes a comparable exception should be established for some payments made to service providers with which audit committee members have a relationship where the nature of the payments is such that they are unlikely to impair the audit committee member's independence.

Under the Proposed Rule, indirect compensation also includes payments accepted by an entity in which an audit 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 or any similar services to the issuer. While we recognize that performing some services, for example, audit services, would necessarily disqualify a person associated with the service provider from serving on an audit committee, the provision of other services may not present the same level of conflict, particularly when one analyzes the nature of the services, the amounts involved and the significance of the fees to the service provider.

As presently drafted, we believe that the Proposal would eliminate from audit committee membership many qualified individuals, some of whom, such as investment bankers, could play a valuable role on the audit committee and could fulfill the Commission's criteria for service as an "audit committee financial expert". The Committee does not believe that such a result serves the objective of attracting qualified individuals who can serve on audit committees. The Committee suggests that in the case of indirect payments to the firms of audit committee members, the Commission consider (i) adopting a revenue based test of the kind described in Item 404(b) of Regulation S-K (although the 5% criterion may not be appropriate); and (ii) confirming that routine services, such as custodial, cash management and stock brokerage services in the case of investment banking firms, are ordinary course commercial business relationships that should not impair independence.

V. Exemption for One Audit Committee Member of a Newly Public Company

The Proposed Rule allows exemption from the independence requirements of one member of the audit committee of a newly public company for 90 days following effectiveness of its registration statement. We believe that the notion of this exemption is entirely appropriate and will give newly public companies a reasonable time period to attract capable and qualified audit committee members after they have completed their initial offering. However, given the situation with many newly public companies, we believe that it would be appropriate to extend this time period to no less than 365 days. We believe that companies which have just completed

the initial public offering process are less likely to face the most difficult of audit committee issues in the period immediately following such offering, and that they should be given an opportunity to build their boards within a reasonable timeframe. Extending this growth period to one year would provide, we believe, increased flexibility for newly public companies.

VI. Procedures for Handling Complaints

The Committee endorses the establishment of formal procedures for receiving and handling complaints regarding accounting, internal accounting controls or auditing matters. The Committee concurs in the Commission view that it should not mandate specific procedures that an audit committee must establish. In addition to the reasons set forth in the Release, the Committee believes listed companies should be given flexibility to develop procedures that are harmonious with procedures they must develop in light of requirements under the Commission's rules regarding the professional responsibility for attorneys required under Section 307 of the Sarbanes-Oxley Act, the Commission's rules regarding whistleblower protection required under Section 806 of the Sarbanes-Oxley Act and general labor and employment principles, some or all of which may be applicable in a given set of circumstances. The Committee also recommends that listed companies be allowed to choose whether or not they disclose their procedures for handling complaints as such procedures are not in the ordinary course of interest to investors or shareholders.

Conclusion

Effective oversight of the financial reporting processes of filing companies is crucial to the continued success of the U.S. securities markets. To the extent the Proposal would improve such oversight by strengthening the independence of audit committees and clearly outlining their responsibilities, we believe the Proposed Rule will help bolster investors' confidence. However, to the extent the Proposed Rule suggests the adoption of criteria that potentially restrict an already limited pool of individuals who are able and willing to serve on audit committees, particularly on audit committees of smaller issuers, we believe the Proposal should be modified.

Please note that this letter does not necessarily reflect the individual views of members of the Committee.

Members of the Committee would be pleased to answer any questions you might have regarding our comments, and to meet with the Staff if that would assist the Commission's efforts.

Respectfully Submitted,

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Committee on Securities Regulation

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