

407 Legal and Regulatory Developments Affecting the Audit Committee

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Michael D. Cahn

Michael D. Cahn is associate general counsel at Textron Inc. in Providence, Rhode Island. He is Textron's principal securities lawyer, advising Textron on issuances of securities, disclosure issues, SEC reporting, and corporate governance issues. He also advises Textron on acquisitions and dispositions, antitrust law, and other legal matters.

Prior to joining Textron 25 years ago, Mr. Cahn was an associate at Cahill Gordon & Reindel in New York.

Mr. Cahn is chair of the 1934 Act Subcommittee of ACCA's Corporate and Securities Law Committee. He also is on the board of directors of the Rhode Island Legal/Educational Partnership, a nonprofit organization that conducts Rhode Island's mock trial competition for high school students and legal courses for high school teachers.

Mr. Cahn received a BA from Michigan State University and his JD from Harvard Law School.

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Teresa E. Iannaconi

Teresa E. Iannaconi is a partner at the firm of KPMG LLP. She currently serves as the partner in charge of practice advisory services in KPMG's National Support Services—Department of Professional Practice in New York. Her responsibilities include providing advice and support on SEC and other financial reporting issues.

Prior to joining KPMG, Ms. Iannaconi was on the staff of the Securities and Exchange Commission. During her tenure with the Commission she served in various positions and divisions. She served as the associate director for accounting operations in the division of corporation finance and previously as the deputy chief accountant of that division.

Ms. Iannaconi is a CPA and a member of the AICPA and American Accounting Association. She served as a member of FASB's Emerging Issues Task Force. She currently serves on the American Accounting Association's Financial Accounting Standards Committee. She previously served as a member of the AICPA's SEC Regulation Committee and as a working group member in connection with FASB's Business Reporting Research Project.

She received a BSBA from Georgetown University and MBA from the University of Maryland. She also served as faculty at the University of Maryland for five years.

Gregory H. Mathews

Gregory H. Mathews is senior vice president and assistant general counsel for First Union Corporation in the Philadelphia office of its legal division. His responsibilities include management of certain litigation against the organization including cases involving personal and corporate trust matters, securities, mutual funds, and class actions.

Mr. Mathews was previously lead counsel for litigation and outside legal services for CoreStates Financial Corp, a bank holding company which merged with First Union in 1998. Prior to going in-house, he was a partner with the law firm of Hoyle, Morris & Kerr in Philadelphia. He also served on the staff of the SEC's Division of Corporation Finance for four years.

This year, Mr. Mathews is the chair of ACCA's Corporate and Securities Law Committee. In addition, he is a past chair of the Philadelphia Bar Association's Business Law Section and its Securities Regulation Committee. He serves as treasurer of both the Philadelphia Bar Association and the Philadelphia Bar Foundation.

Mr. Mathews received a BA from the University of Florida, holds a master's degree in political communication from the State University of New York, and received his JD from the Antioch College School of Law.

John F. Olson

John F. Olson is a senior partner in the Washington, DC office of Gibson, Dunn & Crutcher.

Mr. Olson served as chair of the ABA's Federal Regulation Securities Committee, and is a member of the executive council of the Federal Bar Association's Securities Committee. He is a member of the Council of the ABA's Business Law Section and the Corporate Laws Section's Committee. He serves on the Legal Advisory Committee of the New York Stock Exchange and has served on the Legal Advisory Board of the National Association of Securities Dealers. He was a founding trustee of the American College of Investment Counsel, and served on a select committee of leading securities lawyers appointed by the chair of the Securities Subcommittee of the Senate Banking Committee.

Mr. Olson served as general counsel of the District of Columbia Bar. He chaired the Task Force on Regulation of Insider Trading of the ABA. He served on the ABA Coordinating Group on Regulatory Reform and served for three years as chair of the ABA's Committee of Foreign Claims. Mr. Olson is a member of the American Law Institute. He recently served on the Blue Ribbon Commission on CEO Succession of the National Association of Corporate Directors and on the NACD's Blue Ribbon Commission on Audit Committees.

He has cochaired the annual program, Proxy Statements, Annual Meetings, and Disclosure Documents, for 21 years. He serves on the advisory committees for the San Diego Securities Regulation Institute and the Practising Law Institute's Annual Securities Regulation Institute. He cochairs the American Law Institute/ABA annual postgraduate course in federal securities law. Mr. Olson is a member of the editorial advisory boards of

Insights: The Corporate and Securities Law Advisor, the BNA's Securities Regulation & Law Report, and the Corporate Governance Advisor.

Ernest L. Ten Eyck

Ernest L. Ten Eyck is an accounting professional with more than 30 years of experience in public accounting, consulting, and at the Securities and Exchange Commission. He specializes in providing corporate investigative and litigation consulting services, including expert witness testimony, for law and accounting firms, public companies, investment bankers, insurance companies, and others.

Over a 10 year period, Mr. Ten Eyck served as Laventhol & Horwath's national accounting and auditing partner, national quality control director, SEC consulting partner, and as an engagement partner in the Litigation and Insurance Consulting Service Group. In addition to his background in public accounting, Mr. Ten Eyck has six years' experience at the SEC, where he served as assistant chief accountant. Mr. Ten Eyck also served as director of information services at Disclosure, Inc. He began his career as an auditor at Ernst & Ernst (now Ernst & Young).

Mr. Ten Eyck served a three-year term on the Auditing Standards Board of the American Institute of Certified Public Accountants(AICPA). He has also been chair of AICPA task forces on Financial Accounting Standards Board Monitoring and Revision of GAAP Hierarchy, and a member of the task forces on Audit Issues and on Forecasts and Projections. He also served as a member of the adjunct faculty at American University. He is a member of the Pennsylvania and Washington, DC institutes of CPAs and the Association of SEC Alumni. He also is a Certified Fraud Examiner (CFE) and an associate member of the ABA.

Mr. Ten Eyck received a BBA from George Washington University.

Luise M. Welby

Luise M. Welby is assistant general counsel at Freddie Mac in McLean, Virginia. She is a securities attorney specializing in matters related to funding and investments, ecommerce, and strategic initiatives.

Prior to joining Freddie Mac, Ms. Welby spent seven years at the Securities and Exchange Commission, and in her last position was counsel to Commissioner Steven M. H. Wallman. She began her career as a corporate and securities associate with Hogan & Hartson in Washington, DC.

Ms. Welby received a BBA from the University of Notre Dame and a JD from the University of California at Los Angeles School of Law.

Final Rule:
Audit Committee Disclosure

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 210, 228, 229, and 240

[Release No. 34-42266; File No. S7-22-99]

RIN 3235-AH83

Audit Committee Disclosure

Agency: Securities and Exchange Commission

Action: Final rule

Summary: The Securities and Exchange Commission is adopting new rules and amendments to its current rules to require that companies' independent auditors review the companies' financial information prior to the companies filing their Quarterly Reports on Form 10-Q or Form 10-QSB with the Commission, and to require that companies include in their proxy statements certain disclosures about their audit committees and reports from their audit committees containing certain disclosures. The rules are designed to improve disclosure related to the functioning of corporate audit committees and to enhance the reliability and credibility of financial statements of public companies.

Dates: Effective Date: January 31, 2000. Compliance Dates: Registrants must obtain reviews of interim financial information by their independent auditors starting with their Forms 10-Q or 10-QSB to be filed for fiscal quarters ending on or after March 15, 2000. Registrants must comply with the new proxy and information disclosure requirements (e.g., the requirement to include a report of their audit committee in their proxy statements, provide disclosures regarding the independence of their audit committee members, and attach a copy of the audit committee's charter) for all proxy and information statements relating to votes of shareholders occurring after December 15, 2000. Companies who become subject to Item 302(a) of Regulation S-K as a result of today's amendments must comply with its requirements after December 15, 2000. Registrants voluntarily may comply with any of the new requirements prior to the compliance dates.

For Further Information Contact: Mark Borges, Attorney-Adviser, Division of Corporation Finance (202-942-2900), Meridith Mitchell, Senior Counselor, Office of the General Counsel (202-942-0900), or W. Scott Bayless, Associate Chief Accountant, or Robert E. Burns, Chief Counsel, Office of the Chief Accountant (202-942-4400).

Supplementary Information: The Commission is adopting amendments to Rule 10-01 of Regulation S-X,¹ Item 310 of Regulation S-B,² Item 7 of Schedule 14A³ under the Securities Exchange Act of 1934 (the "Exchange Act"),⁴ and Item 302 of Regulation S-K.⁵

Additionally, the Commission is adopting new Item 306 of Regulation S-K6 and Item 306 of Regulation S-B.7

I. Executive Summary

We are adopting new rules and amendments to current rules to improve disclosure relating to the functioning of corporate audit committees and to enhance the reliability and credibility of financial statements of public companies.⁸ As more fully described in the Proposing Release, the new rules and amendments are based in large measure on recommendations made by the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (the "Blue Ribbon Committee").⁹ The new rules and amendments have been adopted in most respects as proposed, with modifications discussed below.

Audit committees play a critical role in the financial reporting system by overseeing and monitoring management's and the independent auditors' participation in the financial reporting process. We have seen a number of significant changes in our markets, such as technological developments and increasing pressure on companies to meet earnings expectations,¹⁰ that make it ever more important for the financial reporting process to remain disciplined and credible.¹¹ We believe that additional disclosures about a company's audit committee and its interaction with the company's auditors and management will promote investor confidence in the integrity of the financial reporting process. In addition, increasing the level of scrutiny by independent auditors of companies' quarterly financial statements should lead to fewer year-end adjustments, and, therefore, more reliable financial information about companies throughout the reporting year.

Accordingly, the new rules and amendments:

- * require that companies' independent auditors review the financial information included in the companies' Quarterly Reports on Form 10-Q or 10-QSB prior to the companies filing such reports with the Commission (see Section III.A below); \
- * extend the requirements of Item 302(a) of Regulation S-K (requiring at fiscal year end appropriate reconciliations and descriptions of any adjustments to the quarterly information previously reported in a Form 10-Q for any quarter) ¹² to a wider range of companies (see Section III.A below);
- * require that companies include reports of their audit committees in their proxy statements;¹³ in the report, the audit committee must state whether the audit committee has: (i) reviewed and discussed the audited financial statements with management; (ii) discussed with the independent auditors the matters required to be discussed by Statement on Auditing Standards No. 61,¹⁴ as may be modified or supplemented; and (iii) received from the auditors disclosures regarding the auditors' independence required by Independence Standards Board Standard No. 1,¹⁵ as may be modified or supplemented, and discussed with the auditors the auditors' independence (see Section III.B below);

* require that the report of the audit committee also include a statement by the audit committee whether, based on the review and discussions noted above, the audit committee recommended to the Board of Directors that the audited financial statements be included in the company's Annual Report on Form 10-K or 10-KSB (as applicable) for the last fiscal year for filing with the Commission (see Section III.B below);

* require that companies disclose in their proxy statements whether their Board of Directors has adopted a written charter for the audit committee, and if so, include a copy of the charter as an appendix to the company's proxy statements at least once every three years (see Section III.C below);

* require that companies, including small business issuers,¹⁶ whose securities are quoted on Nasdaq or listed on the American Stock Exchange ("AMEX") or New York Stock Exchange ("NYSE"), disclose in their proxy statements whether the audit committee members are "independent" as defined in the applicable listing standards,¹⁷ and disclose certain information regarding any director on the audit committee who is not "independent" (see Section III.D below); require that companies, including small business issuers, whose securities are not quoted on Nasdaq or listed on the AMEX or NYSE disclose in their proxy statements whether, if they have an audit committee, the members are "independent," as defined in the NASD's, AMEX's or NYSE's listing standards, and which definition was used (see Section III.D below); and

* provide "safe harbors" for the new proxy statement disclosures to protect companies and their directors from certain liabilities under the federal securities laws (see Section III.E below).

To provide companies with the opportunity to evaluate their compliance with the revised listing standards of the NASD, AMEX, and NYSE and to prepare for the new disclosure requirements, we are providing transition periods for compliance with the new requirements (see Section V below).

II. Background

As discussed in the Proposing Release, given the changes in our markets, such as the increasing number of investors entering our markets and changes in the way and speed with which investors receive information, it is vitally important for investors to remain confident that they are receiving the highest quality financial reporting. The demand for reliable financial information appears to be at an all time high, as technology makes information available to more people more quickly. The new dynamics of our capital markets have presented companies with an increasingly complex set of challenges. One challenge is that companies are under increasing pressure to meet earnings expectations.¹⁸ We have become increasingly concerned about inappropriate "earnings management," the practice of distorting the true financial performance of the company.¹⁹

The changes in our markets and the increasing pressures on companies to maintain positive earnings trends have highlighted the importance of strong and effective audit committees. Effective oversight of the financial reporting process is fundamental to preserving the integrity of our markets. Audit committees play a critical role in the

financial reporting system by overseeing and monitoring management's and the independent auditors' participation in the financial reporting process. Audit committees can, and should, be the corporate participant best able to perform that oversight function.

As discussed more fully in the Proposing Release, since the early 1940s, the Commission, along with the auditing and corporate communities, has had a continuing interest in promoting effective and independent audit committees. Most recently, the NYSE and NASD sponsored the Blue Ribbon Committee in response to "an increasing sense of urgency surrounding the need for responsible financial reporting given the market's increasing focus on corporate earnings and a long and powerful bull market."²⁰ The new rules and amendments affirm what have long been considered sound practice and good policy within the accounting and corporate communities.²¹

While almost all of the commenters that provided comment letters on the Proposing Release²² supported our goals of improving disclosure about audit committees and enhancing the reliability and credibility of financial statements, many commenters suggested alternative approaches to achieving those goals. Some commenters believed that we should impose more rigorous requirements.²³ Other commenters recommended that we not adopt certain aspects of the proposals. In this regard, the concern most frequently expressed was that as a result of the new requirements to provide certain disclosures in a report, audit committees may be exposed to additional liability, and that consequently it may be difficult for companies to find qualified people to serve on audit committees.²⁴

It is not our intention to subject audit committee members to increased liability. We addressed concerns about liability by modifying our initial proposals from the Blue Ribbon Committee's recommendations and by providing safe harbor protections. Nevertheless, we appreciate that many commenters continue to be concerned about the audit committee report generally, and specifically the requirement that the audit committee state whether anything has come to the attention of the members of the audit committee that caused the audit committee to believe that the audited financial statements included in the company's Annual Report on Form 10-K or 10-KSB 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 under which they were made, not misleading.

In response, we have modified that disclosure item, which was the subject of most of the commentary. We are adopting, instead, one of the other alternatives proposed – the audit committee must state whether, based on the review and discussion of the audited financial statements with management and discussions with the independent auditors, the audit committee recommended to the Board that the audited financial statements be included in the company's Annual Report on Form 10-K or 10-KSB (as applicable) for the last fiscal year for filing with the Commission. As we discussed in the Proposing Release, we do not believe that improved disclosure about the audit committee and increased involvement by the audit committee should result in increased exposure to liability. Consequently, we believe that this modification, together with the safe harbors, should further alleviate concerns about increased liability exposure, while promoting our goal of improving the financial reporting process.

Some commenters expressed concern about applying the new requirements to small businesses, particularly the interim financial review requirement. We have considered those comments carefully. We think that improvements in the financial reporting process for companies of all sizes is important for promoting investor confidence in our markets.²⁵ In this regard, because we have seen instances of financial fraud at small companies as well as at large companies, ²⁶ we think that improving disclosures about the audit committees of small and large companies is important. As discussed in the Proposing Release, interim financial information generally may include more estimates than annual financial statements, but interim financial statements have never been subject to the discipline provided by having auditors associated with these statements on a timely basis. Investors, however, rely on and react quickly to quarterly results of companies, large and small. Accordingly, we believe that it is appropriate to require small business issuers to obtain reviews of interim financial information. As discussed below, however, small business issuers are not included in the expanded group of issuers subject to Item 302(a) disclosure requirements. In addition, we think that the transition period should help small businesses prepare for and adapt to the new requirements.

The Blue Ribbon Committee also made recommendations that call for action by the NASD, the NYSE, and the AICPA. In response, the NASD and NYSE proposed, and the Commission approved, changes to their listing standards,²⁷ and the Auditing Standards Board ("ASB") recently proposed amendments²⁸ to SAS 6129 and SAS 71.30

III. Discussion of New Rules and Amendments

A. Pre-Filing Review of Quarterly Financial Statements; Item 302(a)

We are adopting, as proposed, amendments to Rule 10-01(d) of Regulation S-X and Item 310(b) of Regulation S-B to require that a company's interim financial statements be reviewed by an independent public accountant prior to the company filing its Form 10-Q or 10-QSB with the Commission.³¹ The amendments would require that independent auditors follow "professional standards and procedures for conducting such reviews, as established by generally accepted auditing standards, as may be modified or supplemented by the Commission." Under current auditing standards, this means that the auditors would be required to follow the procedures set forth in SAS 71, or such other auditing standards that may in time modify, supplement, or replace SAS 71.

As noted above, we believe that more discipline is needed for the quarterly financial reporting process.³² We believe that the reviews required will facilitate early identification and resolution of material accounting and reporting issues because the auditors will be involved earlier in the year. Early involvement of the auditors should reduce the likelihood of restatements or other year-end adjustments and enhance the reliability of financial information. In addition, as a result of changes in the markets, companies may be experiencing increasing pressure to "manage" interim financial results. Inappropriate earnings management could be deterred by imposing more discipline on the process of preparing interim financial information before filing such information with the Commission.

Many commenters supported the interim review requirement.³³ Several commenters expressed concern, however, about the cost of obtaining interim reviews, particularly for small business issuers.³⁴ As discussed above, we believe that improving the interim reporting process is important for companies of all sizes. As noted in the Proposing Release, we understand that the five largest U.S. accounting firms and other firms have policies to require that their clients have reviews of quarterly financial statements as a condition to acceptance of the audit.³⁵ Consequently, those firms already have implemented the new requirement for the companies that are audited by those firms.

In the Proposing Release, we solicited comment on whether, in light of the proposal to require interim reviews, we should require all companies to comply with Item 302(a) of Regulation S-K. Currently, under Item 302(a) of Regulation S-K, larger, more widely-held companies³⁶ supplement their annual financial information with disclosures of selected quarterly financial data. Item 302(a) requires appropriate reconciliations and descriptions of any adjustments to the quarterly information previously reported in a Form 10-Q for any quarter. The selected financial data must be reviewed by the independent auditors in accordance with SAS 71, but the review can occur at the end of the year and as part of the audit of the annual financial statements. We are amending Item 302(a) to extend the requirements to all companies³⁷ (except small business issuers filing on small business forms) that have securities registered under Sections 12(b)³⁸ or 12(g)³⁹ of the Exchange Act regardless of the size of the company or public float.⁴⁰

Regulation S-B does not require small business issuers to provide Item 302(a) type disclosures. Today's amendments continue to exclude small business issuers filing under Regulation S-B from those disclosure requirements,⁴¹ but we will continue to consider whether and how such requirements should apply to small business issuers.

We believe that the amendments to Item 302(a) are consistent with the new requirement to obtain interim reviews. Both new measures should add discipline to the process of preparing and reporting quarterly financial information. Both should also encourage early identification of accounting issues and resolution of those issues before they must be subject to an auditor's review or a "reconciling" disclosure under Item 302(a)(2). Because the information to be disclosed should be readily available from each company's Form 10-Q filings, no additional audit or review costs will be imposed by the amendments to Item 302(a).

B. The Audit Committee Report

We are adopting new Item 306 of Regulations S-K and S-B and Item 7(e)(3) of Schedule 14A that require the audit committee to provide a report in the company's proxy statement. The required disclosure will help inform shareholders of the audit committee's oversight with respect to financial reporting, and underscore the importance of that role.

Many commenters were concerned that a report by the audit committee that indicates whether various discussions have occurred would expose the audit committee members to increased scrutiny and liability.⁴² We do not believe that will be the case. Under state corporation law, the more informed the audit committee becomes through its discussions with management and the auditors, the more likely that the "business judgment rule" will

apply and provide broad protection.⁴³ Those discussions should serve to strengthen the "information and reporting system" that should be in place.⁴⁴ Adherence to a sound process should result in less, not more, exposure to liability.⁴⁵

Accordingly, we are adopting, as proposed, the requirement that the audit committee disclose whether the audit committee has reviewed and discussed the audited financial statements with management and discussed certain matters with the independent auditors.⁴⁶ Under paragraphs (a) (1), (a) (2), and (a) (3) of Item 306 (paragraph (a) (4) is discussed separately, below), audit committees must state whether:

- (1) the audit committee has reviewed⁴⁷ and discussed the audited financial statements with management;
- (2) the audit committee has discussed with the independent auditors the matters required to be discussed by SAS 61, as may be modified or supplemented;⁴⁸ and
- (3) the audit committee has received the written disclosures and the letter from the independent auditors required by ISB Standard No. 1, as may be modified or supplemented, and has discussed with the auditors the auditors' independence.

If the company does not have an audit committee, the board committee tasked with similar responsibilities, or the full board of directors, would be responsible for the disclosure.

The disclosure required by paragraph (a) (3) relates to written disclosures, a letter from the independent auditors, and discussions between the audit committee and the independent auditors required by ISB Standard No. 1. The Commission has long recognized the importance of auditors being independent from their audit clients.⁴⁹ Public confidence in the reliability of a company's financial statements depends on investors perceiving the company's auditors as being independent from the company.

As noted above, paragraph (a) (4) was the subject of the most criticism. Commenters expressed concern about increased liability exposure, which they believed may result in qualified audit committee members resigning or companies having difficulty recruiting qualified members.⁵⁰ Some commenters, on the other hand, were skeptical that there would be increased liability exposure.⁵¹

Because of concerns about liability, we did not propose the disclosure requirement recommended by the Blue Ribbon Committee,⁵² but instead proposed that the audit committee indicate whether, based on its discussions with management and the auditors, its members became aware of material misstatements or omissions in the financial statements. As discussed in the Proposing Release, we did not intend, nor do we believe, that the proposed disclosure about the audit committee and increased involvement by the audit committee would result in increased exposure to liability. Because commenters continued to be concerned, however, we are adopting an alternative contained in the Proposing Release. We believe that the revised language, together with the safe harbors, addresses those concerns.

As adopted, new paragraph (a) (4) requires the audit committee to state whether, based on the review and discussions referred to in paragraphs (a) (1) through (a) (3), it recommended to the Board of Directors that the financial statements be included in the

Annual Report on Form 10-K or 10-KSB for the last fiscal year for filing with the Commission.⁵³ Because the new language in paragraph (a) (4) focuses on the annual audited financial statements and the filing of those financial statements with the Commission, we believe that this requirement will provide investors with a better understanding of the audit committee's oversight role in the financial reporting process. The audit committee's recommendation that the financial statements be used in Commission filings already is implicit in, and is consistent with, board members signing the company's Annual Report on Form 10-K or 10-KSB.⁵⁴ Further, several commenters preferred this alternative.⁵⁵

In addition, in performing its oversight function, the audit committee likely will be relying on advice and information that it receives in its discussions with management and the independent auditors. Accordingly, the text of the new requirement acknowledges that the audit committee had such discussions with management and the auditors, and, based on those discussions, made decisions about the financial statements and the filing of the company's Form 10-K or 10-KSB. This approach is consistent with state corporation law that permits board members to rely on the representations of management and the opinions of experts retained by the corporation when reaching business judgments.⁵⁶ The Blue Ribbon Committee noted the "impracticability of having the audit committee do more than rely upon the information it receives, questions, and assesses in making this disclosure."⁵⁷

We are adopting, as proposed, the requirement that the new disclosure appear over the printed names of each member of the audit committee.⁵⁸ This requirement will emphasize for shareholders the importance of the audit committee's oversight role in the financial reporting process.

The disclosures are required in the company's proxy statement because they could have a direct bearing on shareholders' voting decisions, and because the proxy statement is actually delivered to shareholders and is accessible on the SEC's web site. Companies must provide the disclosure only in a proxy statement relating to an annual meeting of shareholders at which directors are to be elected (or special meeting or written consents in lieu of such meeting). The disclosure needs to be provided only one time during the year (e.g., in a proxy statement for an annual meeting at which directors are to be elected, but not in proxy solicitation material used in a subsequent election contest during that same year).

C. Audit Committee Charters

We are adopting, as proposed, the requirement that companies disclose in their proxy statements whether their audit committee is governed by a charter, and if so, include a copy of the charter as an appendix to the proxy statement at least once every three years. The requirement appears in new paragraph (e) (3) under Item 7 of Schedule 14A. The new disclosure regarding audit committees' charters should help shareholders assess the role and responsibilities of the audit committee.

We believe that audit committees that have their responsibilities set forth in a written charter are more likely to play an effective role in overseeing the company's financial

reports. The amendments, however, will not require companies to adopt audit committee charters, or dictate the content of the charter if one is adopted.⁵⁹

Several commenters expressed concern that the requirement to attach the charter would result in boilerplate charters.⁶⁰ We believe that it is useful for shareholders to know about the responsibilities and the duties of audit committees,⁶¹ and while it is inevitable that some of the same provisions will appear in charters of different audit committees, we encourage companies to tailor the charters to their specific circumstances.

Consistent with some of the comments regarding the audit committee report, some commenters recommended that the charter be attached to the Form 10-K instead of the proxy statement because of concerns about expanding the length of the proxy statement.⁶² We believe that information about the responsibilities and the duties of audit committees is most relevant to shareholders when they are electing directors and reviewing their performance. Accordingly, we have determined to require, as proposed, that the charter be attached to the proxy statement every three years.

D. Disclosure About "Independence" of Audit Committee Members

As early as 1940, the Commission encouraged the use of audit committees composed of independent directors. As the Commission staff stated in a report to Congress in 1978, "[i]f the [audit] committee has members with vested interests related to those of management, the audit committee probably cannot function effectively. In some instances this may be worse than having no audit committee at all by creating the appearance of an effective body while lacking the substance."⁶³ Further, as the Blue Ribbon Committee noted, ". . . common sense dictates that a director without any financial, family, or other material personal ties to management is more likely to be able to evaluate objectively the propriety of management's accounting, internal control and reporting practices."⁶⁴

As noted in the Proposing Release, because of the importance of having an audit committee that is comprised of independent directors,⁶⁵ we believe that shareholders should know about the independence of the members. We believe that the new disclosures will accomplish that goal.

Under the revised listing standards of the NYSE, AMEX, and NASD, under exceptional and limited circumstances, companies may appoint to their audit committee one director who is not independent if the Board determines that membership on the committee by the individual is required by the best interests of the corporation and its shareholders, and the Board discloses, in the next annual proxy statement subsequent to such determination, the nature of the relationship and the reasons for that determination. We are adopting, as proposed, the requirement that companies whose securities are listed on the NYSE or AMEX or quoted on Nasdaq that have a non-independent audit committee member disclose the nature of the relationship that makes that individual not independent and the reasons for the Board's determination to appoint the director to the audit committee. Small business issuers are not required to comply with this requirement.

In addition, companies, including small business issuers, whose securities are listed on the NYSE or AMEX or quoted on Nasdaq, must disclose whether the audit committee members are independent, as defined in the applicable listing standards.⁶⁶ While companies are required to provide in their proxy statements certain disclosures that relate to the independence of directors,⁶⁷ we thought that it was important to make the disclosure about all of the audit committee members' independence explicit and clear for shareholders. For example, if we required disclosure about only those audit committee members who are not independent, there would have been an implication that all of the other members are independent. Because of the importance of having independent directors on the audit committee, shareholders should be informed explicitly, rather than implicitly, of each member's status.

While we recognize that the new requirements of the NYSE, AMEX, and NASD regarding independence of audit committees need not be complied with for 18 months, we think that companies will be able to provide the new disclosures in the first proxy season after year 2000 because, as a practical matter, to meet the 18-month deadline, most companies will elect new directors during the year 2000. For other companies, this will show their progress in moving toward compliance with the listing requirements.

We are also adopting, as proposed, the requirement that companies, including small business issuers, whose securities are not listed on the NYSE or AMEX or quoted on Nasdaq, disclose in their proxy statements whether, if they have an audit committee, the members are independent as defined in the NYSE's, AMEX's, or NASD's listing standards, and which definition was used. These companies would be able to choose which definition of "independence" to apply to the audit committee members in making the disclosure. Whichever definition is chosen must be applied consistently to all members of the audit committee.

E. Safe Harbors

We are adopting, as proposed, "safe harbors" for the new disclosures.⁶⁸ The "safe harbors" would track the treatment of compensation committee reports under Item 402 of Regulation S-K.⁶⁹ The safe harbors are in paragraph (c) in new Item 306 of Regulations S-K and S-B and paragraph (e) (v) of Schedule 14A. Under the "safe harbors," the additional disclosure would not be considered "soliciting material," "filed" with the Commission, subject to Regulation 14A or 14C (and, therefore, not subject to the antifraud provisions of Rules 14a-9 or 14c-6) ⁷⁰ or to the liabilities of Section 18 of the Exchange Act, except to the extent that the company specifically requests that it be treated as soliciting material, or specifically incorporates it by reference into a document filed under the Securities Act or the Exchange Act.

Several commenters recommended that the Commission also provide a safe harbor from private litigation.⁷¹ After careful consideration, we do not believe an additional safe harbor is necessary or appropriate. As discussed more fully above, in adopting the new rules and amendments, we do not intend to subject companies or their directors to increased exposure to liability under the federal securities laws, or to create new standards for directors to fulfill their duties under state corporation law. We do not believe that the disclosure requirements will result in increased exposure to liability or create new standards. We have modified the disclosure required in Item 306 in response

to commenters' concerns. To the extent the disclosure requirements would result in more clearly defined procedures for, and disclosure of, the operation of the audit committee, liability claims alleging breach of fiduciary duties under state law actually may be reduced. Accordingly, we believe that the safe harbors adopted are appropriate and sufficient.

IV. Applicability to Foreign Private Issuers and Section 15(d) Reporting Companies

A. Foreign Private Issuers

We proposed to exclude from the new requirements foreign private issuers with a class of securities registered under Section 12 of the Exchange Act or that file reports under Section 15(d) of the Exchange Act.⁷² Foreign private issuers currently are exempt from the proxy rules, are not required to file Quarterly Reports on Form 10-Q or 10-QSB,⁷³ and are subject to different corporate governance regimes in their home countries. Accordingly, we do not believe it is appropriate to extend the new requirements to foreign private issuers at this time. The Commission, however, is continuing to consider how the periodic reporting requirements for domestic companies should apply to foreign private issuers.

B. Section 15(d) Reporting Companies

As noted in the Proposing Release, companies whose reporting obligations arise solely under Section 15(d) of the Exchange Act are not required to file proxy statements with the Commission. We solicited comment on whether we should require those companies to provide the new disclosures in their Form 10-Ks or some other filing. Because we believe that the disclosures are most relevant to voting decisions on the basis of disclosure in proxy statements, and because of the nature of the market for the securities of such companies, we are not adopting such a scheme. Accordingly, at this time we are not extending the proxy statement disclosure requirements to Section 15(d) companies.

V. Compliance Dates

Several commenters requested that we provide a transition period to allow companies time to consider the rules and to revise, if necessary, any of their procedures.⁷⁴ We agree, and have provided a transition period for compliance with the new requirements. Registrants must obtain reviews of interim financial information by their independent auditors starting with their Forms 10-Q or 10-QSB to be filed for fiscal quarters ending on or after March 15, 2000. Registrants must comply with the new proxy and information disclosure requirements (e.g., the requirement to include a report of their audit committee in their proxy statements, provide disclosures regarding the independence of their audit committee members, and attach a copy of their audit committee's charter) for all proxy and information statements relating to votes of shareholders occurring after December 15, 2000. Companies who become subject to Item 302(a) as a result of today's amendments must comply with its requirements after December 15, 2000. Registrants voluntarily may comply with any of the new requirements prior to the compliance dates.

VI. Paperwork Reduction Act

Earlier this year, the staff submitted the proposed amendments to Regulations 14A and 14C to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. § 3507(d) and 5 CFR 1320.11. Regulations 14A and 14C contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 (44 U.S.C. § 3501 et seq.). The titles for the collections of information are: (1) Proxy Statements – Regulation 14A (Commission Rules 14a-1 through 14a-15) and Schedule 14A; and (2) Information Statements – Regulation 14C (Commission Rules 14c-1 through 14c-7) and Schedule 14C. Also, in accordance with the Paperwork Reduction Act, we solicited comments on the accuracy of our burden estimates for Regulations 14A and 14C. We did not receive any comments that address specifically the estimated paperwork burdens associated with those collections of information. The comments we received primarily addressed the costs and benefits of the proposals in general terms, and liability concerns, rather than issues relating to the collection of information. Commenters' more generalized concerns about costs and benefits of the amendments are addressed more fully in the cost-benefit and other sections of this release.

We proposed and are adopting amendments that will require a company to include additional disclosures in Schedules 14A and 14C, including certain information about the company's audit committee. The audit committee will have to disclose whether it had certain discussions with management and the company's independent auditors. The substance of the discussions would not be required to be disclosed. Companies will also have to disclose information regarding the independence of audit committee members. The amendments would also require companies that have adopted a written charter for their audit committee to include a copy of the charter as an appendix to Schedules 14A and 14C at least once every three years. The amendments do not require companies to prepare charters.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. Schedule 14A (OMB Control No. 3235-0059)75 and Schedule 14C (OMB Control No. 3235-0057)76 were adopted pursuant to Sections 14(a) and 14(c) of the Exchange Act. Schedule 14A prescribes information that a company must include in its proxy statement to ensure that shareholders are provided material information relating to voting decisions. Schedule 14C prescribes information that a company must include in its information statement to shareholders where votes are solicited by means other than proxies.

We solicited comments on whether we should require all companies to comply with Item 302(a) of Regulation S-K. As discussed in previous sections of the release, Item 302(a) of Regulation S-K currently requires larger, more widely-held companies to supplement their annual financial information with disclosures of selected quarterly financial data. We are amending Item 302(a) to extend the requirements to all companies (but not small business issuers filing on small business forms and foreign private issuers) that have securities registered under Section 12(b) or 12(g) of the Exchange Act. The Item 302(a) information will continue to appear as a table in the Form 10-K.

Form 10-K under the Exchange Act (OMB Control Number 3235-0063)⁷⁷ is used by registrants to file annual reports. The title for this collection of information is Form 10-K. Form 10-K provides a comprehensive overview of the registrant's business and financial condition. The Commission estimates that Form 10-K currently results in a total annual compliance burden of approximately 17,886,463 hours. The burden was calculated by multiplying the estimated number of entities filing Form 10-K (approximately 10,381) by the estimated average number of hours each entity spends completing the Form (approximately 1723 hours). The Commission based the number of entities that complete and file Form 10-K on the actual number of filers during the 1998 fiscal year. The staff estimated the average number of hours an entity spends completing Form 10-K by contacting a number of law firms and other persons regularly involved in completing the forms.

We estimate that the incremental burden of extending Item 302(a) to all companies with securities registered under Sections 12(b) or 12(g) of the Exchange Act (except small business issuers filing on small business forms) will increase the total by approximately 2000 hours. This burden was calculated by multiplying the estimated number of entities that do not currently provide Item 302(a) information by the number of additional hours it would take to provide the additional information. The staff estimates that approximately 8000 Form 10-K filers do not currently provide Item 302(a) information, and that it would take a total of approximately .25 hours to include the new disclosure in a Form 10-K. The Commission based the number of Form 10-K filers not currently providing Item 302(a) information on the approximate number of companies in the Compustat database that currently are required to file Item 302(a) information based on the criteria set forth in Item 302(a) of Regulation S-K.

We believe that the amendments will promote investor confidence in the securities markets by informing investors about the important role that audit committees play in the financial reporting process and will enhance the reliability and credibility of financial statements of public companies.

Compliance with the disclosure requirements is mandatory. There will be no mandatory retention period for the information disclosed, and responses to the disclosure requirements will not be kept confidential.

Pursuant to 44 U.S.C. § 3506(c) (2) (B), the Commission solicits comments to: (i) evaluate whether the revised rule is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility; (ii) evaluate the accuracy of the Commission's estimate of the burden of the proposed collection of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) evaluate whether there are ways to minimize the burden of the collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons submitting comments on the collection of information requirements for Form 10-K should direct the comments to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, D.C. 20503, and should send a copy to Jonathan G. Katz,

Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-0609, with reference to File No. S7-22-99. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-22-99, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication of this release. Consequently, a comment to OMB is assured of having its full effect if OMB receives it within 30 days of publication.

VII. Cost-Benefit Analysis

The amendments are expected to improve disclosure related to the functioning of the corporate audit committees and to enhance the reliability and credibility of financial statements of public companies. We believe that the amendments will promote investor confidence in the securities markets by informing investors about the important role that audit committees play in the financial reporting process. As the Blue Ribbon Committee summarized:

Improving oversight of the financial reporting process necessarily involves the imposition of certain burdens and costs on public companies. Despite these costs, the Committee believes that a more transparent and reliable financial reporting process ultimately results in a more efficient allocation of and lower cost of capital. To the extent that instances of outright fraud, as well as other practices that result in lower quality financial reporting, are reduced with improved oversight, the benefits clearly justify these expenditures of resources.⁷⁸

As noted above, the amendments are part of a larger, coordinated series of actions by the NYSE, NASD, AMEX, and the accounting profession that were recommended by the Blue Ribbon Committee to improve the financial reporting process. The Commission's rule amendments and new rules complement and strengthen the efforts of the NYSE, NASD, AMEX and the accounting profession. This cost-benefit analysis concentrates only on the effect of the Commission's rules. The benefits of the new requirements cannot be readily quantified.⁷⁹ However, these measures should mitigate inappropriate earnings management, enhance the reliability of financial information, improve disclosure to investors, and could improve securities pricing efficiency by encouraging the distribution of higher quality earnings numbers on a more timely basis.

Reviews of Quarterly Financial Statements

We are requiring interim reviews of quarterly financial statements filed on Form 10-Q or 10-QSB.⁸⁰ Under the amendments, a company's quarterly financial statements must be reviewed by independent auditors using "professional standards and procedures for conducting such reviews, as established by generally accepted auditing standards, as may be modified or supplemented by the Commission." Currently, that means that the review would follow the procedures established by SAS 71. The amendments apply only to the financial information contained in the company's Quarterly Reports on Form 10-Q or 10-QSB. Accordingly, the amendments do not require any review of quarterly financial information released to the public before the filing of the Form 10-Q or 10-QSB, such as the so-called quarterly "earnings release."

We believe that companies are under increasing pressure to meet financial analysts' expectations, and that pressure can be even more acute in the context of reports on quarterly earnings. We believe that the participation of auditors in the financial reporting process at interim dates will help to counterbalance that pressure and impose increased discipline on the process of preparing interim financial information.⁸¹ Auditor involvement in the financial reporting process earlier in the year should facilitate timely identification and resolution of significant and sensitive issues and result in fewer year-end adjustments, which should reduce the cost of annual audits.⁸² The increased focus and discipline imposed on the preparation of interim financial statements should enhance the efficiency of the capital markets by improving the reliability of quarterly financial statements, although these benefits are difficult to quantify.

We have prepared our best estimate of the incremental costs of preparing a SAS 71 review for those companies not currently having them performed. Our estimate of those incremental costs is based on data provided to the staff by the SEC Practice Section of the AICPA ("SECPS"), discussions with experienced practitioners, the experiences of current SEC staff members, and data provided by commenters.

Firms providing information to the SECPS indicated that the procedures they currently use are similar, if not the same, as those described in SAS 71. Most indicated that review reports are seldom issued. The firms also indicated that they are not aware of (and do not expect) clients switching auditing firms because of their new policies.

The firms providing information to the SECPS identified several unquantifiable benefits that they believe would result from the reviews, including better interim reporting, earlier identification and resolution of accounting issues, improvement in the quality of accounting estimates, and improved communications between clients and auditors. These benefits could also improve pricing efficiency of the issuer's securities. Several comment letters from accounting firms supported this view.⁸³ Medium and smaller sized accounting firms, however, indicated to the SECPS that SAS 71 reviews of small companies' interim financial statements may cause delays in filing Forms 10-Q or 10-QSB, be relatively more costly for small companies, be hampered by inadequate financial reporting processes, and would result in small companies shifting work from the company to the CPA firm. One small business commenter expressed concern that increased pressure to meet the filing deadlines would require hiring another employee.⁸⁴ Based on staff experience and discussions with practitioners, we believe many of the required review procedures can be performed simultaneously with the preparation of the quarterly financial statements, and accordingly, should not delay these filings. In addition, we believe that the same management personnel who work with the auditors at year end should be able to assist with the quarterly reviews.

The firms responding to the SECPS generally indicated that the costs of reviews of quarterly financial statements vary depending on several factors, including: (i) the sophistication of the client's accounting and reporting system; (ii) the quality of the client's accounting personnel; (iii) the identification of "fraud risk factors;" (iv) the client's industry; (v) the number and location of the client's subsidiaries; (vi) the seasonality of the client's business; (vii) the existence of contentious accounting issues;

and (viii) whether there will be a staffing "crunch" at the firm to handle the reviews each quarter.

The five largest U.S. accounting firms, the so-called "Big 5," and some other firms, currently have in place policies that require their clients to have interim reviews as a condition to acceptance of an audit. Based on the Compustat database and information from the SECPS and from commenters, we estimate that approximately 8,934 companies for calendar year 1998 retained auditors that require SAS 71 reviews. Based on a total of approximately 12,972 Forms 10-K and 10-KSB filed in 1998, we therefore estimate that approximately 4,038 companies are not currently subject to SAS 71 reviews.

Based on the data provided to staff by the SECPS, our experience, and information from commenters, we estimate the incremental cost to conduct a SAS 71 review will be nominal for those companies currently audited by the Big 5 firms and for the remaining companies would range from approximately \$1,000 to about \$4,000⁸⁵ per quarter. Multiplying \$7,500 (the midpoint of the average cost per firm of \$3,000 to \$12,000 per year) by 4038 produces an estimated \$30 million a year cost for SAS 71 reviews.⁸⁶ Obviously, if more companies are currently subject to SAS 71 reviews, or if the cost of the reviews is offset by a reduction in annual fees, the cost estimate would be smaller.

Disclosure Related to the Functioning of the Audit Committee

The principal benefits of the proposals are improved disclosure relating to the functioning of corporate audit committees and enhanced reliability and credibility of financial statements. The benefits of improved disclosure regarding the audit committee's communications with management and the independent auditors are not readily quantifiable. We believe, however, that they would include increased market efficiency due to improved information and investor confidence in the reliability of companies' financial disclosures. As discussed above, most of the commenters supported the goals of improving disclosure about audit committees, although some suggested alternative disclosure requirements. Commenters' principal concern was that audit committees may be exposed to additional liability, with the result that they would find it more difficult to recruit qualified audit committee members; others disagreed with that view. As discussed above, we modified the Item 306 audit committee report requirement to respond to commenters' concerns about liability.

We believe the costs associated with these amendments would derive principally from the disclosure obligations – we are not placing any substantive requirements on audit committees or their members. At the proposing stage, we estimated that the additional disclosure contemplated by the amendments would, on average, require less than three-fourths of a page in a company's proxy statement, based on the staff's experience with proxy statements, and analogous cost estimates. A financial printing company informed the staff that this disclosure would not likely increase the printing cost because up to three-fourths of a page can normally be incorporated without increasing the page length by reformatting the document. The printer reported that adding one more page could increase costs by about \$1,500 for an average sized company.

Only a few commenters mentioned printing costs, with one stating that the costs of printing the charter in the proxy statement "could be significant," but did not quantify

the amount.⁸⁷ We continue to believe that the printing costs of the disclosures and charter⁸⁸ would not be significant. The charter, for example, needs to be printed only once every three years, so the cost has been averaged over three years. We estimate the total average disclosure per year – the average annual burden of printing the charter and the other disclosures – would be one printed proxy statement page. Consequently, the annual aggregate cost would be approximately \$15 million.⁸⁹

This amount, however, does not include possible "start up" costs for some companies. First, some companies may have to set up procedures to monitor the activities of their audit committee in order to collect and record the information required by the amendments. In our view, such monitoring costs are most likely to result from disclosing the fact of the audit committee's discussions with management and the independent auditors and receiving from the independent auditors certain required disclosures and a letter from the independent auditors. We believe such monitoring costs will be insignificant.

Second, some companies may seek the help of outside experts, particularly outside legal counsel, in formulating responses to the new requirements.⁹⁰ In some circumstances, for instance, the audit committee may seek the advice of legal counsel before making the required disclosure about the audited financial statements. Commenters provided no cost data. We understand that many audit committees already use outside experts, but do not know what, if any, incremental cost there will be. As we modified our proposals to reflect better the oversight role of audit committees and address liability concerns, we anticipate that any costs attributable to the increased use of outside experts to respond to the new disclosure requirements will be negligible.

For purposes of the Paperwork Reduction Act, we estimated that our required disclosures would, on average, impose one additional burden hour, exclusive of printing costs, on each filer of Schedule 14A or 14C, or an aggregate annual total of 10,145 additional burden hours. This estimate reflects the time companies would spend preparing the additional disclosures in the proxy statement.⁹¹ The total annual costs accordingly would be approximately \$1 million.

These amendments are not intended to increase companies' or directors' exposure to liability under federal or state law. A number of commenters indicated that, in their assessment, the proposals would have the effect of increasing the companies' and/or directors' exposure to liability, with attendant costs, but provided no economic data. For the reasons discussed in previous sections of this release, we believe that the amendments will likely result in better and more reliable financial reporting, but should not increase liability exposure. In particular, we modified requirements to address this liability concern. In addition, the amendments include liability "safe harbors" similar to those that apply to compensation committee reports under current rules.⁹²

Item 302(a) of Regulation S-K

The Commission is requiring more companies to provide the supplemental financial information described in Item 302 of Regulation S-K. That information consists of selected quarterly financial data, such as net sales and gross profit, for the prior two years. We recognize that requiring all public companies (except Form S-B filers, Section 15(d)

reporting companies, and foreign private issuers) to provide supplemental financial information under Item 302 (a) of Regulation S-K may have some incremental cost. Currently only certain large, widely-held companies that meet certain tests (involving, among other things, the number of security holders, stock price, and market capitalization) must file supplemental financial information. Taking into account that auditors will be performing SAS 71 reviews for these companies, the incremental cost of preparing and presenting the supplementary financial information is small.

Based on the staff's experience, we do not believe that it will take company employees much time to pull the data from their prior quarterly reports to prepare the supplementary financial information for the Form 10-K. While the information will take up part of an additional page in the Form 10-K, there are no printing costs attributable to disclosure of this information since it is not typically contained in the annual report that is printed and distributed to investors.

We believe the supplementary financial information is a useful resource for investors and justifies the cost of its collection and filing. By tying the regulatory threshold to an existing, widely used test (e.g., the definition of small business issuer in Regulation S-B), the Commission is simplifying the regulatory scheme. Such simplification is an additional benefit of the amendments.

VIII. Consideration of Impact on the Economy, Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

Section 3(f) of the Exchange Act requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, also to consider whether the action will promote efficiency, competition, and capital formation. We believe that the proposals will promote investor confidence in the securities markets by improving the transparency of the role of corporate audit committees and enhancing the reliability and credibility of financial statements of public companies. More reliable financial statements should help to lower the costs of capital. Accordingly, the proposals should promote capital formation and market efficiency.

Section 23(a) of the Exchange Act requires the Commission, when adopting rules under the Exchange Act, to consider the impact on competition of any rule it adopts. We do not believe that the proposals would have any anti-competitive effects since the proposals should improve the transparency, reliability, and credibility of companies' financial statements. We requested comment on any anti-competitive effects of the proposals. For the reasons discussed above, we have decided to exclude foreign private issuers from these disclosure requirements. Any competitive effect that may occur by requiring domestic public companies to comply with these additional disclosure requirements, compared to foreign private issuers, is necessary and appropriate for the protection of investors.

IX. Final Regulatory Flexibility Analysis

This Final Regulatory Flexibility Analysis has been prepared in accordance with the Regulatory Flexibility Act ("RFA"). It relates to amendments to Rule 10-01 of Regulation

S-X, Item 310 of Regulation S-B, Item 302(a) of Regulation S-K, Item 7 of Schedule 14A under the Exchange Act, and new Item 306 of Regulations S-B and S-K.

A. Need for the Rules and Rule Amendments

The new rules and amendments to current rules are designed to improve disclosure relating to the functioning of corporate audit committees and to enhance the reliability and credibility of financial statements of public companies. The required disclosure will help inform shareholders of the audit committee's role in overseeing the preparation of the financial statements and underscore the importance of the audit committee's participation in the financial reporting process.

The required reviews of interim financial information should facilitate early identification and resolution of material accounting and reporting issues because the auditors will be involved earlier in the year. More reliable interim financial information will be available to investors, and early involvement of the auditors should reduce the number of restatements or other year-end adjustments. We believe that the disclosures will reinforce the audit committee's awareness of its responsibilities, and make visible for shareholders the audit committee's role in promoting reliable and transparent financial reporting.

B. Significant Issues Raised by Public Comment

Many commenters were concerned that the proposed rules would expose audit committee members to increased scrutiny and liability. As a result, those commenters suggested that we amend certain disclosure requirements and provide an additional safe harbor from private litigation. We modified the required audit committee report to address the liability concerns, and consequently, as discussed in previous sections of this release, we do not believe additional safe harbors are necessary or appropriate. We are adopting, as proposed, the same report requirements and safe harbors for companies of all sizes.

The Commission requested comment on whether the scope of the proposed rules should be narrowed to exclude companies under a certain size. Some commenters questioned the need for interim reviews for small entities,⁹³ particularly in light of the additional costs. However, we continue to believe that improving the interim reporting process is important for small companies. Investors rely on and react quickly to quarterly results of companies, large and small. Moreover, the COSO Report found that the incidence of financial fraud was greater at small companies.⁹⁴ The COSO Report specifically noted that the "concentration of fraud among companies with under \$50 million in revenues and with generally weak audit committees highlights the importance of rigorous audit committee practices, even for smaller organizations."⁹⁵ In light of the COSO Report, we believe it would be inconsistent with the purposes of the rule to exempt small business issuers from the proposed requirement for interim reviews.

We also solicited comment on whether we should require all companies to comply with Item 302(a) of Regulation S-K. Commenters generally agreed that we should extend the requirements to other companies, but questioned the need to include small companies. We are adopting the Item 302(a) requirement for all Section 12(b) and 12(g) registered

companies (except small business issuers reporting on small business forms) to maintain the more simplified reporting format of the regulatory scheme for small business issuers.

C. Small Entities Subject to the Rule

For purposes of the RFA, Exchange Act Rule 0-10 defines "small business" as a company whose total assets on the last day of its most recent fiscal year were \$5 million or less.⁹⁶ The rules will affect small businesses that are required to file proxy materials on Schedule 14A or 14C and Quarterly Reports on Form 10-Q or 10-QSB under the Exchange Act. We estimate that there are approximately 830 reporting companies (that are not investment companies) with assets of \$5 million or less. The Commission bases its estimate on information from the Insight database from Compustat, a division of Standard and Poors.

D. Projected Reporting, Recordkeeping, and Other Compliance Requirements

1. Reviews of Quarterly Financial Statements

The rules will require companies to engage their independent auditors to conduct interim reviews of their quarterly financial statements prior to the company filing its Forms 10-Q or 10-QSB. Based on information provided to the Commission by the SECPS,⁹⁷ it appears that most companies already engage their independent auditors to undertake some level of review of their quarterly financial statements.

Medium and smaller sized accounting firms indicated to the SECPS that SAS 71 reviews of small companies' interim financial statements may cause delays in filing Forms 10-Q or 10-QSB, be relatively more costly for all companies, be hampered by inadequate financial reporting processes, and would result in small companies shifting financial responsibilities from the company to the CPA firm.

However, based on the SECPS survey, we believe that the costs of compliance would be partially offset by a reduction in year-end audit fees and would lead to earlier identification of accounting and auditing issues and an improvement in the quality of the process used for preparing interim financial reports.

2. Disclosure Related to the Functioning of the Audit Committee

Issuers, both large and small, will be required to provide certain additional disclosure in their proxy statements regarding the company's audit committee, including attaching every three years a copy of the audit committee's charter, if they have one. Companies will be required to include reports of their audit committees in which the audit committee provides disclosure about whether certain discussions between the audit committee and management and the auditors took place. No disclosure of the substance of the discussions is required. The increased disclosure will require all entities, large and small, to spend additional time and incur additional costs in preparing disclosures. In particular, smaller companies may incur additional costs to set up procedures in order to respond to the new disclosure requirements. Smaller companies may also incur additional costs in seeking the help of outside experts, particularly outside legal counsel, in formulating responses to the new requirements.

3. Disclosure Related to Independence

We are requiring that companies whose securities are listed on the NYSE, AMEX, or traded on Nasdaq make certain disclosures about any member of the audit committee who is not independent (small business issuers are not subject to that requirement) and whether the audit committee members are independent. Companies, including small business issuers, whose securities are not listed on the NYSE or AMEX or quoted on Nasdaq are required to disclose whether their members are independent, but may choose which definition of independence to use and must disclose which definition was used.

E. Agency Action to Minimize Effect on Small Entities

As required by Section 603 of the RFA, the Commission has considered the following alternatives to minimize the economic impact of the rules on small entities: (a) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (b) the clarification, consolidation, or simplification of compliance and reporting requirements under the rules for small entities; (c) the use of performance rather than design standards; and (d) an exemption from coverage of the rules, or any part thereof, for small entities.

We continue to believe investors in smaller companies would want and benefit from the disclosures about the audit committee and the advantages of interim reviews just as much as investors in larger companies. We have made some adjustments to the rules to decrease their impact on small businesses. For example, we did not extend Item 302(a) to small business issuers filing on small business forms.

In addition, small businesses not subject to the NASD's, AMEX's or NYSE's listing standards can choose which definition of independence to use, as long as it is used consistently. Further, small business issuers are not required to state the reasons for including a non-independent audit committee member, since under the listing standards, they are not required to have all independent members on their audit committees.

Finally, to provide companies with the opportunity to evaluate their compliance with the revised listing standards of the NASD, AMEX, and NYSE and to prepare for the new disclosure requirements, we are providing transition periods for compliance with the new requirements, which should benefit all companies, large and small.

X. Statutory Bases and Text of Amendments

We are adopting amendments to Rules 10-01 of Regulation S-X and 14a-101 (Schedule 14A), Item 310 of Regulation S-B, and Item 302(a) of Regulation S-K, and adopting new Item 306 of Regulations S-K and S-B, under the authority set forth in Sections 2, 13, 14, and 23 of the Exchange Act.

List of Subjects

17 CFR Part 210

Accountant, Accounting, Reporting and recordkeeping requirements, Securities.

17 CFR Part 228

Reporting and recordkeeping requirements, Securities, Small businesses.

17 CFR Parts 229 and 240

Reporting and recordkeeping requirements, Securities.

Text of Amendments

In accordance with the foregoing, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

PART 210 - FORM AND CONTENT OF AND REQUIREMENTS FOR FINANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, PUBLIC UTILITY HOLDING COMPANY ACT OF 1935, INVESTMENT COMPANY ACT OF 1940, AND ENERGY POLICY AND CONSERVATION ACT OF 1975

1. The authority citation for Part 210 continues to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77aa(25), 77aa(26), 78j-l, 78l, 78m, 78n, 78o(d), 78u-5, 78w(a), 78ll(d), 79e(b), 79j(a), 79n, 79t(a), 80a-8, 80a-20, 80a-29, 80a-30, 80a-37(a), unless otherwise noted.

2. By amending § 210.10-01 by revising paragraph (d) to read as follows:

§ 210.10-01 Interim financial statements.

* * * * *

(d) Interim review by independent public accountant. Prior to filing, interim financial statements included in quarterly reports on Form 10-Q (17 CFR 249.308(a)) must be reviewed by an independent public accountant using professional standards and procedures for conducting such reviews, as established by generally accepted auditing standards, as may be modified or supplemented by the Commission. If, in any filing, the company states that interim financial statements have been reviewed by an independent public accountant, a report of the accountant on the review must be filed with the interim financial statements.

* * * * *

PART 228 - INTEGRATED DISCLOSURE SYSTEM FOR SMALL BUSINESS ISSUERS

3. The authority citation for Part 228 continues to read as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z-2, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77jjj, 77nnn, 77sss, 78l, 78m, 78n, 78o, 78u-5, 78w, 78ll, 80a-8, 80a-29, 80a-30, 80a-37, 80b-ll, unless otherwise noted.

4. Section 228.305 is added and reserved and § 228.306 is added to read as follows:

§ 228.305 [RESERVED]

§ 228.306 (Item 306) Audit Committee Report .

(a) The audit committee must state whether:

(1) The audit committee has reviewed and discussed the audited financial statements with management;

(2) The audit committee has discussed with the independent auditors the matters required to be discussed by SAS 61, as may be modified or supplemented;

(3) The audit committee has received the written disclosures and the letter from the independent accountants required by Independence Standards Board Standard No. 1 (Independence Standards Board Standard No. 1, Independence Discussions with Audit Committees), as may be modified or supplemented, and has discussed with the independent accountant the independent accountant's independence; and

(4) Based on the review and discussions referred to in paragraphs (a) (1) through (a) (3) of this Item, the audit committee recommended to the Board of Directors that the audited financial statements be included in the company's Annual Report on Form 10-KSB (17 CFR 249.310b) for the last fiscal year for filing with the Commission.

(b) The name of each member of the company's audit committee (or, in the absence of an audit committee, the board committee performing equivalent functions or the entire board of directors) must appear below the disclosure required by this Item.

(c) The information required by paragraphs (a) and (b) of this Item shall not be deemed to be "soliciting material," or to be "filed" with the Commission or subject to Regulation 14A or 14C (17 CFR 240.14a-1 et seq. or 240.14c-1 et seq.), other than as provided in this Item, or to the liabilities of section 18 of the Exchange Act (15 U.S.C. 78r), except to the extent that the company specifically requests that the information be treated as soliciting material or specifically incorporates it by reference into a document filed under the Securities Act or the Exchange Act.

(d) The information required by paragraphs (a) and (b) of this Item need not be provided in any filings other than a registrant proxy or information statement relating to an annual meeting of security holders at which directors are to be elected (or special meeting or written consents in lieu of such meeting). Such information will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act, except to the extent that the registrant specifically incorporates it by reference.

5. By amending § 228.310 by revising the introductory text of paragraph (b) to read as follows:

§ 228.310 (Item 310) Financial Statements.

* * * * *

(b) Interim Financial Statements. Interim financial statements may be unaudited; however, prior to filing, interim financial statements included in quarterly reports on Form 10-QSB (17 CFR 249.308b) must be reviewed by an independent public accountant using professional standards and procedures for conducting such reviews, as established by generally accepted auditing standards, as may be modified or supplemented by the Commission. If, in any filing, the issuer states that interim financial statements have been reviewed by an independent public accountant, a report of the accountant on the review must be filed with the interim financial statements. Interim financial statements shall include a balance sheet as of the end of the issuer's most recent fiscal quarter and income statements and statements of cash flows for the interim period up to the date of such balance sheet and the comparable period of the preceding fiscal year.

* * * * *

PART 229 - STANDARD INSTRUCTIONS FOR FILING FORMS UNDER SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934 AND ENERGY POLICY AND CONSERVATION ACT OF 1975 - REGULATION S-K

6. The authority citation for Part 229 continues to read in part as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z-2, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77iii, 77jjj, 77nnn, 77sss, 78c, 78i, 78j, 78l, 78m, 78n, 78o, 78u-5, 78w, 78ll(d), 79e, 79n, 79t, 80a-8, 80a-29, 80a-30, 80a-37, 80b-11, unless otherwise noted.

* * * * *

7. By amending § 229.302 by revising paragraph (a) (5) to read as follows:

§ 229.302 (Item 302) Supplementary financial information.

(a) Selected quarterly financial data. * * *

(5) This paragraph (a) applies to any registrant, except a foreign private issuer, that has securities registered pursuant to sections 12(b) (15 U.S.C. § 78l(b)) (other than mutual life insurance companies) or 12(g) of the Exchange Act (15 U.S.C. § 78l(g)).

* * * * *

8. By adding § 229.306 to read as follows:

§ 229.306 (Item 306) Audit committee report.

(a) The audit committee must state whether:

(1) The audit committee has reviewed and discussed the audited financial statements with management;

(2) The audit committee has discussed with the independent auditors the matters required to be discussed by SAS 61 (Codification of Statements on Auditing Standards, AU § 380), as may be modified or supplemented;

(3) The audit committee has received the written disclosures and the letter from the independent accountants required by Independence Standards Board Standard No. 1 (Independence Standards Board Standard No. 1, Independence Discussions with Audit Committees), as may be modified or supplemented, and has discussed with the independent accountant the independent accountant's independence; and

(4) Based on the review and discussions referred to in paragraphs (a) (1) through (a) (3) of this Item, the audit committee recommended to the Board of Directors that the audited financial statements be included in the company's Annual Report on Form 10-K (17 CFR 249.310) (or, for closed-end investment companies registered under the Investment Company Act of 1940 (15 U.S.C. § 80a-1 et seq.), the annual report to shareholders required by Section 30(e) of the Investment Company Act of 1940 (15 U.S.C. § 80a-29(e)) and Rule 30d-1 (17 CFR 270.30d-1) thereunder) for the last fiscal year for filing with the Commission.

(b) The name of each member of the company's audit committee (or, in the absence of an audit committee, the board committee performing equivalent functions or the entire board of directors) must appear below the disclosure required by this Item.

(c) The information required by paragraphs (a) and (b) of this Item shall not be deemed to be "soliciting material," or to be "filed" with the Commission or subject to Regulation 14A or 14C (17 CFR 240.14a-1 et seq. or 240.14c-1 et seq.), other than as provided in this Item, or to the liabilities of section 18 of the Exchange Act (15 U.S.C. § 78r), except to the extent that the company specifically requests that the information be treated as soliciting material or specifically incorporates it by reference into a document filed under the Securities Act or the Exchange Act.

(d) The information required by paragraphs (a) and (b) of this Item need not be provided in any filings other than a company proxy or information statement relating to an annual meeting of security holders at which directors are to be elected (or special meeting or written consents in lieu of such meeting). Such information will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act, except to the extent that the company specifically incorporates it by reference.

* * * * *

PART 240 - GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

9. The authority citation for Part 240 continues to read, in part, as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78f, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x,

78ll(d), 78mm, 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4 and 80b-11, unless otherwise noted.

* * * * *

10. By amending § 240.14a-101 by adding paragraph (e) (3) to Item 7 to read as follows:

§ 240.14a-101 Schedule 14A. Information required in proxy statement.

* * * * *

Item 7. Directors and executive officers. * * *

(e) * * *

(3) If the registrant has an audit committee:

(i) Provide the information required by Item 306 of Regulation S-K (17 CFR 229.306).

(ii) State whether the registrant's Board of Directors has adopted a written charter for the audit committee.

(iii) Include a copy of the written charter, if any, as an appendix to the registrant's proxy statement, unless a copy has been included as an appendix to the registrant's proxy statement within the registrant's past three fiscal years.

(iv) (A) For registrants whose securities are listed on the New York Stock Exchange ("NYSE") or American Stock Exchange ("AMEX") or quoted on Nasdaq:

(1) Disclose whether the members of the audit committee are independent (as independence is defined in Sections 303.01 (B) (2) (a) and (3) of the NYSE's listing standards, Section 121 (A) of the AMEX's listing standards, or Rule 4200(a) (15) of the National Association of Securities Dealers' ("NASD") listing standards, as applicable and as may be modified or supplemented); and

(2) If the registrant's Board of Directors determines in accordance with the requirements of Section 303.02 (D) of the NYSE's listing standards, Section 121 (B) (b) (ii) of the AMEX's listing standards, or Section 4310(c) (26) (B) (ii) or 4460(d) (2) (B) of the NASD's listing standards, as applicable and as may be modified or supplemented, to appoint one director to the audit committee who is not independent, disclose the nature of the relationship that makes that individual not independent and the reasons for the Board's determination. Small business issuers (17 CFR 228.10(a) (1)) need not provide the information required by this paragraph (e) (3) (iv) (A) (2).

(B) For registrants, including small business issuers, whose securities are not listed on the NYSE or AMEX or quoted on Nasdaq, disclose whether, if the registrant has an audit committee, the members are independent. In determining whether a member is independent, registrants must use the definition of independence in Sections 303.01 (B) (2) (a) and (3) of the NYSE's listing standards, Section 121 (A) of the AMEX's

listing standards, or Rule 4200(a) (15) of the NASD's listing standards, as such sections may be modified or supplemented, and state which of these definitions was used. Whichever definition is chosen must be applied consistently to all members of the audit committee.

(v) The information required by paragraph (e) (3) of this Item shall not be deemed to be "soliciting material," or to be "filed" with the Commission or subject to Regulation 14A or 14C (17 CFR 240.14a-1 et seq. or 240.14c-1 et seq.), other than as provided in this Item, or to the liabilities of section 18 of the Exchange Act (15 U.S.C. § 78r), except to the extent that the registrant specifically requests that the information be treated as soliciting material or specifically incorporates it by reference into a document filed under the Securities Act or the Exchange Act. Such information will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act, except to the extent that the registrant specifically incorporates it by reference.

(vi) The disclosure required by this paragraph (e) (3) need only be provided one time during any fiscal year.

(vii) Investment companies registered under the Investment Company Act of 1940 (15 U.S.C. § 80a-1 et seq.), other than closed-end investment companies, need not provide the information required by this paragraph (e) (3).

* * * * *

By the Commission.
Jonathan G. Katz
Secretary

Dated: December 22, 1999

Footnotes

1 17 CFR 210.10-01.

2 17 CFR 228.310.

3 17 CFR 240.14a-101.

4 15 U.S.C. § 78a et seq.

5 17 CFR 229.302.

6 17 CFR 229.306.

7 17 CFR 228.306.

8 The new rules and amendments were proposed in Exchange Act Release No. 41987 (Oct. 7, 1999) [64 FR 55648] (the "Proposing Release").

9 See Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (1999) (the "Blue Ribbon Report"). The Blue Ribbon Report is available [Webmaster note: in PDF format] on the internet at <http://www.nasd.com> and <http://www.nyse.com>.

10 See, e.g., Jack Ciesielski, Editorial, More Second-Guessing: Markets Need Better Disclosure of Earnings Management, *Barrons*, Aug. 24, 1998, at 47.

11 The Commission recently filed 30 enforcement actions against 68 individuals and companies for fraud and related misconduct in the accounting, reporting, and disclosure of financial results by 15 different public companies. See SEC Press Release 99-124 (Sept. 28, 1999).

12 17 CFR 229.302(a).

13 References in this release to proxy statements also include information statements.

14 See Codification of Statements on Auditing Standards, AU § 380 ("SAS 61").

15 Independence Standards Board Standard No. 1, Independence Discussions with Audit Committees ("ISB Standard No. 1"). A copy of ISB Standard No. 1 can be obtained at www.cpaindependence.org.

16 "Small business issuer" is defined in Item 10(a) (1) of Regulation S-B, 17 CFR 228.10(a) (1), as a company with less than \$25 million in revenues and market capitalization.

17 The listing standards of the National Association of Securities Dealers ("NASD"), AMEX and NYSE are available on their websites at: <http://www.nasd.com>, <http://www.amex.com>, and <http://www.nyse.com>, respectively. See *infra* note 27 regarding recent changes to the listing standards of the NASD, AMEX, and NYSE.

18 See, e.g., Carol J. Loomis et al., Lies, Damned Lies, and Managed Earnings, *Fortune*, Aug. 2, 1999, at 74; Thor Valdmanis, Accounting Abracadabra, *USA Today*, Aug. 11, 1998, at 1B; Bernard Condon, Pick a Number, Any Number, *Forbes*, Mar. 23, 1998, at 124; Justin Fox & Rajiv Rao, Learn to Play the Earnings Game, *Fortune*, Mar. 31, 1997, at 76.

19 See, e.g., Arthur Levitt, Chairman, SEC, Address to the NYU Center for Law and Business (Sept. 28, 1998). A copy of this speech is available on the SEC's website at www.sec.gov.

20 Blue Ribbon Report, *supra* note 9, at 17.

21 See Advisory Panel on Auditor Independence ("Kirk Panel"), Strengthening the Professionalism of the Independent Auditor, Report by the Oversight Board of the SEC Practice Section, American Institute of Certified Public Accountants ("AICPA") (Sept. 13, 1994) (the "Kirk Panel Report"); see also Report of the National Commission on Fraudulent Financial Reporting (Oct. 1987) (the "Treadway Report").

22 You may read and copy the comment letters in our Public Reference Room at 450 Fifth Street, N.W., Washington, D.C. 20549. Ask for File No. S7-22-99. You may view the comment letters that were submitted by electronic mail at the Commission's web site: www.sec.gov.

23 See, e.g., Letter dated November 8, 1999 from Sarah A.B. Teslik, Executive Director, Council of Institutional Investors; Letter dated October 14, 1999 from Robert B. Hodes, Willkie Farr & Gallagher.

24 See, e.g., Letter dated November 29, 1999 from Stephanie B. Mudick, General Counsel -Corporate Law, Citigroup Inc. ("Citigroup Letter"); Letter dated November 22, 1999 from Michael L. Conley, Executive Vice President and CFO, McDonald's Corporation.

25 See, e.g., Letter dated November 19, 1999 from the New York State Bar Association, Committee on Securities Regulation ("NYS Bar Letter") and Letter dated November 17, 1999 from KPMG LLP ("KPMG Letter") supporting application of the amendments and new rules to companies of all sizes.

26 See *supra* note 11; see also Beasley, Carcello, and Hermanson, *Fraudulent Financial Reporting: 1987-1997, An Analysis of U.S. Public Companies* (Mar. 1999) (study commissioned by the Committee of Sponsoring Organizations of the Treadway Commission) (the "COSO Report").

27 See Order Approving Proposed Rule Change by the NASD, Exchange Act Release No. 42231, File No. SR-NASD-99-48; Order Approving Proposed Rule Change by the NYSE, Exchange Act Release No. 42233, File No. SR-NYSE-99-39. While the Blue Ribbon Committee's recommendations were directed to the NYSE and the NASD, the AMEX proposed, and the Commission approved, rule changes to AMEX's listing standards. See Order Approving Proposed Rule Change by the AMEX, Exchange Act Release No. 42232, File No. SR-Amex-99-38.

28 See Exposure Draft for Proposed Statement on Auditing Standards: Amendments to Statements on Auditing Standard No. 61, Communication with Audit Committees and Statements on Auditing Standard No. 71, Interim Financial Information (Oct. 1, 1999) ("ASB Exposure Draft"). A copy of the ASB Exposure Draft can be obtained at www.aicpa.org/members/div/auditstd/drafts.htm.

29 SAS 61 requires independent auditors to communicate certain matters related to the conduct of an audit to those who have responsibility for oversight of the financial reporting process, specifically the audit committee. Among the matters to be communicated to the audit committee are: (1) methods used to account for significant unusual transactions; (2) the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus; (3) 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 (4) disagreements with management over the application of accounting

principles, the basis for management's accounting estimates, and the disclosures in the financial statements.

30 See Codification of Statements on Auditing Standards, AU § 722. SAS 71 provides guidance to independent accountants on performing reviews of interim financial information.

31 In the Proposing Release, we solicited comment on whether to require companies to disclose whether their quarterly financial statements have been reviewed by independent auditors. We are not adopting that requirement, but are retaining the current requirement of Rule 10-01(d) of Regulation S-X, 17 CFR 210.10-01(d), that if a company discloses that an independent auditor has performed a review of interim financial information, it must file a copy of the auditor's report. A conforming change to Item 310(b) has been made as proposed.

32 In 1989, the Commission issued a concept release on whether it should propose amendments to its rules to require more involvement of the independent accountant in the preparation of interim financial information. See Exchange Act Release No. 26949 (June 20, 1989) [54 FR 27023]. The Treadway Commission recommended that the SEC require independent public accountants to review quarterly financial data before a company releases it to the public. Treadway Report, *supra* note 21, at 53.

33 See, e.g., Letter dated November 29, 1999 from The Business Roundtable ("We believe that a requirement for such a review would not impose a substantial burden and would help to improve the investor's comfort with interim statements"); Letter dated November 23, 1999 from Mark Wovsaniker, Vice President - Accounting Policy, America Online Incorporated ("To promote the accuracy and the high quality of the quarterly results, the auditor's regular involvement throughout the year, not just once at the end of each year, is necessary"); Letter dated November 22, 1999 from the Association for Investment Management and Research - Advocacy Advisory Committee ("AIMR Letter") ("[The proposal] will require auditor involvement throughout the year, which should help mitigate earnings management, as well as reduce the likelihood of restatements or other year-end adjustments").

34 See, e.g., Letter dated December 3, 1999 from the American Bar Association - Section of Business Law ("ABA Letter").

35 One firm's policy apparently applies only to clients filing selected quarterly financial data under Item 302(a) of Regulation S-K, 17 CFR 229.302(a).

36 Prior to today's amendments, Item 302(a) required registrants to provide Item 302(a) information if the registrant met certain tests, including but not limited to: (1) two of the three following requirements: (a) shares outstanding have a market value of at least \$2.5 million; (b) the minimum bid price is at least \$5 per share; or (c) the registrant has at least \$2.5 million of capital, surplus, and undivided profits; and (2) the registrant and its subsidiaries: (a) have had net income after taxes but before extraordinary items and the cumulative effect of a change in accounting of at least \$250,000 for each of the last three fiscal years; or (b) had total assets of at least \$200 million for the last fiscal year end.

37 See, e.g., KPMG Letter, *supra* note 25, supporting this amendment.

38 15 U.S.C. § 78l(b).

39 15 U.S.C. § 78l(g)

40 We are eliminating the requirement for large, widely-traded insurance companies, which file periodic reports solely pursuant to Section 15(d) of the Exchange Act, to provide Item 302(a) information. It is noted in this regard that other types of issuers reporting solely pursuant to Section 15(d) are not required to provide Item 302(a) information. The Item 302(a) amendments will accord insurance companies the same treatment under Item 302(a) as other issuers that report solely pursuant to Section 15(d).

41 See Letter dated November 29, 1999 from Ernst & Young recommending that the criteria for Item 302(a) compliance be based on a company's market capitalization, such as above \$25 million.

42 See, e.g., Letter dated November 24, 1999 from Tommy Chisholm, Secretary, Southern Company; Citigroup Letter, *supra* note 24. But see Letter dated November 26, 1999 from Peter C. Clapman, Senior Vice President and Chief Counsel, Investments, Teachers Insurance and Annuity Association College Retirement Equities Fund ("TIAA-CREF Letter").

43 See 1 American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* 134-98 (1994); *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 967-70 (Del. Ch. 1996).

44 *Caremark*, 698 A.2d at 970 (boards must assure "themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance").

45 See generally Report of the Public Oversight Board ("POB"), "Directors, Management, and Auditors: Allies in Protecting Shareholder Interests," in which the POB discusses, among other things, a recommendation of the Kirk Panel to require audit committees to discuss with management and the auditors the quality of the accounting principles and judgments used in preparing financial statements. The POB notes its belief that compliance with that recommendation would not increase the exposure of board members to litigation because, among other things, the procedures will reduce the possibility that the financial statements are in fact misleading, thereby reducing the danger of finding directors at fault, and the additional steps taken should be persuasive in convincing courts and juries that the financial statements were prepared with care.

46 At least in some measure, these discussions are already prescribed by the auditing literature. See SAS 61. See, e.g., Letter dated November 29, 1999 from America's Community Bankers and Letter dated November 22, 1999 from the Massachusetts

Financial Services Company supporting the requirements of paragraphs (a) (1), (2) and (3).

47 We recognize that the auditing literature defines the term "review" to include a particular set of required procedures. See SAS 71. In using the term "reviewed" in the new disclosure requirement, we are not suggesting that the audit committee members can or should follow the procedures required of auditors performing reviews of interim financial statements.

48 See ASB Exposure Draft, *supra* note 28.

49 The federal securities laws recognize the importance of independent auditors. See, e.g., Items 25 and 26 of Schedule A of the Securities Act and Sections 12(b) (1) (J) and 13(a) (2) of the Exchange Act, 15 U.S.C. §§ 78l(b) (1) (J) and 78m(a) (2).

50 See *supra* note 24.

51 See, e.g., TIAA-CREF Letter, *supra* note 42.

52 The Blue Ribbon Committee recommended that the audit committee state that, in reliance on the review and discussions with management and the auditors, the audit committee "believes that the company's financial statements are fairly presented in conformity with Generally Accepted Accounting Principles (GAAP) in all material respects." Blue Ribbon Report, *supra* note 9, at 35.

53 For closed-end investment companies, paragraph (a) (4) clarifies that this requirement applies to financial statements included in a fund's annual report to shareholders required by Section 30(e) of the Investment Company Act of 1940 and Rule 30d-1. These reports must be filed with the Commission pursuant to Rule 30b2-1, 17 CFR 270.30b2-1, under the Investment Company Act of 1940. Commenters disagreed about whether closed-end funds be excluded altogether from the new proxy statement disclosure requirements. See, e.g., ABA Letter, *supra* note 34; Letter dated November 29, 1999 from Stuart M. Strauss, Morgan Stanley Dean Witter; Letter dated November 29, 1999 from Arthur Andersen LLP; Letter dated November 3, 1999 from the Investment Company Institute. We have concluded, however, that the application of these requirements to closed-end funds is warranted because of the critical role that audit committees play in overseeing the financial reporting process.

54 The signature requirement is described in General Instruction D of Form 10-K and General Instruction C of Form 10-KSB. The Commission amended the signature requirements for Form 10-K in 1980 in order to "enhance director awareness of and participation in the preparation of the Form 10-K information." See Securities Act Release No. 6176 (Jan. 15, 1980) [45 FR 5972].

55 See, e.g., Letter dated December 1, 1999 from Ira M. Millstein, Weil Gotshal & Manges LLP, and John C. Whitehead. Messrs. Millstein and Whitehead were co-chairmen of the Blue Ribbon Committee; Letter dated November 29, 1999 from Deloitte & Touche LLP; Letter dated November 29, 1999 from James E. Kelly, General Counsel, Dime Bancorp, Inc.; Letter dated November 23, 1999 from Michael A. Rocca, Senior Vice President,

Chief Financial Officer, Mallinckrodt Inc. ("This type of report better describes the audit committee's oversight role. . . . Moreover, in our view this alternative language would create a less significant litigation risk to audit committees"); NYS Bar Letter, *supra* note 25; Letter dated November 16, 1999 from Ernst & Young LLP. See also Letter dated August 20, 1999 from Ernst & Young LLP to Harvey J. Goldschmid, General Counsel, and Lynn E. Turner, Chief Accountant, SEC, commenting on the recommendations of the Blue Ribbon Committee and recommending a variation of this alternative.

56 Delaware General Corporation Law, for example, states that board members are "fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees . . . or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence" Del. Code Ann. tit. 8, § 141(e).

57 See Blue Ribbon Report, *supra* note 9, at 34.

58 This approach is consistent with the current treatment of the report from the company's compensation committee. See Instruction 9 to Item 402(a)(3) of Regulation S-K, 17 CFR 229.402(a)(3).

59 We note, however, that the revised listing standards of the NYSE, NASD, and AMEX require the audit committee to: (1) adopt a formal written charter that is approved by the full board of directors and that specifies the scope of the committee's responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements; and (2) review and reassess the adequacy of the audit committee's charter on an annual basis. See *supra* note 27.

60 See, e.g., Letter dated November 29, 1999 from William E. Eason, Jr., Senior Vice President and General Counsel, Scientific-Atlanta, Inc.; Letter dated November 29, 1999 from Paul V. Stahlin, Senior Vice President and Comptroller, Summit Bancorp.

61 See, e.g., TIAA-CREF Letter, *supra* note 42.

62 See, e.g., Letter dated November 29, 1999 from David K. Owens, Edison Electric Institute.

63 Staff of the SEC, 95th Cong., 2d Sess., Report to Congress on the Accounting Profession and the Commission's Oversight Role, Subcommittee on Governmental Efficiency and the District of Columbia of the Senate Committee on Governmental Affairs, at 97 (Comm. Print July 1978). See also Blue Ribbon Report, *supra* note 9, at 22-23; Treadway Report, *supra* note 21, at 40-41; In the Matter of McKesson & Robbins, Accounting Series Release No. 19, Exchange Act Release No. 2707 (Dec. 5, 1940).

64 Blue Ribbon Report, *supra* note 9, at 22.

65 See, e.g., TIAA-CREF Letter, *supra* note 42.

66 The revised listing standards of the NASD and AMEX require that small business issuers have at least two members of their audit committee, a majority of whom must be independent. In responding to the new disclosure requirement, small business issuers, of course, can disclose that the listing standards of the NASD or AMEX do not require that all members of their audit committee be independent. See *supra* note 27.

67 Item 7 of Schedule 14A requires companies to provide the disclosures required by Items 401 and 404(a) and (c) of Regulation S-K.

68 See Blue Ribbon Report, *supra* note 9, at 35, recommending a safe harbor.

69 See Instruction 9 to Item 402(a)(3) of Regulation S-K, 17 CFR 229.402(a)(3).

70 The other antifraud provisions of the Exchange Act and Securities Act of 1933 (the "Securities Act"), however, would continue to apply.

71 See, e.g., Letter dated November 29, 1999 from Katherine K. Combs, Deputy General Counsel and Corporate Secretary, PECO Energy Company; Letter dated November 30, 1999 from the American Society of Corporate Secretaries (the "ASCS Letter").

72 15 U.S.C. § 78o(d).

73 A "foreign private issuer" must file reports on Form 6-K promptly after the information required by the Form is made public in accordance with the laws of its home country or a foreign securities exchange. See 17 CFR 240.13a-16(b).

74 See, e.g., ASCS Letter, *supra* note 71.

75 17 CFR 240.14a-101.

76 17 CFR 240.14c-101.

77 17 CFR 249.310.

78 Blue Ribbon Report, *supra* note 9, at 19.

79 OMB, Report to Congress on the Costs and Benefits of Federal Regulation 21 (1998) (OMB has recognized that while it may be difficult to quantify the benefits of disclosure requirements, there is a strong consensus among economists that, in general, disclosure-based regulatory schemes can improve the functioning of markets and produce significant benefits for consumers).

80 See Section III.A above.

81 COSO Report, *supra* note 26, at 34 ("Close scrutiny of quarterly financial information and a move toward continuous auditing strategies may increase opportunities for earlier detection of financial statement improprieties").

82 See, e.g., AIMR Letter, *supra* note 33.

83 See, e.g., KPMG Letter, *supra* note 25 ("In our experience that policy [of conducting SAS 71 reviews] has resulted in the earlier identification of accounting and reporting issues and has therefore enhanced the quality of interim financial reporting").

84 Letter dated November 22, 1999 from Michael Dee.

85 One non-Big 5 accounting firm indicated in its comment letter that the upper end of the range (i.e., about \$4,000 per quarter) comported with its experience for small to medium size companies. Letter dated October 14, 1999 from Edward W. O'Connell, Wiss & Company, LLP.

86 At the proposing stage, we used 2,150 companies to reach an estimate of \$16 million.

87 See NYS Bar Letter, *supra* note 25.

88 Preparation of the charter is required by the NYSE, NASD, and AMEX and not the Commission's rules.

89 The \$15 million figure derives from one page at \$1,500 per page for approximately 10,145 companies.

90 See, e.g., Letter dated November 19, 1999 from Patricia Gallup, Chairman of the Board, PC Connection, Inc.

91 The estimate does not include the amount of time the audit committee would spend conducting the discussions with the independent accountants and management to which new Item 306 of Regulations S-K and S-B and the amendments to Item 7 of Schedule 14A refer. The amendments would not require that the audit committee hold the discussions, but merely that it disclose whether the discussions have taken place.

92 See Section III.E above.

93 See ABA Letter, *supra* note 34.

94 See generally COSO Report, *supra* note 26. In fact, the COSO Report specifically found that a "regulatory focus on companies with market capitalization in excess of \$200 million may fail to target companies with greater risk for financial statement fraud activities." *Id.* at 4.

95 COSO Report, *supra* note 26, at 5.

96 A "small business issuer" under Regulation S-B, however, is a company with less than \$25 million in revenues and market capitalization.

97 See Section VII above.

<http://www.sec.gov/rules/final/34-42266.htm>

NYSE Rulemaking:

Order Approving Proposed Rule Change Amending the Audit Committee Requirements and Notice of Filing and Order Granting Accelerated Approval of Amendments No. 1 and No. 2 Thereto

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34-42233; File No. SR-NYSE-99-39)

December 14, 1999

Self-Regulatory Organizations; Order Approving Proposed Rule Change by the New York Stock Exchange, Inc. Amending the Exchange's Audit Committee Requirements and Notice of Filing and Order Granting Accelerated Approval of Amendments No. 1 and No. 2 Thereto

I. Introduction

On September 20, 1999, the New York Stock Exchange, Inc. ("NYSE" or "Exchange") submitted to the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a proposed rule change amending the Exchange's audit committee requirements.

The Federal Register published the proposed rule change for comment on October 13, 1999.³ In response, the Commission received 25 comment letters.⁴ On October 15, 1999 and December 8, 1999, the Exchange submitted Amendments No. 15 and No. 2,⁶ respectively, to the proposed rule change. This order approves the proposed rule change and grants accelerated approval to Amendments No. 1 and No. 2. The Commission is also soliciting comment on Amendments No. 1 and No. 2 to the proposed rule change.

II. Description of the Proposed Rule Change**A. Background**

In February 1999, the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees ("Blue Ribbon Committee") issued a report containing recommendations aimed at strengthening the independence of the audit committee, making the audit committee more effective, and addressing mechanisms for accountability among the audit committee, the outside auditors, and management.⁷

The Exchange distributed to its listed companies the Exchange staff's suggestions for rule changes in response to the Blue Ribbon Committee's report. The comments from the Exchange's listed companies were generally supportive of the suggestions put forth by the Exchange, with some commenters expressing concerns about "financial literacy" requirement.

In response to the Blue Ribbon Committee's recommendations, the Exchange proposes to revise its listing standards regarding audit committees. The proposed rule change specifies four requirements for a qualified audit committee and defines the terms

"Immediate Family" and "Affiliate" for purposes of the proposed audit committee requirements.

The text of the proposed rule change, as amended by Amendments No. 1 and No. 2, is as follows. Language deleted by Amendments No. 1 and No. 2 is in brackets. Language added by Amendments No. 1 and No. 2 is in italics.

NYSE Listed Company Manual

* * *

Section 3

Corporate Responsibility

303.00 Corporate Governance Standards

In addition to the numerical listing standards, the Exchange has adopted certain corporate governance listing standards. These standards apply to all companies listing common stock on the Exchange. However, the Exchange does not apply a particular standard to a non-U.S. company if the company provides the Exchange with a written certification from independent counsel of the company's country of domicile stating that the company's corporate governance practices comply with home country law and the rules of the principal securities market for the company's stock outside the United States.

303.01 Audit Committee

(A) Audit Committee Policy. Each company must have a qualified audit committee.

(B) Requirements for a Qualified Audit Committee.

(1) Formal Charter. [Each audit committee must adopt a formal written charter that is approved by the Board of Directors.] The Board of Directors must adopt and approve a formal written charter for the audit committee. The audit committee must review and reassess the adequacy of the audit committee charter on an annual basis. The charter must specify the following:

- (a) the scope of the audit committee's responsibilities and how it carries out those responsibilities, including structure, processes and membership requirements;
- (b) that the outside auditor for the company is ultimately accountable to the Board of Directors and audit committee of the company, that the audit committee and Board of Directors have the ultimate authority and responsibility to select, evaluate and, where appropriate, replace the outside auditor (or to nominate the outside auditor to be proposed for shareholder approval in any proxy statement); and
- (c) that the audit committee is responsible for ensuring that the outside auditor submits on a periodic basis to the audit committee a formal written statement delineating all relationships between the auditor and the company and that the audit committee is responsible for actively engaging in a dialogue with the outside auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the outside auditor and for recommending that the Board of Directors take

appropriate action [to ensure the independence of the outside auditor] in response to the outside auditors' report to satisfy itself of the outside auditors' independence.

(2) Composition/Expertise Requirement of Audit Committee Members.

(a) Each audit committee shall consist of at least three directors, all of whom have no relationship to the company that may interfere with the exercise of their independence from management and the company ("Independent");

(b) Each member of the audit committee shall be financially literate, as such qualification is interpreted by the company's Board of Directors in its business judgment, or must become financially literate within a reasonable period of time after his or her appointment to the audit committee; and

(c) At least one member of the audit committee must have accounting or related financial management expertise, as the Board of Directors interprets such qualification in its business judgment.

(3) Independence Requirement of Audit Committee Members. In addition to the definition of Independent provided above in (2) (a), the following restrictions shall apply to every audit committee member:

(a) Employees. A director who is an employee (including non-employee executive officers) of the company or any of its affiliates may not serve on the audit committee until three years following the termination of his or her employment. In the event the employment relationship is with a former parent or predecessor of the company, the director could serve on the audit committee after three years following the termination of the relationship between the company and the former parent or predecessor.

(b) Business Relationship. A director (i) who is a partner, controlling shareholder, or executive officer of an organization that has a business relationship with the company, or (ii) 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 of Directors determines in its business judgment that the relationship does not interfere with the director's exercise of independent judgment. In making a determination regarding the independence of a director pursuant to this paragraph, the Board of Directors should consider, among other things, the materiality of the relationship to the company, to the director, and, if applicable, to the organization with which the director is affiliated.

"Business relationships" can include commercial, industrial, banking, consulting, legal, accounting and other relationships. A director can have this relationship directly with the company, or the director can be a partner, officer or employee of an organization that has such a relationship. The director may serve on the audit committee without the above-referenced Board of Directors' determination after three years following the termination of, as applicable, either (1) the relationship between the organization with which the director is affiliated and the company, (2) the relationship between the director and his or her partnership status, shareholder interest or executive officer position, or (3) the direct business relationship between the director and the company.

(c) Cross Compensation Committee Link. A director who is employed as an executive of another corporation where any of the company's executives serves on that corporation's compensation committee may not serve on the audit committee.

(d) Immediate Family. A director who is an Immediate Family member of an individual who is an executive officer of the company or any of its affiliates cannot serve on the

audit committee until three years following the termination of such employment relationship. See para. 303.02 for definition of "Immediate Family."

303.02 Application of Standards

(A) "Immediate Family" includes a person's spouse, parents, children, siblings, mothers-in-law and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, and anyone (other than employees) who shares such person's home.

(B) "Affiliate" includes a subsidiary, sibling company, predecessor, parent company, or former parent company.

(C) Written Affirmation. As part of the initial listing process, and with respect to any subsequent changes to the composition of the audit committee, and otherwise approximately once each year, each company should provide the Exchange written confirmation regarding:

- (1) any determination that the company's Board of Directors has made regarding the independence of directors pursuant to any of the subparagraphs above;
- (2) the financial literacy of the audit committee members;
- (3) the determination that at least one of the audit committee members has accounting or related financial management expertise; and
- (4) the annual review and reassessment of the adequacy of the audit committee charter.

(D) Independence Requirement of Audit Committee Members. Notwithstanding the requirements of subparagraphs (3) (a) and (3) (d) of para. 303.01, one director who is no longer an employee or who is an Immediate Family member of a former executive officer of the company or its affiliates, but is not considered independent pursuant to these provisions due to the three-year restriction period, may be appointed, under exceptional and limited circumstances, to the audit committee if the company's board of directors determines in its business judgment that membership on the committee by the individual is required by the best interests of the corporation and its shareholders, and the company discloses, in the next annual proxy statement subsequent to such determination, the nature of the relationship and the reasons for that determination.

(E) "Officer" shall have the meaning specified in Rule 16a-1 (f) under the Securities Exchange Act of 1934, or any successor rule.

(F) Initial Public Offering. Companies listing in conjunction with their initial public offering (including spin-offs and carve outs) will be required to have two qualified audit committee members in place within three months of listing and a third qualified member in place within twelve months of listing.

B. Charter

The Exchange proposes to require audit committees to adopt a formal written charter that is approved by the company's board and to review and reassess annually the adequacy of the charter. The charter must specify: (i) the scope of the audit committee's responsibilities and how they are being carried out; (ii) the ultimate accountability of the outside auditor to the board and audit committee; (iii) the responsibility of the audit

committee and board for selection, evaluation and replacement of the outside auditor; and (iv) the responsibility of the audit committee for ensuring the independence of the outside auditor by reviewing, and discussing with the board if necessary, any relationships between the auditor and the company or any other relationships that may adversely affect the independence of the auditor.

C. Structure and Membership of the Audit Committee

The Exchange also proposes to change the structure and membership qualifications of the audit committee. Under the proposed rule change, each audit committee must have at least three independent directors, subject to a board override for one director. The board may override the three-year bar for one audit committee member after finding that an override is required in the best interests of the company and its shareholders. If it exercises the override, the company must disclose in its next annual proxy statement the nature of the relationship and the reasons for that determination. Potential candidates that are not considered independent because of a business relationship with the company or a cross compensation committee link may not be the subject of a board override.

As a result of the audit committee's responsibility for a company's accounting and financial reporting, the Exchange believes that audit committee members should have a basic understanding of financial statements. Therefore, the proposed rule change requires each audit committee member to be financially literate, or to become financially literate within a reasonable period of time after his or her appointment to the audit committee, as such qualification is interpreted by the company's board in its business judgment. Furthermore, in order to further enhance the effectiveness of the audit committee, the proposal requires at least one member of each audit committee to have accounting or related financial management expertise, as the company's board interprets such qualification in its business judgment.

D. Independence

The proposed rule change places four restrictions on audit committee members for purposes of determining each member's independence. First, employees (including non-employee executive officers) 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 (see definition of "Affiliate" described in Subsection F below), the three-year bar applies to the time period following the severance of the relationship between the company and the former parent or predecessor.

Second, a director: (i) who is a partner, controlling shareholder, or executive officer of an organization that has a business relationship with the company, or (ii) 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. Business relationships can include commercial, industrial, banking, consulting, legal, accounting and other relationships. A director can have this relationship directly with the company, or the director can be a partner, officer or employee of an organization that has the business relationship.

Third, a director who is employed as an executive of another corporation where any of the company's executives serves on that corporation's compensation committee may not serve on the audit committee.

Fourth, a director who is "Immediate Family" (as that term is defined by proposed Exchange Rule 303.01 (B) (3) (d)) of an individual who is an executive officer of the company or any of its affiliates cannot serve on the audit committee until three years following the termination of such employment relationship.

E. Written Affirmation

To monitor compliance with the proposed rule change, the Exchange proposes to incorporate an ongoing written affirmation requirement. In this regard, as part of the initial listing process, and with respect to any subsequent changes to the composition of the audit committee, and otherwise approximately once each year, each company must provide the Exchange written confirmation regarding:

- i) any determination that the company's board has made regarding the independence of directors;
- ii) the financial literacy of the audit committee members;
- iii) the determination that at least one of the audit committee members has accounting or related financial management expertise; and
- iv) the annual review and reassessment of the adequacy of the audit committee charter.

F. Definitions

The Exchange proposes to codify two long-standing interpretations under the current audit committee requirements as follows:

- i) "Immediate Family" includes a person's spouse, parents, children, siblings, mothers-in-law and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, and anyone (other than employees) who shares such person's home; and
- ii) "Affiliate" includes a subsidiary, sibling company, predecessor, parent company, or former parent company.

G. Implementation

The Exchange proposes to implement a transition period to provide its issuers with sufficient time to comply with the proposed rule change. Specifically, the Exchange proposes to: (i) "grandfather" all public company audit committee members qualified under current NYSE rules until they are re-elected or replaced; and (ii) give companies that have less than three members on their audit committees eighteen months from the date of Commission approval of this rule filing to recruit the requisite members. Issuers listed on the Exchange as of the effective date of the proposed rule change will have six months to adopt a formal written audit committee charter.⁸

III. Comments

As of December 9, 1999, the Commission received 25 comment letters on the proposed rule change.⁹ In general, most commenters favored the proposed rule change but recommended certain modifications. Three commenters opposed the proposed rule change.¹⁰

In particular, the CII supports the new requirements, but stated that the proposed board override provision, which allows a company's board to include a non-independent director on an audit committee, is not appropriate because companies should not have a problem finding financially literate, truly independent directors.¹¹ In addition, the AFL-CIO stated that the restriction period for former employees, or relatives of former employees, should be three years instead of five years.¹² MFSC stated that audit committees should not be required to describe in their charters how they carry out their responsibilities.¹³

Many of the commenters pointed to differences between the proposed rule change, on the one hand, and the Amex Proposal and Nasdaq Proposal, on the other. Specifically, several commenters stated that the Exchange should adopt the Amex's and Nasdaq's definitions of financial literacy and expertise.¹⁴ These commenters noted that allowing individual companies to define these terms will lead to inconsistencies. In addition, several commenters stated that the proposed rule change will discourage qualified candidates from serving on audit committees.¹⁵ Moreover, one commenter stated that the restriction that prohibits an individual who is an immediate family member of an executive officer of the company or any of its affiliates from serving on the audit committee should not be limited to executive officers.¹⁶ Finally, three commenters stated that the Exchange should adopt a bright line test for identifying when a director has a significant business relationship with the company, as in the Amex Proposal and Nasdaq Proposal.¹⁷ On the other hand, another commenter opposed a bright line test and stated that the Exchange should not revise its current test to determine if a significant business relationship exists.¹⁸

In addition, one commenter stated that past non-executive employment should be treated as a significant business relationship.¹⁹ This commenter also stated that consultants who receive from the company more than a de minimis amount of compensation should be treated as employees, while consultants who do not should be treated as having a business relationship with the company.²⁰ According to the commenter, the company's board should be permitted to determine that the compensation does not impair the director's objectivity.²¹ Moreover, the commenter objected to the financial expertise requirement and stated that no director will want to be designated the financial expert because of the added exposure to liability.²²

APTC stated that the proposed rule change will be counter productive to the goal of better audit committees.²³ In addition, APTC stated that the proposed rule change will disadvantage smaller companies more than larger companies, but concluded that it is appropriate to apply the proposed rule change to all companies, regardless of size.²⁴ Moreover, APTC is opposed to the proposal's financial literacy requirement.²⁵ APTC believes that the financial literacy requirement may deprive audit committees of the service of individuals with "exceptional character and/or operational experience."²⁶ The

commenter suggested that the Exchange replace this requirement with a requirement that the committee as a whole possess a certain level of financial acumen.²⁷

TI stated that to reduce unrealistic expectations, the proposed rule change should require or permit a disclaimer in the audit committee charter stating that the committee does not provide any special assurances with regard to the company's financial statements, nor does the audit committee give a professional evaluation of the quality of the audits performed by the independent public accountants.²⁸ Exxon and NYSBA stated that the company's board, not the audit committee, should be required to adopt the audit committee charter because audit committees are created by the board in its discretion and under authority granted by state law.²⁹

Exxon also stated that proposed Rule 303.01 (B) (2) (a), which requires audit committees to have at least three directors, all of whom must be independent, should provide a business judgment standard for independence, as subparts (b) and (c) of this Rule do with respect to financial literacy and expertise.³⁰ Exxon also stated that proposed Rule 303.01 (B) (1) should not give both the board and the audit committee ultimate responsibility to select, evaluate, and replace the outside auditor.³¹ Exxon stated that only one body can have ultimate authority.³² McDonald's stated that a yearly written confirmation regarding financial literacy, financial expertise, independence of directors, and adequacy of the audit committee's charter is unnecessary.³³

Deloitte and PWC each stated that requiring a company's board or audit committee to "ensure" the independence of the outside auditor goes beyond what can reasonably be expected of the board and the audit committee in their oversight role.³⁴ Deloitte suggested that the Exchange replace the word "ensure" with "monitor" or "actively oversee."³⁵ E&Y supports the proposed rule change overall, but stated that Small Business Filers should not be exempt from the financial literacy and expertise requirements and that the Exchange should expand its definition of immediate family member to include sons-in-law and daughters-in-law.³⁶ Airlease stated that smaller companies should not be required to have three independent auditors on their audit committees.³⁷

In addition, the NVCA stated that the proposed rule change should exclude venture capital investors from the independence qualifications.³⁸ The NVCA also stated that the proposed rule change should give companies that have just completed an initial public offering ("IPO") eighteen months to comply with the new requirements.³⁹

Three commenters stated that the proposed rule change should not apply to closed-end investment companies.⁴⁰ ICI and MSDW noted that closed-end investment companies are adequately regulated under the 1940 Act.⁴¹ These two commenters also stated that the potential abuses that the proposed rule change is designed to address do not exist with respect to closed-end investment funds because the assets of closed-end funds, consist exclusively of investment securities and thus there is no opportunity to "manage" earnings or results through the selective application of accounting policies.⁴²

IV. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities

exchange,⁴³ and, in particular, the requirements of Section 6(b)(5) of the Act.⁴⁴ The Commission believes that the proposed rule change will protect investors by improving the effectiveness of audit committees of companies listed on the Exchange. The Commission also believes that the new requirements will enhance the reliability and credibility of financial statements of companies listed on the Exchange by making it more difficult for companies to inappropriately distort their true financial performance.

Specifically, the Commission believes that the proposed definition of independence will promote the quality and reliability of a company's financial statements. The Commission believes that directors without financial, familial, or other material personal ties to management will be more likely to objectively evaluate the propriety of management's accounting, internal control, and financial reporting practices. The Commission also believes that the proposal's prohibition against employees serving on the audit committee is appropriate and that the Exchange should not be required to distinguish between executive and non-executive employees.⁴⁵ In addition, the Commission considers that the proposed provision permitting a company to appoint one non-independent director to its audit committee, if the board determines that membership on the committee by the individual is required by the best interests of the corporation and its shareholders, adequately balances the need for objective, independent directors with the company's need for flexibility in exceptional and unusual circumstances. The Commission believes that the proposal's requirement that the company disclose in its next annual proxy statement the nature of the relationship and the board's reasons for determining that the appointment was in the best interests of the corporation will adequately guard against abuse of the proposed exception to the independence requirement.⁴⁶

The Commission does not believe that venture capital investors should be excluded from the Exchange's definition of independence. The Commission does not view the proposed rule change as posing an undue hardship on venture capital firms or companies listed on the NYSE. The Commission notes that the proposed rule change will only prohibit venture capital investors from sitting on a company's audit committee if the investor does not fall within the Exchange's definition of independence. The proposed rule change will not prohibit previously eligible investors from serving on the company's board.

In addition, the Commission believes that requiring boards of directors of listed companies to adopt formal written charters specifying the audit committee's responsibilities, and how it carries out those responsibilities, will help the audit committee, management, investors, and the company's auditors recognize, and understand the function of the audit committee and the relationship among the parties. Moreover, the Commission believes that the proposal's requirement that companies provide yearly written confirmation regarding the independence, financial literacy, and financial expertise of directors, as well as the adequacy of the audit committee charter, will help the Exchange to ensure that listed companies are complying with the proposed rule change.

The Commission believes that the proposed rule change's requirement that each issuer have an audit committee composed of three independent directors who are able to read and understand fundamental financial statements will enhance the effectiveness of the audit committee and help to ensure that audit committee members are able to adequately fulfill their responsibilities. The Commission believes that requiring each audit committee member to satisfy this standard will help to ensure that the committee as

a whole is financially literate.⁴⁷ Moreover, the Commission believes that requiring one member of the audit committee to have past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background that indicates the individual's financial sophistication, will further enhance the effectiveness of the audit committee in carrying out its financial oversight responsibilities. The Commission does not believe that these requirements will discourage qualified candidates from serving on audit committees. Rather, the Commission believes that these requirements will better enable companies to identify and select qualified directors. In addition, the Commission does not believe that companies will experience undue difficulty recruiting an audit committee member that satisfies the financial expertise requirements.

Webmaster Note: In reference to the paragraph below, see Release No. 34-42233A.

Moreover, the Commission considers the Exchange's decision to exempt Small Business Filers as appropriate.⁴⁸ The Commission notes that relatively few companies that qualify for listing on the Exchange would also qualify as Small Business Filers under SEC Regulation S-B.⁴⁹

Furthermore, the Commission does not believe that the Exchange should be required to adopt the Amex and Nasdaq proposed definitions of financial literacy and expertise or the test to determine when a potential director has a significant business relationship with the company. The Commission notes that the proposed rule change is not inconsistent with the Act.

Moreover, the Commission has concluded that the Exchange's decision to include investment companies in the proposed rule change is warranted. While the Commission recognizes that the opportunity for some types of financial reporting abuses may be limited by the nature of fund assets,⁵⁰ it believes that audit committees do play an important role in overseeing the financial reporting process for investment companies.

Finally, the Commission does not view the proposed rule change as circumventing state law.⁵¹ The Commission notes that the Exchange is amending its own listing standards, which is a function within the Exchange's discretion, as long as those changes are consistent with the Act.

The Commission finds good cause for approving Amendments No. 1 and No. 2 to the proposed rule change prior to the thirtieth day after publication in the Federal Register. The Commission notes that Amendment No. 1 revises the implementation time periods for the proposed rule change solely to provide greater clarity to issuers and to investors. The Commission believes that Amendment No. 1 will enable issuers to determine when they must comply with the new requirements and will enable investors to determine when to rely on the protections afforded by the proposed rule change. The Commission notes that Amendment No. 2 simply codifies the Exchange's existing policy on the timing of audit committee requirements for IPOs; clarifies that the company's board must take appropriate action to satisfy itself of the outside auditor's independence, and is not intended to provide an absolute guarantee of independence; and requires the board to adopt the audit committee charter, rather than approving the charter adopted by the audit committee. The Commission believes that accelerated approval will allow the Exchange to simultaneously make all relevant modifications to its Listed Company

Manual and will avoid potential confusion. Accordingly, the Commission finds good cause to accelerate approval of Amendments No. 1 and No. 2 to the proposed rule change, consistent with Sections 6(b)(5) 52 and 19(b) 53 of the Act.

V. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the Exchange. All submissions should refer to the File No. SR-NYSE-99-39 and should be submitted by [insert date 21 days from the date of publication].

VI. Conclusion

For the foregoing reasons, the Commission finds that the Exchange's proposal to amend its audit committee requirements is consistent with the requirements of the Act and the rules and regulations thereunder.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,⁵⁴ that the amended proposed rule change (SR-NYSE-99-39) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁵⁵

Jonathan G. Katz
Secretary

Footnotes

¹¹⁵ U.S.C. 78s(b)(1).

²¹⁷ CFR 240.19b-4.

³ Securities Exchange Act Release No. 41980 (Oct. 6, 1999), 64 FR 55514 (Oct. 13, 1999). The Nasdaq Stock Market, Inc. and The American Stock Exchange LLC have proposed rule changes relating to audit committees. See Securities Exchange Act Release No. 41982 (Oct. 6, 1999), 64 FR 55510 (Oct. 13, 1999) ("Nasdaq Proposal"), and Securities Exchange Act Release No. 41981 (Oct. 6, 1999), 64 FR 55505 (Oct. 13, 1999) ("Amex Proposal").

⁴ The comment letters are discussed in Section III of this order.

5Letter from James E. Buck, Senior Vice President and Secretary, NYSE, to Richard Strasser, Assistant Director, Division of Market Regulation ("Division"), Commission, dated October 14, 1999 ("Amendment No. 1"). The Exchange submitted Amendment No. 1 to require issuers to adopt a formal written audit committee charter within six months of the effective date of the proposed rule change. As originally filed, the proposed rule change required issuers to adopt the charter within eighteen months of the effective date of the proposed rule change. Amendment No. 1 also extends the definition of "officer" in Rule 16a-1 (f) under the Act to Paragraph 303 of the Exchange's Listed Company Manual. Previously, the Exchange permitted each company's by-laws and charter to define this term.

6Letter from James E. Buck, Senior Vice President and Secretary, NYSE, to Richard Strasser, Assistant Director, Division, Commission, dated December 6, 1999 ("Amendment No. 2"). Amendment No. 2 revises proposed rule 303.01 (B) (1) to require the board to adopt the audit committee charter. Under the original proposal, the audit committee adopted the charter, subject to board approval. Amendment No. 2 also revises proposed Rule 303.01 (B) (1) (c) to replace the provision that required the board to take appropriate steps to ensure the independence of the outside auditors. The revised provision requires the board "to take appropriate action in response to the outside auditors report to satisfy itself of the outside auditor's independence." Finally, Amendment No. 2 revises proposed Rule 303.02 to require companies listing on the Exchange in conjunction with an initial public offering to have two qualified audit committee members in place within three months of listing, and a third qualified member within twelve months of listing.

7Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (1999). A copy of this Report [Webmaster note: in PDF format] can be found on-line at www.nasdaqnews.com.

8See Amendment No. 1, supra n.5.

9See letters from: Ernst & Young LLP ("E&Y") dated November 1, 1999; Deloitte & Touche LLP ("Deloitte") dated November 3, 1999; Council of Institutional Investors ("CII") dated November 8, 1999; Brian T. Borders (on behalf of the National Venture Capital Association ("NVCA")) dated November 12, 1999; Investment Company Institute ("ICI") dated November 3, 1999; PricewaterhouseCoopers LLP ("PWC") dated November 1, 1999; Gary P. Kreider ("Kreider") dated November 5, 1999; Emerson Electric Co. ("Emerson") dated November 1, 1999; Exxon Corporation ("Exxon") dated November 3, 1999; McDonald's Corporation (McDonald's) dated November 1, 1999; Connectiv ("Connectiv") dated November 2, 1999; Texas Instruments ("TI") dated November 2, 1999; Dime Bancorp, Inc. ("Dime") dated November 3, 1999; Airlease Management Services, Inc. ("Airlease") dated November 3, 1999; The Dun & Bradstreet Corporation ("D&B") dated November 3, 1999; EMC Corporation ("EMC") dated November 1, 1999; Dorsey & Whitney LLP ("Dorsey") (on behalf of nine closed-end investment management companies whose stock is listed on the Exchange) dated October 28, 1999; Massachusetts Financial Services Company ("MFSC") (on behalf of six closed-end funds advised by MFSC) dated November 22, 1999; Meritor Automotive, Inc. ("Meritor") dated November 24, 1999; American Federation of Labor and Congress of Industrial Organizations ("AFL-CIO") dated November 29, 1999; Mayer, Brown & Platt on behalf of Morgan Stanley Dean Witter ("MSDW") dated November 29, 1999; Arthur Andersen LLP ("Arthur

Andersen") dated December 3, 1999; Association of Publicly Traded Companies ("APTC") dated December 6, 1999; Robert A. Profusek ("Profusek") dated December 3, 1999; Stanley Keller and Richard Rowe ("Keller and Rowe") dated December 7, 1999; and The Committee on Securities Regulation of the Business Law Section of the New York State Bar Association ("NYSBA") dated December 1, 1999.

10See Kreider Letter at 2; EMC Letter at 2; APTC Letter at 2. Kreider stated his belief that the proposed rule change circumvents state corporate law. EMC stated that the proposed rule change substitutes over-generalized restrictions for the more flexible, traditional standards of good faith, candor, care and loyalty that underlie the business judgment rule under state law. EMC also stated that the independence standards may deprive audit committees of valuable financially-expert directors.

11 CII Letter at 2; see also AFL-CIO Letter at 2.

12 AFL-CIO Letter at 2.

13 MFSC Letter at 1.

14 Dorsey Letter at 7, 9; E&Y Letter at 3; Connectiv Letter at 2; D&B Letter at 2; Emerson Letter at 2; NYSBA Letter at 5. In addition, two commenters stated that the terms financial literacy and expertise are too subjective and should be further defined, but did not state the Amex/Nasdaq versions should be adopted. See McDonald's Letter at 1; MFSC Letter at 2. MFSC also stated that it is not reasonable to expect a company's board to request agreement from a potential audit committee candidate that he will become financially literate because there are no accreditation criteria or specific timeframes for completing this undertaking. MFSC Letter at 2.

15 Dime Letter at 2; NVCA Letter at 2; D&B Letter at 2; MFSC at 2.

16Keller and Rowe Letter at 2.

17 E&Y Letter at 2; Emerson at 2; Arthur Andersen Letter at 1. In addition, the AFL-CIO stated that the NYSE should adopt a bright line test, but does not think the \$60,000 threshold adopted by the Amex and Nasdaq is stringent enough. AFL-CIO Letter at 3.

18Profusek Letter at 2

19 Keller and Rowe Letter at 2.

20Id. at 3.

21Id.

22Id.; see also NYSBA Letter at 6.

23 APTC Letter at 2.

24Id. at 3.

25Id. at 4-5.

26Id.

27Id. at 5.

28 TI Letter at 1.

29 Exxon Letter at 1; NYSBA Letter at 2.

30 Exxon Letter at 2. The Commission notes that proposed Rule 303.01(B)(2)(b) and (c) require each company's board to interpret the terms "financial literary" and "financial expertise." The business judgment standard therefore applies to the board's interpretation of these terms. Subpart (a) of the rule does not require the board to interpret the term "independence" and, thus, there is no need for a business judgment standard.

31 Exxon Letter at 1.

32Id.

33 McDonald's Letter at 2.

34Deloitte Letter at 1; PWC Letter at 1; Meritor Letter at 2.

35Id. at 2.

36 E&Y Letter at 4. In addition, the NVCA stated that the exemption for Small Business Filers should be expanded to apply to companies with less than \$50 million in revenue. NVCA Letter at 4. The Commission notes, unlike the Nasdaq Proposal and the Amex Proposal, there is no exemption for Small Business Filers under the NYSE's proposed rule change.

37 Airlease Letter at 1.

38 NVCA Letter at 5.

39Id. at 4.

40 ICI Letter at 2; MSDW Letter at 1; Keller and Rowe Letter at 3. In addition, Keller and Rowe stated that the proposed rule change should exempt all investment companies because their audit committee members are already required not to be "interested persons" as that term is defined in Section 2(a)(9) of the Investment Company Act of 1940 ("1940 Act"). Keller and Rowe Letter at 5. Moreover, Dorsey supported the application of the proposed rule change to investment companies. Dorsey Letter at 3.

41 ICI Letter at 3-4; MSDW Letter at 2.

42 ICI Letter at 3; MSDW Letter at 1. ICI and MSDW also noted that the independent accountants of investment funds are selected by the independent directors of the fund.

43In approving the proposal, the Commission has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

4415 U.S.C. 78f(b) (5).

45See Keller and Rowe Letter at 2.

46The Commission does not believe that the Exchange should require its listed companies to adopt a separate provision on consultants. See Keller and Rowe Letter at 3.

47See APTC Letter at 5.

48See NVCA and Airlease Letters.

49Small Business Filer is defined by Regulation S-B as an issuer that: (i) has revenue of less than \$25,000,000; (ii) is a U.S. or Canadian issuer; and (iii) if a majority owned subsidiary, the parent corporation is a small business issuer. 17 CFR 228.10(a) (1).

50See Keller and Rowe Letter at 5; ICI Letter at 3; MSDW Letter at 1.

51Kreider Letter at 2.

5215 U.S.C. 78f(b) (5).

5315 U.S.C. 78s(b).

5415. U.S.C. 78s(b) (2).

5517 CFR 200.30-3(a) (12).

<http://www.sec.gov/rules/sro/ny9939o.htm>

NASD Rulemaking:

Order Approving Proposed Rule Change Amending the Audit Committee Requirements and Notice of Filing and Order Granting Accelerated Approval of Amendments No. 1 and No. 2 Thereto

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34-42231; File No. SR-NASD-99-48)

December 14, 1999

Self-Regulatory Organizations; Order Approving Proposed Rule Change by the National Association of Securities Dealers, Inc. Amending Its Audit Committee Requirements and Notice of Filing and Order Granting Accelerated Approval of Amendments No. 1 and No. 2 Thereto

I. Introduction

On September 20, 1999, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its wholly owned subsidiary, The Nasdaq Stock Market, Inc. ("Nasdaq"), submitted to the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b) (1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a proposed rule change amending Nasdaq's audit committee requirements.

The Federal Register published the proposed rule change for comment on October 13, 1999.³ In response, the Commission received fourteen comment letters. On November 15, 1999 and December 9, 1999, the Association submitted Amendments No. 14 and No. 2,⁵ respectively, to the proposed rule change. This order approves the proposed rule change and grants accelerated approval to Amendments No. 1 and No. 2. The Commission is also soliciting comment on Amendments No. 1 and No. 2 to the proposed rule change.

II. Description of the Proposed Rule Change

A. Background

In February 1999, the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees ("Blue Ribbon Committee") issued a report containing recommendations aimed at strengthening the independence of the audit committee; making the audit committee more effective; and addressing mechanisms for accountability among the audit committee, the outside auditors, and management.⁶ In response to the Blue Ribbon Committee's recommendations, Nasdaq proposes to amend its listing standards regarding audit committee requirements. The proposed changes cover three general areas: 1) the definition of independence; 2) the structure and membership of the audit committee; and 3) the audit committee charter.

The text of the proposed rule change, as amended by Amendments No. 1 and No. 2, is as follows. Language deleted by Amendments No. 1 and No. 2 is in brackets. Language added by Amendments No. 1 and No. 2 is in italics.

Rule 4200. Definitions

(a) For purposes of the Rule 4000 Series, unless the context requires otherwise:

(1) - (14) No change

(15) "Independent director" means a person other than an officer or employee of the company or its subsidiaries or any other individual having a relationship which, in the opinion of the company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director. The following persons shall not be considered independent:

(a) a director who is employed by the corporation or any of its affiliates for the current year or any of the past three years;

(b) a director who accepts 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;

(c) a director who is a 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. Immediate family includes a person's spouse, parents, children, siblings, mother-in-law, father-in-law, brother-in-law, sister-in-law, son-in-law, daughter-in-law, and anyone who resides in such person's home;

(d) a director who is a partner 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 5% 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;

(e) a director who is employed as an executive of another entity where any of the company's executives serve on that entity's compensation committee.

(15) - (36) renumbered as (16) - (37)

(b) No change

Rule 4310. Qualification Requirements for Domestic and Canadian Securities

To qualify for inclusion in Nasdaq, a security of a domestic or Canadian issuer shall satisfy all applicable requirements contained in paragraphs (a) or (b), and (c) hereof.

(a) - (b) No change

(c) In addition to the requirements contained in paragraph (a) or (b) above, and unless otherwise indicated, a security shall satisfy the following criteria for inclusion in Nasdaq:

- (1) - (24) No change
 (25) Corporate Governance Requirements
 * * * * *

- (A) No change
 (B) Independent Directors
 Each issuer shall maintain a sufficient number of independent directors on its board of directors to satisfy the audit committee requirement set forth in Rule 4310(c) (26) (B).
 (D) - (H) renumbered as (C) - (G)

(26) Audit Committee

- (A) Audit Committee Charter
 Each Issuer must certify that it has adopted a formal written audit committee charter and that the Audit Committee has reviewed and reassessed the adequacy of the formal written charter on an annual basis. The charter must specify the following:

- (i) the scope of the audit committee's responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements;
- (ii) the audit committee's responsibility for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the company, consistent with Independence Standards Board Standard 1, and the audit committee's responsibility for actively engaging in a dialogue with the auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the auditor and for taking, or recommending that the full board take, appropriate action to [ensure] oversee the independence of the outside auditor; and
- (iii) the outside auditor's ultimate accountability to the board of directors and the audit committee, as representatives of shareholders, and these shareholder representatives' ultimate authority and responsibility to select, evaluate, and, where appropriate, replace the outside auditor (or to nominate the outside auditor to be proposed for shareholder approval in any proxy statement).

(B) Audit Committee Composition

- (i) Each issuer must have, and certify that it has and will continue to have, an audit committee of at least three members, comprised solely of independent directors, each of whom is able to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement or will become able to do so within a reasonable period of time after his or her appointment to the audit committee. Additionally, each issuer must certify that it has, and will continue to have, at least one member of the audit committee that has past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.
- (ii) Notwithstanding paragraph (i), one director who is not independent as defined in Rule 4200, and is not a current employee or an immediate family member of such

employee, may be appointed to the audit committee, if the board, under exceptional and limited circumstances, determines that membership on the committee by the individual is required by the best interests of the corporation and its shareholders, and the board discloses, in the next annual proxy statement subsequent to such determination, the nature of the relationship and the reasons for that determination.

(iii) Exception for Small Business Filers -- Paragraphs (B) (i) and (B) (ii) do not apply to issuers that file reports under SEC Regulation S-B. Such issuers must establish and maintain an Audit Committee of at least two members, a majority of the members of which shall be independent directors.

(26) - (28) renumbered as (27) - (29)

(d) No change

Rule 4320. Qualification Requirements for Non-Canadian Foreign Securities and American Depositary Receipts

To qualify for inclusion in Nasdaq, a security of a non-Canadian foreign issuer, an American Depositary Receipt (ADR) or similar security issued in respect of a security of a foreign issuer shall satisfy the requirements of paragraphs (a), (b) or (c), and (d) and (e) of this Rule.

(a) - (d) No change

(e) In addition to the requirements contained in paragraphs (a), (b) or (c), and (d), the security shall satisfy the following criteria for inclusion in Nasdaq:

(1) - (20) No change

(21) Corporate Governance Requirements -- No provisions of this subparagraph or of subparagraph (24) shall be construed to require any foreign issuer to do any act that is contrary to a law, rule or regulation of any public authority exercising jurisdiction over such issuer or that is contrary to generally accepted business practices in the issuer's country of domicile. Nasdaq shall have the ability to provide exemptions from the applicability of these provisions as may be necessary or appropriate to carry out this intent.

Nasdaq shall review the issuer's past corporate governance activities. This review may include activities taking place while the issuer is listed on Nasdaq or an exchange that imposes corporate governance requirements, as well as activities taking place after the issuer is no longer listed on Nasdaq or an exchange that imposes corporate governance requirements. Based on such review, Nasdaq may take any appropriate action, including placing of restrictions on or additional requirements for listing, or the denial of listing of a security if Nasdaq determines that there have been violations or evasions of such corporate governance standards. Determinations under this subparagraph shall be made on a case-by-case basis as necessary to protect investors and the public interest.

(A) No change

(B) Independent Directors

Each issuer shall maintain a sufficient number of independent directors on its board of directors to satisfy the audit committee requirement set forth in Rule 4320(e) (22) (B).

(D) - (H) renumbered as (C) - (G)

(22) Audit Committee

(A) Audit Committee Charter

Each Issuer must certify that it has adopted a formal written audit committee charter and that the Audit Committee has reviewed and reassessed the adequacy of the formal written charter on an annual basis. The charter must specify the following:

- (i) the scope of the audit committee's responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements;
- (ii) the audit committee's responsibility for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the company, consistent with Independence Standards Board Standard 1, and the audit committee's responsibility for actively engaging in a dialogue with the auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the auditor and for taking, or recommending that the full board take, appropriate action to [ensure] oversee the independence of the outside auditor; and
- (iii) the outside auditor's ultimate accountability to the board of directors and the audit committee, as representatives of shareholders, and these shareholder representatives' ultimate authority and responsibility to select, evaluate, and, where appropriate, replace the outside auditor (or to nominate the outside auditor to be proposed for shareholder approval in any proxy statement).

(B) Audit Committee Composition

- (i) Each issuer must have, and certify that it has and will continue to have, an audit committee of at least three members, comprised solely of independent directors, each of whom is able to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement or will become able to do so within a reasonable period of time after his or her appointment to the audit committee. Additionally, each issuer must certify that it has, and will continue to have, at least one member of the audit committee that has past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.
- (ii) Notwithstanding paragraph (i), one director who is not independent as defined in Rule 4200, and is not a current employee or an immediate family member of such employee, may be appointed to the audit committee, if the board, under exceptional and limited circumstances, determines that membership on the committee by the individual is required by the best interests of the corporation and its shareholders, and the board discloses, in the next annual proxy statement subsequent to such determination, the nature of the relationship and the reasons for that determination.
- (iii) Exception for Small Business Filers -- Paragraphs (B) (i) and (B) (ii) do not apply to issuers that file reports under SEC Regulation S-B. Such issuers must establish and maintain an Audit Committee of at least two members, a majority of the members of which shall be independent directors.

(22) - (24) renumbered as (23) - (25)

(f) No change

Rule 4460. Non-Quantitative Designation Criteria for Issuers Excepting Limited Partnerships

(a) - (b) No change

(c) Independent Directors

Each NNM issuer shall maintain a sufficient number of independent directors on its board of directors to satisfy the audit committee requirement set forth in Rule 4460(d) (2).

(d) Audit Committee

(1) Audit Committee Charter

Each Issuer must certify that it has adopted a formal written audit committee charter and that the Audit Committee has reviewed and reassessed the adequacy of the formal written charter on an annual basis. The charter must specify the following:

- (A) the scope of the audit committee's responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements;
- (B) the audit committee's responsibility for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the company, consistent with Independence Standards Board Standard 1, and the audit committee's responsibility for actively engaging in a dialogue with the auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the auditor and for taking, or recommending that the full board take, appropriate action to [ensure] oversee the independence of the outside auditor; and
- (C) the outside auditor's ultimate accountability to the board of directors and the audit committee, as representatives of shareholders, and these shareholder representatives' ultimate authority and responsibility to select, evaluate, and, where appropriate, replace the outside auditor (or to nominate the outside auditor to be proposed for shareholder approval in any proxy statement).

(2) Audit Committee Composition

(A) Each issuer must have, and certify that it has and will continue to have, an audit committee of at least three members, comprised solely of independent directors, each of whom is able to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement or will become able to do so within a reasonable period of time after his or her appointment to the audit committee. Additionally, each issuer must certify that it has, and will continue to have, at least one member of the audit committee that has past employment experience in finance or accounting, requisite professional certification in accounting, or any other

comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.

(B) Notwithstanding paragraph (i), one director who is not independent as defined in Rule 4200, and is not a current employee or an immediate family member of such employee, may be appointed to the audit committee, if the board, under exceptional and limited circumstances, determines that membership on the committee by the individual is required by the best interests of the corporation and its shareholders, and the board discloses, in the next annual proxy statement subsequent to such determination, the nature of the relationship and the reasons for that determination.

(C) Exception for Small Business Filers -- Paragraphs (2) (A) and (2) (B) do not apply to issuers that file reports under SEC Regulation S-B. Such issuers must establish and maintain an Audit Committee of at least two members, a majority of the members of which shall be independent directors.

(e) - (n) No change

B. Independence

Nasdaq proposes to narrow its current definition of "independent director" by specifying five new relationships that could impair a director's independent judgment as a result of financial, familial, or other material ties to management or the corporation. The proposed definition will apply to all directors, not just those serving on audit committees. Under the proposed rule change, directors with any of the following five relationships will not be considered independent: (1) employment by the corporation or any of its affiliates for the current year or any of the past three years; (2) 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; (3) 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; (4) 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 (5) employment as an executive of another entity where any of the company's executives serve on that entity's compensation committee.

C. Structure and Membership of the Audit Committee

Nasdaq also proposes to change the structure and membership qualifications of the audit committee. Specifically, Nasdaq proposes to change the required composition of the audit committee from at least two to at least three members. Furthermore, the audit committee must be comprised solely of independent directors rather than a majority of independent directors. Nasdaq is conscious of the fact that in exceptional circumstances, issuers may appropriately conclude that it would be in the best interests of the corporation for a non-independent director to serve on the audit committee. In such exceptional and limited circumstances, a non-independent director can serve on the

audit committee, provided that the board determines that it is required by the best interests of the corporation and its shareholders, and the board discloses its reasons for the determination in the next annual proxy statement. Due to the nature of this exception, however, a corporation could have no more than one non-independent director serving on its audit committee. Also, current employees or officers, or their immediate family members, may not serve on the audit committee under this exception.

As a result of the audit committee's responsibility for a corporation's accounting and financial reporting, Nasdaq believes that audit committee members should have a basic understanding of financial statements. Therefore, the proposed rule change requires each member of the audit committee to be able to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement, or become able to do so within a reasonable period of time after his or her appointment to the audit committee. Furthermore, in order to further enhance the effectiveness of the audit committee, at least one member of the audit committee must have past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer, or other senior officer with financial oversight responsibilities.

Nasdaq is sensitive to the potential burden that the proposed changes to the audit committee composition requirements may place on small companies. Therefore, Nasdaq proposes to exempt those corporations that file under SEC Regulation S-B ("Small Business Filers").⁷ Small Business Filers will be held to Nasdaq's existing requirements with respect to audit committee composition. That is, they must maintain an audit committee of at least two members, a majority of whom are independent.

D. Charter

Nasdaq believes that a written charter will help the audit committee as well as management and the corporation's auditors recognize the function of the audit committee and the relationship among these parties. The proposed rule change requires each issuer to adopt a formal written charter. This charter must specify the scope of the audit committee's responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements. In addition, the charter must specify the audit committee's responsibility for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the company, consistent with Independence Standards Board Standard 1.8 The charter must also specify the audit committee's responsibility for actively engaging in a dialogue with the auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the auditor and for taking, or recommending that the full board take, appropriate action to oversee the independence of the outside auditor. Finally, it must specify the outside auditor's ultimate accountability to the board of directors and the audit committee, as representatives of shareholders, and these shareholder representatives' ultimate authority and responsibility to select, evaluate, and, where appropriate, replace the outside auditor (or to nominate an outside auditor for shareholder approval in any proxy statement). The proposed rule change requires issuers to review their charter on an annual basis.

E. Implementation

In order to minimize disruption to existing issuer audit committees, to permit current audit committee members to serve out their terms, and to allow adequate time to recruit the requisite members, Nasdaq proposes to provide its issuers listed as of the effective date of the proposed rule change eighteen months after the proposed rule change is approved by the Commission to meet the audit committee structure and membership requirements.

Additionally, Nasdaq proposes that issuers listed as of the effective date of the rule change be provided six months following the date of Commission approval of the proposed rule change to adopt a formal written audit committee charter in compliance with proposed Rules 4310(c)(26)(A), 4320(e)(22)(A), or 4460(d)(1).

Further, for issuers that applied for listing prior to the effective date of the proposed rule change, Nasdaq proposes that they be able to qualify for listing under the listing standards in force at the time of their application, and to receive the same grace periods provided to currently listed issuers, as described above. Also, in order to avoid prejudicing issuers that transfer to Nasdaq from the American Stock Exchange and the New York Stock Exchange, Nasdaq proposed that these issuers be afforded the same grace periods they would have received under their previous market's implementation schedule.

III. Comments

As of December 9, 1999, the Commission received 14 comment letters on the proposed rule change.⁹ In general, the commenters favored the proposed rule change but recommended certain modifications. Two commenters opposed the proposed rule change.¹⁰

In particular, the CII supports the new requirements, but stated that the proposed override provision, which allows a company's board to include a non-independent director on the audit committee is not appropriate because companies should not have a problem finding financially literate, truly independent directors.¹¹ In addition, the AFL-CIO stated that the restriction period for former employees, or relatives of former employees, should be five years instead of three years.¹² The AFL-CIO also stated that the \$60,000 threshold to disqualify a candidate because of a significant business relationship is not stringent enough.¹³ Another commenter, on the other hand, stated that a quantitative test is too inflexible.¹⁴ Keller and Rowe stated that former non-executive employment should be treated as a significant business relationship.¹⁵ This commenter also stated that consultants who receive from the company more than a de minimis amount of compensation should be treated as employees, while consultants who do not should be treated as having a business relationship with the company.¹⁶ According to this comment letter, the company's board should be permitted to determine that the compensation does not impair the director's objectivity.¹⁷ Keller and Rowe also objected to the financial expertise requirement and stated that no director will want to be designated the financial expert because of the added exposure to liability.¹⁸

Deloitte and Price each stated that requiring a company's board or audit committee to "ensure" the independence of the outside auditor goes beyond what can reasonably be expected of the board and the audit committee in their oversight role.¹⁹ Deloitte suggested that Nasdaq replace the word "ensure" with "monitor" or "actively oversee."²⁰ E&Y supported the proposed rule change, but stated that Nasdaq should not exempt Small Business Filers from the financial literacy and expertise requirements and also should expand its definition of immediate family member to include sons-in-law and daughters-in-law.²¹ NYSBA stated that the company's board should be required to adopt the audit committee charter, rather than the audit committee adopting the charter subject to board approval.²²

In addition, the NVCA stated that the proposed rule change should exclude venture capital investors from the independence qualifications.²³ The NVCA also stated that the proposed rule change should give companies that have just completed an initial public offering eighteen months to comply with the new requirements and that the exemption for Small Business Filers should be expanded to apply to companies with less than \$50 million in revenue.²⁴

APTC stated that the proposed rule change will be counter productive to the goal of better audit committees.²⁵ In addition, APTC stated that the proposed rule change will disadvantage smaller companies more than larger companies, but concluded that it is appropriate to apply the proposed rule change to all companies, regardless of size.²⁶ Moreover, APTC is opposed to the proposal's financial literacy requirement.²⁷ APTC believes that the financial literacy requirement may deprive audit committees of the service of individuals with "exceptional character and/or operational experience."²⁸ The commenter suggested that the Exchange replace this requirement with a requirement that the committee as a whole possess a certain level of financial acumen.²⁹

Finally, two commenters stated that the proposed rule change should not apply to closed-end investment companies.³⁰ These commenters noted that closed-end investment companies are adequately regulated under the 1940 Act.³¹ The commenters also stated that the potential abuses that the proposed rule change is designed to address do not exist with closed-end investment funds.³² Finally, the commenters noted that because the assets of these funds consist exclusively of investment securities, there is no opportunity to "manage" earnings or results through selective application of accounting policies.³³

IV. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association,³⁴ and, in particular, the requirements of Section 15A(b)(6) of the Act.³⁵ The Commission believes that the proposed rule change will protect investors by improving the effectiveness of audit committees of companies listed on Nasdaq. The Commission also believes that the new requirements will enhance the reliability and credibility of financial statements of companies listed on Nasdaq by making it more difficult for companies to inappropriately distort their true financial performance.

Specifically, the Commission believes that the proposed definition of independence will promote the quality and reliability of a company's financial statements. The Commission

believes that directors without financial, familial, or other material personal ties to management will be more likely to objectively evaluate the propriety of management's accounting, internal control, and financial reporting practices. The Commission believes that the proposal's prohibition against employees serving on the audit committee is appropriate and that the Exchange should not be required to distinguish between executive and non-executive employees.³⁶ The Commission also believes that the proposed provision that permits a company to appoint one director to its audit committee who is not independent, if the board determines that membership on the committee by the individual is required by the best interests of the corporation and its shareholders, adequately balances the need for objective, independent directors with the company's need for flexibility in exceptional and unusual circumstances. The Commission believes that the requirement that the company disclose in its next annual proxy statement the nature of the director's relationship with the company and the board's reasons for determining the appointment was in the best interests of the corporation will adequately guard against abuse of the proposed exception to the independence requirement. Moreover, the Commission believes that the \$60,000 threshold to determine if a potential audit committee director has a significant business relationship with the company is a reasonable measure to balance the company's need to recruit audit committee members with the independence requirement.

The Commission does not believe that venture capital investors should be excluded from Nasdaq's definition of independence. The Commission does not believe that the proposed rule change will pose an undue hardship on venture capital firms or companies listed on Nasdaq. The Commission notes that the proposed rule change will only prohibit venture capital investors from sitting on a company's audit committee if the investor does not fall within Nasdaq's definition of independent. The proposed rule change will not prohibit previously eligible investors from serving on the company's board. The Commission also notes that a venture capital investor that is not considered independent may serve on the company's audit committee, if the board determines it is in the best interests of the corporation and its shareholders and the company discloses its reasons for the determination and the nature of the director's relationship to the company in its next annual proxy statement.

In addition, the Commission believes that requiring companies to adopt formal written charters specifying the audit committee's responsibilities, and how the committee carries out those responsibilities, will help the audit committee, management, investors, and the company's auditors recognize the function of the audit committee and the relationship among the parties. Moreover, the Commission believes that requiring the charter to specify that the audit committee is responsible for taking, or recommending that the company's full board take, appropriate action to oversee the independence of the outside auditor will make it more likely that companies will select objective, unbiased auditors.

The Commission believes that the proposed rule change's compositional requirement that each issuer have an audit committee composed of three independent directors who are able to read and understand fundamental financial statements will enhance the effectiveness of the audit committee and help to ensure that audit committee members are able to adequately fulfill their responsibilities. The Commission believes that requiring each audit committee member to satisfy this standard will help to ensure that the committee as a whole is financially literate.³⁷ Moreover, the Commission considers

that requiring one member of the audit committee to have past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background that indicates the individual's financial sophistication, will further enhance the effectiveness of the audit committee in carrying out its financial oversight responsibilities. In addition, the Commission does not believe that companies will experience undue difficulty recruiting an audit committee member that satisfies the financial expertise requirements. Moreover, the Commission believes that the proposed rule change appropriately exempts Small Business Filers from the proposed composition requirements because these companies may experience more difficulty meeting these enhanced requirements. The Commission notes that these companies will remain subject to Nasdaq's existing rules on audit committees, which require an audit committee to have at least two members, a majority of whom are independent.

Moreover, the Commission does not believe that the proposed rule change circumvents state law.³⁸ The Commission notes that Nasdaq is amending its own qualification requirements governing an issuer's listing on Nasdaq, which is an appropriate function for Nasdaq as long as those requirements are consistent with the Act.

Moreover, the Commission has concluded that Nasdaq's decision to include investment companies in the proposed rule change is warranted. While the Commission recognizes that the opportunity for some types of financial reporting abuses may be limited by the nature of fund assets,³⁹ it believes that audit committees do play an important role in overseeing the financial reporting process for investment companies

The Commission finds good cause for approving Amendments No. 1 and No. 2 to the proposed rule change prior to the thirtieth day after publication in the Federal Register. The Commission notes that Amendment No. 1 merely revises the implementation time periods for the proposed rule change to provide greater clarity to issuers and to investors. The Commission believes that Amendment No. 1 will enable issuers to determine when they must comply with the new requirements and will enable investors to determine when to rely on the protections afforded by the proposed rule change. The Commission notes that Amendment No. 2 simply clarifies that the audit committee is required to oversee, rather than ensure, the independence of the company's outside auditors, and expands Nasdaq's definition of "immediate family." The Commission believes that accelerated approval will allow Nasdaq to simultaneously make all relevant modifications to its Rules and will avoid potential confusion. Accordingly, the Commission finds good cause to accelerate approval of Amendments No. 1 and No. 2 to the proposed rule change, consistent with Sections 6(b)(5)⁴⁰ and 19(b)⁴¹ of the Act.

V. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any

person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to the File No. SR-NASD-99-48 and should be submitted by [insert date 21 days from the date of publication].

VI. Conclusion

For the foregoing reasons, the Commission finds that Nasdaq's proposal to amend its audit committee requirements is consistent with the requirements of the Act and the rules and regulations thereunder.

It is therefore ordered, pursuant to Section 19(b) (2) of the Act,⁴² that the amended proposed rule change (SR-NASD-99-48) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁴³

Jonathan G. Katz
Secretary

Footnotes

115 U.S.C. 78s(b) (1).

217 CFR 240.19b-4.

³Securities Exchange Act Release No. 41982 (Oct. 6, 1999), 64 FR 55510. The American Stock Exchange LLC and The New York Stock Exchange, Inc. have proposed rule changes relating to audit committees. See Securities Exchange Act Release No. 41981 (Oct. 6, 1999), 64 FR 55505 (Oct. 13, 1999) ("Amex Proposal"), and Securities Exchange Act Release No. 41980 (Oct. 6, 1999), 64 FR 55514 (Oct. 13, 1999) ("NYSE Proposal").

⁴Letter from Robert E. Aber, Senior Vice President and General Counsel, Nasdaq-Amex Market Group, to Richard Strasser, Assistant Director, Division of Market Regulation, Commission, dated November 12, 1999 ("Amendment No. 1"). The Association submitted Amendment No. 1 to require issuers listed as of the effective date of Commission approval of the proposed rule change to adopt a formal written audit committee charter within six months of the effective date of the proposed rule change. As originally filed, the proposed rule change required issuers to adopt the charter within eighteen months of the effective date of the proposed rule change. Amendment No. 1 also states that issuers that applied for listing prior to the effective date of the proposed rule change would qualify for listing under the listing standards in force at the time of their application, and receive the same grace periods provided to currently listed issuers. Finally, Amendment No. 1 modifies proposed Rule 4320(e) (21) to provide that the requirement that each issuer execute a listing agreement will not be construed to require

any foreign issuer to do any act that is contrary to a law of any public authority exercising jurisdiction over the foreign issuer.

5Letter from Sara Nelson Bloom, Associate General Counsel, Nasdaq-Amex Market Group, to Richard Strasser, Assistant Director, Division, Commission, dated December 8, 1999 ("Amendment No. 2"). The Association submitted Amendment No. 2 to revise proposed Rules 4310(c) (26) (A) (ii), 4320(e) (22) (A) (ii), and 4460(d) (1) (B) to provide that the audit committee is required to oversee the independence of the outside auditor, rather than ensure the independence of the outside auditor. Amendment No. 2 also revises Nasdaq's definition of immediate family found in Rule 4200(a) (15) (c) to include sons-in-law and daughters-in-law.

6Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (1999). A copy of this Report [Webmaster note: in PDF format] can be found on-line at www.nasdaqnews.com.

7Small Business Filer is defined by Regulation S-B as an issuer that: (i) has revenue of less than \$25,000,000; (ii) is a U.S. or Canadian issuer; and (iii) if a majority owned subsidiary, the parent corporation is a small business issuer. 17 CFR 228.10(a) (1).

8Independence Standard No. 1, Independence Discussions with Audit Committees (January 1999), which can be found on-line at www.cpaindependence.org.

9See letters from: Ernst & Young LLP ("E&Y") dated November 1, 1999; Deloitte & Touche LLP ("Deloitte") dated November 3, 1999; Council of Institutional Investors ("CII") dated November 8, 1999; Brian T. Borders on behalf of the National Venture Capital Association ("NVCA") dated November 12, 1999; PricewaterhouseCoopers LLP ("Price") dated November 1, 1999; Gary P. Kreider ("Kreider") dated November 5, 1999; American Federation of Labor and Congress of Industrial Organizations ("AFL-CIO") dated November 29, 1999; Mayer, Brown & Platt on behalf of Morgan Stanley Dean Witter ("MSDW") dated November 29, 1999; Investment Company Institute ("ICI") dated November 3, 1999; Arthur Andersen LLP ("Arthur Andersen") dated December 3, 1999; Association of Publicly Traded Companies ("APTC") dated December 6, 1999; Robert A. Profusek ("Profusek") dated December 3, 1999; Stanley Keller and Richard Rowe ("Keller and Rowe") dated December 7, 1999; and The Committee on Securities Regulation of the Business Law Section of the New York State Bar Association ("NYSBA") dated December 1, 1999.

10See Kreider Letter; APTC Letter at 2. Kreider stated that the proposed rule change "represent[s] an awkward attempt to circumvent state corporate law and micro-manage the functions of audit committees." Id. at 2.

11CII Letter, at 2; see also AFL-CIO Letter at 2.

12AFL-CIO Letter at 2.

13Id.

14Profusek Letter at 2. In addition, Keller and Rowe stated that this provision might preclude a number of highly qualified candidates from serving on audit committees. Keller and Rowe Letter at 3.

15Keller and Rowe Letter at 2.

16Id. at 3.

17Id.

18Id.

19Deloitte Letter at 1; Price Letter at 1.

20Id. at 2.

21E&Y Letter at 4.

22NYSBA Letter at 2.

23NVCA Letter at 5.

24Id. at 4.

25APTC Letter at 2.

26Id. at 3.

27Id. at 4-5.

28Id.

29Id. at 5.

30ICI Letter at 2; MSDW Letter at 1. In addition, Keller and Rowe stated that the proposed rule change should exempt all investment companies because their audit committee members are already required not to be "interested persons" as that term is defined in Section 2(a)(9) of the Investment Company Act of 1940 ("1940 Act"). Keller and Rowe Letter at 5.

31ICI Letter at 3-4; MSDW Letter at 2.

32ICI Letter at 3; MSDW Letter at 1. ICI and MSDW also noted that the independent accountants of investment funds are selected by the independent directors of the fund.

33ICI Letter at 3; MSDW Letter at 1.

34In approving the proposal, the Commission has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

3515 U.S.C. 78o-3(b) (6).

36See Keller and Rowe Letter at 2.

37See APTC Letter at 5.

38Kreider Letter at 2.

39See Keller and Rowe Letter at 5; ICI Letter at 3; MSDW Letter at 1.

4015 U.S.C. 78f(b) (5).

4115 U.S.C. 78s(b).

4215. U.S.C. 78s(b) (2).

4317 CFR 200.30-3(a) (12).

<http://www.sec.gov/rules/sro/nd9948o.htm>

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3. By amending section 602.02.b.i to remove paragraphs 2 and 3.

4. By amending section 602.02.b.ii to remove examples 1, 2, 3, 4, 6, 7, 8, and 10, and redesignate examples 5 and 9 as examples 1 and 2.

5. By amending section 602.02.b.iii to remove examples 1, 2, and 4, and redesignate example 3 as example 1.

6. By removing section 602.02.b.iv.

7. By amending section 602.02.b.v to remove example 4.

8. By amending section 602.02.c.i to remove the last two paragraphs.

9. By removing section 602.02.c.ii.

10. By removing section 602.02.c.iii.

11. By removing section 602.02.d.

12. By removing section 602.02.e.ii.

13. By removing section 602.02.e.iii.

14. By removing section 602.02.f.

15. By amending examples 2, 3, 4, 5, 6, 7, 8, 10, 13, 15, 16, 20, and 23 in section 602.02.g by replacing the references to "partner," "partners," "certifying accountant," or "accountant" to "covered person," "covered persons," "covered person" and "covered person," respectively, except no change should be made where references to "partner" are preceded by the word "limited" or "general."

16. By amending section 602.02.g to replace the reference to Rule 2-01(b) in the last sentence of the first introductory paragraph with "Rule 2-01" and to remove examples 17, 18, 19, and 22 and redesignate examples 20, 21, 23, and 24 as examples 17, 18, 19, and 20, respectively.

17. By removing section 602.02.h.

18. By adding a new section 602.01, captioned "Discussion of Rule 2-01," to include the text in Section IV of this release.

19. By amending Section 601.03 to include, at the end, the text in Section III.C.6 of this release.

20. By amending section 602.02 to redesignate sections 602.02.b.v, 602.02.e.i, 602.02.e.iv, 602.02.g, 602.02.i.i, and 602.02.i.ii as sections 602.02.b.iv, 602.02.d.i, 602.02.d.ii, 602.02.e, 602.02.f.i, and 602.02.f.ii, respectively.

The Codification is a separate publication of the Commission. It will not be published in the Code of Federal Regulations.

X. Statutory Bases and Text of Amendments

We are adopting amendments to Rule 2-01 of Regulation S-X and Item 9 of Schedule 14A under the authority set forth in Schedule A and Sections 7, 8, 10, 19, and 28 of the Securities Act, Sections 3, 10A, 12, 13, 14, 17, 23, and 36 of the Exchange Act, Sections 5, 10, 14, and 20 of the Public Utility Holding

Company Act of 1935, Sections 8, 30, 31, and 38 of the Investment Company Act of 1940, and Sections 203 and 211 of the Investment Advisers Act of 1940.

List of Subjects

17 CFR Part 210

Accountants, Accounting.

17 CFR Part 240

Reporting and recordkeeping requirements, Securities.

Text of Amendments

In accordance with the foregoing, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

PART 210—FORM AND CONTENT OF AND REQUIREMENTS FOR FINANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, PUBLIC UTILITY HOLDING COMPANY ACT OF 1935, INVESTMENT COMPANY ACT OF 1940, INVESTMENT ADVISERS ACT OF 1940, AND ENERGY POLICY AND CONSERVATION ACT OF 1975

1. The heading for Part 210 is revised as set forth above.

2. The authority citation for Part 210 is revised to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 78c, 78j-1, 78l, 78m, 78n, 78o(d), 78q, 78u-5, 78w(a), 78ll, 78mm, 79e(b), 79j(a), 79n, 79t(a), 80a-8, 80a-20, 80a-29, 80a-30, 80a-37(a), 80b-3, 80b-11 unless otherwise noted.

3. By amending § 210.2-01 by adding a preliminary note and paragraphs (d), (e) and (f) and revising paragraphs (b) and (c) to read as follows:

§ 210.2-01 Qualifications of accountants.

Preliminary Note to § 210.2-01

1. Section 210.2-01 is designed to ensure that auditors are qualified and independent of their audit clients both in fact and in appearance. Accordingly, the rule sets forth restrictions on financial, employment, and business relationships between an accountant and an audit client and restrictions on an accountant providing certain non-audit services to an audit client.

2. Section 210.2-01(b) sets forth the general standard of auditor independence. Paragraphs (c)(1) to (c)(5) reflect the application of the general standard to particular circumstances. The rule does not purport to, and the Commission could not, consider all circumstances that raise independence concerns, and these are subject to the general standard in § 210.2-01(b). In considering this standard, the Commission looks in the first instance to whether a relationship or the provision of a service: creates a mutual or conflicting interest between the accountant and the audit client;

places the accountant in the position of auditing his or her own work; results in the accountant acting as management or an employee of the audit client; or places the accountant in a position of being an advocate for the audit client.

3. These factors are general guidance only and their application may depend on particular facts and circumstances. For that reason, § 210.2-01 provides that, in determining whether an accountant is independent, the Commission will consider all relevant facts and circumstances. For the same reason, registrants and accountants are encouraged to consult with the Commission's Office of the Chief Accountant before entering into relationships, including relationships involving the provision of services, that are not explicitly described in the rule.

(a) * * *

(b) The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. In determining whether an accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission.

(c) This paragraph sets forth a non-exclusive specification of circumstances inconsistent with paragraph (b) of this section.

(1) *Financial relationships.* An accountant is not independent if, at any point during the audit and professional engagement period, the accountant has a direct financial interest or a material indirect financial interest in the accountant's audit client, such as:

(i) *Investments in audit clients.* An accountant is not independent when:

(A) The accounting firm, any covered person in the firm, or any of his or her immediate family members, has any direct investment in an audit client, such as stocks, bonds, notes, options, or other securities. The term *direct investment* includes an investment in an audit client through an intermediary if:

(1) The accounting firm, covered person, or immediate family member, alone or together with other persons, supervises or participates in the intermediary's investment decisions or has control over the intermediary; or

(2) The intermediary is not a diversified management investment company, as defined by section 5(b)(1) of the Investment Company Act of 1940,

15 U.S.C. 80a-5(b)(1), and has an investment in the audit client that amounts to 20% or more of the value of the intermediary's total investments.

(B) Any partner, principal, shareholder, or professional employee of the accounting firm, any of his or her immediate family members, any close family member of a covered person in the firm, or any group of the above persons has filed a Schedule 13D or 13G (17 CFR 240.13d-101 or 240.13d-102) with the Commission indicating beneficial ownership of more than five percent of an audit client's equity securities or controls an audit client, or a close family member of a partner, principal, or shareholder of the accounting firm controls an audit client.

(C) The accounting firm, any covered person in the firm, or any of his or her immediate family members, serves as voting trustee of a trust, or executor of an estate, containing the securities of an audit client, unless the accounting firm, covered person in the firm, or immediate family member has no authority to make investment decisions for the trust or estate.

(D) The accounting firm, any covered person in the firm, any of his or her immediate family members, or any group of the above persons has any material indirect investment in an audit client. For purposes of this paragraph, the term *material indirect investment* does not include ownership by any covered person in the firm, any of his or her immediate family members, or any group of the above persons of 5% or less of the outstanding shares of a diversified management investment company, as defined by section 5(b)(1) of the Investment Company Act of 1940, 15 U.S.C. 80a-5(b)(1), that invests in an audit client.

(E) The accounting firm, any covered person in the firm, or any of his or her immediate family members:

(1) Has any direct or material indirect investment in an entity where:

(i) An audit client has an investment in that entity that is material to the audit client and has the ability to exercise significant influence over that entity; or

(ii) The entity has an investment in an audit client that is material to that entity and has the ability to exercise significant influence over that audit client;

(2) Has any material investment in an entity over which an audit client has the ability to exercise significant influence; or

(3) Has the ability to exercise significant influence over an entity that has the ability to exercise significant influence over an audit client.

(ii) *Other financial interests in audit client.* An accountant is not independent when the accounting firm, any covered person in the firm, or any of his or her immediate family members has:

(A) *Loans/debtor-creditor relationship.* Any loan (including any margin loan) to or from an audit client, or an audit client's officers, directors, or record or beneficial owners of more than ten percent of the audit client's equity securities, except for the following loans obtained from a financial institution under its normal lending procedures, terms, and requirements:

(1) Automobile loans and leases collateralized by the automobile;

(2) Loans fully collateralized by the cash surrender value of an insurance policy;

(3) Loans fully collateralized by cash deposits at the same financial institution; and

(4) A mortgage loan collateralized by the borrower's primary residence provided the loan was not obtained while the covered person in the firm was a covered person.

(B) *Savings and checking accounts.* Any savings, checking, or similar account at a bank, savings and loan, or similar institution that is an audit client, if the account has a balance that exceeds the amount insured by the Federal Deposit Insurance Corporation or any similar insurer, except that an accounting firm account may have an uninsured balance provided that the likelihood of the bank, savings and loan, or similar institution experiencing financial difficulties is remote.

(C) *Broker-dealer accounts.* Brokerage or similar accounts maintained with a broker-dealer that is an audit client, if:

(1) Any such account includes any asset other than cash or securities (within the meaning of "security" provided in the Securities Investor Protection Act of 1970 ("SIPA") (15 U.S.C. 78aaa *et seq.*));

(2) The value of assets in the accounts exceeds the amount that is subject to a Securities Investor Protection Corporation advance, for those accounts, under Section 9 of SIPA (15 U.S.C. 78fff-3); or

(3) With respect to non-U.S. accounts not subject to SIPA protection, the value of assets in the accounts exceeds the amount insured or protected by a program similar to SIPA.

(D) *Futures commission merchant accounts.* Any futures, commodity, or similar account maintained with a futures commission merchant that is an audit client.

(E) *Credit cards.* Any aggregate outstanding credit card balance owed to

a lender that is an audit client that is not reduced to \$10,000 or less on a current basis taking into consideration the payment due date and any available grace period.

(F) *Insurance products.* Any individual policy issued by an insurer that is an audit client unless:

(1) The policy was obtained at a time when the covered person in the firm was not a covered person in the firm; and

(2) The likelihood of the insurer becoming insolvent is remote.

(G) *Investment companies.* Any financial interest in an entity that is part of an investment company complex that includes an audit client.

(iii) *Exceptions.* Notwithstanding paragraphs (c)(1)(i) and (c)(1)(ii) of this section, an accountant will not be deemed not independent if:

(A) *Inheritance and gift.* Any person acquires an unsolicited financial interest, such as through an unsolicited gift or inheritance, that would cause an accountant to be not independent under paragraph (c)(1)(i) or (c)(1)(ii) of this section, and the financial interest is disposed of as soon as practicable, but no later than 30 days after the person has knowledge of and the right to dispose of the financial interest.

(B) *New audit engagement.* Any person has a financial interest that would cause an accountant to be not independent under paragraph (c)(1)(i) or (c)(1)(ii) of this section, and:

(1) The accountant did not audit the client's financial statements for the immediately preceding fiscal year; and

(2) The accountant is independent under paragraph (c)(1)(i) and (c)(1)(ii) of this section before the earlier of:

(i) Signing an initial engagement letter or other agreement to provide audit, review, or attest services to the audit client; or

(ii) Commencing any audit, review, or attest procedures (including planning the audit of the client's financial statements).

(C) *Employee compensation and benefit plans.* An immediate family member of a person who is a covered person in the firm only by virtue of paragraphs (f)(11)(iii) or (f)(11)(iv) of this section has a financial interest that would cause an accountant to be not independent under paragraph (c)(1)(i) or (c)(1)(ii) of this section, and the acquisition of the financial interest was an unavoidable consequence of participation in his or her employer's employee compensation or benefits program, provided that the financial interest, other than unexercised employee stock options, is disposed of as soon as practicable, but no later than

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30 days after the person has the right to dispose of the financial interest.

(iv) *Audit clients' financial relationships.* An accountant is not independent when:

(A) *Investments by the audit client in the accounting firm.* An audit client has, or has agreed to acquire, any direct investment in the accounting firm, such as stocks, bonds, notes, options, or other securities, or the audit client's officers or directors are record or beneficial owners of more than 5% of the equity securities of the accounting firm.

(B) *Underwriting.* An accounting firm engages an audit client to act as an underwriter, broker-dealer, market-maker, promoter, or analyst with respect to securities issued by the accounting firm.

(2) *Employment relationships.* An accountant is not independent if, at any point during the audit and professional engagement period, the accountant has an employment relationship with an audit client, such as:

(i) *Employment at audit client of accountant.* A current partner, principal, shareholder, or professional employee of the accounting firm is employed by the audit client or serves as a member of the board of directors or similar management or governing body of the audit client.

(ii) *Employment at audit client of certain relatives of accountant.* A close family member of a covered person in the firm is in an accounting role or financial reporting oversight role at an audit client, or was in such a role during any period covered by an audit for which the covered person in the firm is a covered person.

(iii) *Employment at audit client of former employee of accounting firm.* A former partner, principal, shareholder, or professional employee of an accounting firm is in an accounting role or financial reporting oversight role at an audit client, unless the individual:

(A) Does not influence the accounting firm's operations or financial policies;

(B) Has no capital balances in the accounting firm; and

(C) Has no financial arrangement with the accounting firm other than one providing for regular payment of a fixed dollar amount (which is not dependent on the revenues, profits, or earnings of the accounting firm):

(1) Pursuant to a fully funded retirement plan, rabbi trust, or, in jurisdictions in which a rabbi trust does not exist, a similar vehicle; or

(2) In the case of a former professional employee who was not a partner, principal, or shareholder of the accounting firm and who has been disassociated from the accounting firm

for more than five years, that is immaterial to the former professional employee.

(iv) *Employment at accounting firm of former employee of audit client.* A former officer, director, or employee of an audit client becomes a partner, principal, shareholder, or professional employee of the accounting firm, unless the individual does not participate in, and is not in a position to influence, the audit of the financial statements of the audit client covering any period during which he or she was employed by or associated with that audit client.

(3) *Business relationships.* An accountant is not independent if, at any point during the audit and professional engagement period, the accounting firm or any covered person in the firm has any direct or material indirect business relationship with an audit client, or with persons associated with the audit client in a decision-making capacity, such as an audit client's officers, directors, or substantial stockholders. The relationships described in this paragraph do not include a relationship in which the accounting firm or covered person in the firm provides professional services to an audit client or is a consumer in the ordinary course of business.

(4) *Non-audit services.* An accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides the following non-audit services to an audit client:

(i) *Bookkeeping or other services related to the audit client's accounting records or financial statements.*

(A) Any service involving:

(1) Maintaining or preparing the audit client's accounting records;

(2) Preparing the audit client's financial statements that are filed with the Commission or form the basis of financial statements filed with the Commission; or

(3) Preparing or originating source data underlying the audit client's financial statements.

(B) Notwithstanding paragraph (c)(4)(i)(A) of this section, the accountant's independence will not be impaired when the accountant provides these services:

(1) In emergency or other unusual situations, provided the accountant does not undertake any managerial actions or make any managerial decisions; or

(2) For foreign divisions or subsidiaries of an audit client, provided that:

(j) The services are limited, routine, or ministerial;

(ii) It is impractical for the foreign division or subsidiary to make other arrangements;

(iii) The foreign division or subsidiary is not material to the consolidated financial statements;

(iv) The foreign division or subsidiary does not have employees capable or competent to perform the services;

(v) The services performed are consistent with local professional ethics rules; and

(vi) The fees for all such services collectively (for the entire group of companies) do not exceed the greater of 1% of the consolidated audit fee or \$10,000.

(ii) *Financial information systems design and implementation.*

(A) Directly or indirectly operating, or supervising the operation of, the audit client's information system or managing the audit client's local area network.

(B) Designing or implementing a hardware or software system that aggregates source data underlying the financial statements or generates information that is significant to the audit client's financial statements taken as a whole, unless:

(1) The audit client's management has acknowledged in writing to the accounting firm and the audit client's audit committee, or if there is no such committee then the board of directors, the audit client's responsibility to establish and maintain a system of internal accounting controls in compliance with section 13(b)(2) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(b)(2));

(2) The audit client's management designates a competent employee or employees, preferably within senior management, with the responsibility to make all management decisions with respect to the design and implementation of the hardware or software system;

(3) The audit client's management makes all management decisions with respect to the design and implementation of the hardware or software system including, but not limited to, decisions concerning the systems to be evaluated and selected, the controls and system procedures to be implemented, the scope and timetable of system implementation, and the testing, training, and conversion plans;

(4) The audit client's management evaluates the adequacy and results of the design and implementation of the hardware or software system; and

(5) The audit client's management does not rely on the accountant's work as the primary basis for determining the

adequacy of its internal controls and financial reporting systems.

(C) Nothing in this paragraph (c)(4)(ii) shall limit services an accountant performs in connection with the assessment, design, and implementation of internal accounting controls and risk management controls, provided the auditor does not act as an employee or perform management functions.

(iii) *Appraisal or valuation services or fairness opinions.*

(A) Any appraisal service, valuation service, or any service involving a fairness opinion for an audit client, where it is reasonably likely that the results of these services, individually or in the aggregate, would be material to the financial statements, or where the results of these services will be audited by the accountant during an audit of the audit client's financial statements.

(B) Notwithstanding paragraph (c)(4)(iii)(A) of this section, the accountant's independence will not be impaired when:

(1) The accounting firm's valuation expert reviews the work of the audit client or a specialist employed by the audit client, and the audit client or the specialist provides the primary support for the balances recorded in the client's financial statements;

(2) The accounting firm's actuaries value an audit client's pension, other post-employment benefit, or similar liabilities, provided that the audit client has determined and taken responsibility for all significant assumptions and data;

(3) The valuation is performed in the context of the planning and implementation of a tax-planning strategy or for tax compliance services; or

(4) The valuation is for non-financial purposes where the results of the valuation do not affect the financial statements.

(iv) *Actuarial services.*

(A) Any actuarially-oriented advisory service involving the determination of insurance company policy reserves and related accounts for the audit client, unless:

(1) The audit client uses its own actuaries or third-party actuaries to provide management with the primary actuarial capabilities;

(2) Management accepts responsibility for any significant actuarial methods and assumptions; and

(3) The accountant's involvement is not continuous.

(B) Subject to complying with paragraph (c)(4)(iv)(A)(1)-(3) of this section, the accountant's independence will not be impaired if the accountant:

(1) Assists management to develop appropriate methods, assumptions, and

amounts for policy and loss reserves and other actuarial items presented in financial reports based on the audit client's historical experience, current practice, and future plans;

(2) Assists management in the conversion of financial statements from a statutory basis to one conforming with generally accepted accounting principles;

(3) Analyzes actuarial considerations and alternatives in federal income tax planning; or

(4) Assists management in the financial analysis of various matters, such as proposed new policies, new markets, business acquisitions, and reinsurance needs.

(v) *Internal audit services.* Either of:

(A) Internal audit services in an amount greater than 40% of the total hours expended on the audit client's internal audit activities in any one fiscal year, unless the audit client has less than \$200 million in total assets. (For purposes of this paragraph, the term *internal audit services* does not include operational internal audit services unrelated to the internal accounting controls, financial systems, or financial statements.); or

(B) Any internal audit services, or any operational internal audit services unrelated to the internal accounting controls, financial systems, or financial statements, for an audit client, unless:

(1) The audit client's management has acknowledged in writing to the accounting firm and the audit client's audit committee, or if there is no such committee then the board of directors, the audit client's responsibility to establish and maintain a system of internal accounting controls in compliance with section 13(b)(2) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(b)(2));

(2) The audit client's management designates a competent employee or employees, preferably within senior management, to be responsible for the internal audit function;

(3) The audit client's management determines the scope, risk, and frequency of internal audit activities, including those to be performed by the accountant;

(4) The audit client's management evaluates the findings and results arising from the internal audit activities, including those performed by the accountant;

(5) The audit client's management evaluates the adequacy of the audit procedures performed and the findings resulting from the performance of those procedures by, among other things, obtaining reports from the accountant; and

(6) The audit client's management does not rely on the accountant's work as the primary basis for determining the adequacy of its internal controls.

(vi) *Management functions.* Acting, temporarily or permanently, as a director, officer, or employee of an audit client, or performing any decision-making, supervisory, or ongoing monitoring function for the audit client.

(vii) *Human resources.*

(A) Searching for or seeking out prospective candidates for managerial, executive, or director positions;

(B) Engaging in psychological testing, or other formal testing or evaluation programs;

(C) Undertaking reference checks of prospective candidates for an executive or director position;

(D) Acting as a negotiator on the audit client's behalf, such as determining position, status or title, compensation, fringe benefits, or other conditions of employment; or

(E) Recommending, or advising the audit client to hire, a specific candidate for a specific job (except that an accounting firm may, upon request by the audit client, interview candidates and advise the audit client on the candidate's competence for financial accounting, administrative, or control positions).

(viii) *Broker-dealer services.* Acting as a broker-dealer, promoter, or underwriter, on behalf of an audit client, making investment decisions on behalf of the audit client or otherwise having discretionary authority over an audit client's investments, executing a transaction to buy or sell an audit client's investment, or having custody of assets of the audit client, such as taking temporary possession of securities purchased by the audit client.

(ix) *Legal services.* Providing any service to an audit client under circumstances in which the person providing the service must be admitted to practice before the courts of a United States jurisdiction.

(5) *Contingent fees.* An accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides any service or product to an audit client for a contingent fee or a commission, or receives a contingent fee or commission from an audit client.

(d) *Quality controls.* An accounting firm's independence will not be impaired solely because a covered person in the firm is not independent of an audit client provided:

(1) The covered person did not know of the circumstances giving rise to the lack of independence;

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(2) The covered person's lack of independence was corrected as promptly as possible under the relevant circumstances after the covered person or accounting firm became aware of it; and

(3) The accounting firm has a quality control system in place that provides reasonable assurance, taking into account the size and nature of the accounting firm's practice, that the accounting firm and its employees do not lack independence, and that covers at least all employees and associated entities of the accounting firm participating in the engagement, including employees and associated entities located outside of the United States.

(4) For an accounting firm that annually provides audit, review, or attest services to more than 500 companies with a class of securities registered with the Commission under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l), a quality control system will not provide such reasonable assurance unless it has at least the following features:

(i) Written independence policies and procedures;

(ii) With respect to partners and managerial employees, an automated system to identify their investments in securities that might impair the accountant's independence;

(iii) With respect to all professionals, a system that provides timely information about entities from which the accountant is required to maintain independence;

(iv) An annual or on-going firm-wide training program about auditor independence;

(v) An annual internal inspection and testing program to monitor adherence to independence requirements;

(vi) Notification to all accounting firm members, officers, directors, and employees of the name and title of the member of senior management responsible for compliance with auditor independence requirements;

(vii) Written policies and procedures requiring all partners and covered persons to report promptly to the accounting firm when they are engaged in employment negotiations with an audit client, and requiring the firm to remove immediately any such professional from that audit client's engagement and to review promptly all work the professional performed related to that audit client's engagement; and

(viii) A disciplinary mechanism to ensure compliance with this section.

(e) *Transition and grandfathering.*

(1) *Transition.*

(i) *Appraisal or valuation services or fairness opinions and internal audit services.* Until August 5, 2002, providing to an audit client the non-audit services set forth in paragraphs (c)(4)(iii) and (c)(4)(v) of this section will not impair an accountant's independence with respect to the audit client if performing those services did not impair the accountant's independence under pre-existing requirements of the Commission, the Independence Standards Board, or the accounting profession in the United States.

(ii) *Other financial interests and employment relationships.* Until May 7, 2001, having the financial interests set forth in paragraph (c)(1)(ii) of this section or the employment relationships set forth in paragraph (c)(2) of this section will not impair an accountant's independence with respect to the audit client if having those financial interests or employment relationships did not impair the accountant's independence under pre-existing requirements of the Commission, the Independence Standards Board, or the accounting profession in the United States.

(iii) *Quality controls.* Until December 31, 2002, paragraph (d)(4) of this section shall not apply to offices of the accounting firm located outside of the United States.

(2) *Grandfathering.* Financial interests included in paragraphs (c)(1)(ii)(A) and (c)(1)(ii)(F) of this section and employment relationships included in paragraph (c)(2) of this section in existence on May 7, 2001, and contracts for the provision of services described in paragraph (c)(4)(ii) of this section in existence on February 5, 2001 will not be deemed to impair an accountant's independence if they did not impair the accountant's independence under pre-existing requirements of the Commission, the Independence Standards Board, or the accounting profession in the United States.

(3) *Settling financial arrangements with former professionals.* To the extent not required by pre-existing requirements of the Commission, the Independence Standards Board, or the accounting profession in the United States, the requirement in paragraph (c)(2)(iii) of this section to settle financial arrangements with former professionals applies to situations that arise after the effective date of this section.

(f) *Definitions of terms.* For purposes of this section:

(1) *Accountant*, as used in paragraphs (b) through (e) of this section, means a certified public accountant or public accountant performing services in

connection with an engagement for which independence is required. References to the accountant include any accounting firm with which the certified public accountant or public accountant is affiliated.

(2) *Accounting firm* means an organization (whether it is a sole proprietorship, incorporated association, partnership, corporation, limited liability company, limited liability partnership, or other legal entity) that is engaged in the practice of public accounting and furnishes reports or other documents filed with the Commission or otherwise prepared under the securities laws, and all of the organization's departments, divisions, parents, subsidiaries, and associated entities, including those located outside of the United States. Accounting firm also includes the organization's pension, retirement, investment, or similar plans.

(3) *Accounting role or financial reporting oversight role* means a role in which a person is in a position to or does:

(i) Exercise more than minimal influence over the contents of the accounting records or anyone who prepares them; or

(ii) Exercise influence over the contents of the financial statements or anyone who prepares them, such as when the person is a member of the board of directors or similar management or governing body, chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, vice president of marketing, or any equivalent position.

(4) *Affiliate of the audit client* means:

(i) An entity that has control over the audit client, or over which the audit client has control, or which is under common control with the audit client, including the audit client's parents and subsidiaries;

(ii) An entity over which the audit client has significant influence, unless the entity is not material to the audit client;

(iii) An entity that has significant influence over the audit client, unless the audit client is not material to the entity; and

(iv) Each entity in the investment company complex when the audit client is an entity that is part of an investment company complex.

(5) *Audit and professional engagement period* includes both:

(i) The period covered by any financial statements being audited or reviewed (the "audit period"); and

(ii) The period of the engagement to audit or review the audit client's financial statements or to prepare a report filed with the Commission (the "professional engagement period"):

(A) The professional engagement period begins when the accountant either signs an initial engagement letter (or other agreement to review or audit a client's financial statements) or begins audit, review, or attest procedures, whichever is earlier; and

(B) The professional engagement period ends when the audit client or the accountant notifies the Commission that the client is no longer that accountant's audit client.

(iii) For audits of the financial statements of foreign private issuers, the "audit and professional engagement period" does not include periods ended prior to the first day of the last fiscal year before the foreign private issuer first filed, or was required to file, a registration statement or report with the Commission, provided there has been full compliance with home country independence standards in all prior periods covered by any registration statement or report filed with the Commission.

(6) *Audit client* means the entity whose financial statements or other information is being audited, reviewed, or attested and any affiliates of the audit client, other than, for purposes of paragraph (c)(1)(i) of this section, entities that are affiliates of the audit client only by virtue of paragraph (f)(4)(ii) or (f)(4)(iii) of this section.

(7) *Audit engagement team* means all partners, principals, shareholders, and professional employees participating in an audit, review, or attestation engagement of an audit client, including those conducting concurring or second partner reviews and all persons who consult with others on the audit engagement team during the audit, review, or attestation engagement regarding technical or industry-specific issues, transactions, or events.

(8) *Chain of command* means all persons who:

(i) Supervise or have direct management responsibility for the audit, including at all successively senior levels through the accounting firm's chief executive;

(ii) Evaluate the performance or recommend the compensation of the audit engagement partner; or

(iii) Provide quality control or other oversight of the audit.

(9) *Close family members* means a person's spouse, spousal equivalent, parent, dependent, nondependent child, and sibling.

(10) *Contingent fee* means, except as stated in the next sentence, any fee established for the sale of a product or the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such product or service. Solely for the purposes of this section, a fee is not a "contingent fee" if it is fixed by courts or other public authorities, or, in tax matters, if determined based on the results of judicial proceedings or the findings of governmental agencies. Fees may vary depending, for example, on the complexity of services rendered.

(11) *Covered persons in the firm* means the following partners, principals, shareholders, and employees of an accounting firm:

(i) The "audit engagement team";

(ii) The "chain of command";

(iii) Any other partner, principal, shareholder, or managerial employee of the accounting firm who has provided ten or more hours of non-audit services to the audit client for the period beginning on the date such services are provided and ending on the date the accounting firm signs the report on the financial statements for the fiscal year during which those services are provided, or who expects to provide ten or more hours of non-audit services to the audit client on a recurring basis; and

(iv) Any other partner, principal, or shareholder from an "office" of the accounting firm in which the lead audit engagement partner primarily practices in connection with the audit.

(12) *Group* means two or more persons who act together for the purposes of acquiring, holding, voting, or disposing of securities of a registrant.

(13) *Immediate family members* means a person's spouse, spousal equivalent, and dependents.

(14) *Investment company complex*.

(i) "Investment company complex" includes:

(A) An investment company and its investment adviser or sponsor;

(B) Any entity controlled by or controlling an investment adviser or sponsor in paragraph (f)(14)(i)(A) of this section, or any entity under common control with an investment adviser or sponsor in paragraph (f)(14)(i)(A) of this section if the entity:

(1) Is an investment adviser or sponsor; or

(2) Is engaged in the business of providing administrative, custodian, underwriting, or transfer agent services to any investment company, investment adviser, or sponsor; and

(C) Any investment company or entity that would be an investment company but for the exclusions provided by section 3(c) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(c)) that has an investment adviser or sponsor included in this definition by either paragraph (f)(14)(i)(A) or (f)(14)(i)(B) of this section.

(ii) An investment adviser, for purposes of this definition, does not include a sub-adviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser.

(iii) Sponsor, for purposes of this definition, is an entity that establishes a unit investment trust.

(15) *Office* means a distinct sub-group within an accounting firm, whether distinguished along geographic or practice lines.

(16) *Rabbi trust* means an irrevocable trust whose assets are not accessible to the accounting firm until all benefit obligations have been met, but are subject to the claims of creditors in bankruptcy or insolvency.

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

4. The general authority citation for Part 240 is revised to read, as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78f, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4 and 80b-11, unless otherwise noted.

* * * * *

5. By amending § 240.14a-101 to add paragraph (e) to Item 9 to read as follows:

§ 240.14a-101 Schedule 14A Information required in proxy statement.

* * * * *

Item 9. *Independent public accountants.*

* * * * *

(e)(1) Disclose, under the caption *Audit Fees*, the aggregate fees billed for professional services rendered for the audit of the registrant's annual financial statements for the most recent fiscal year and the reviews of the financial statements included in the registrant's Forms 10-Q (17 CFR 249.308a) or 10-QSB (17 CFR 249.308b) for that fiscal year.

(2) Disclose, under the caption *Financial Information Systems Design and Implementation Fees*, the aggregate fees billed for the professional services described in Paragraph (c)(4)(ii) of Rule 2-01 of Regulation S-X (17 CFR 210.2-01(c)(4)(ii)) rendered by the principal accountant for the most recent fiscal year. For purposes of this disclosure item, registrants that are

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investment companies must disclose fees billed for services rendered to the registrant, the registrant's investment adviser (not including any sub-adviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser), and any entity controlling, controlled by, or under common control with the adviser that provides services to the registrant.

(3) Disclose, under the caption *All Other Fees*, the aggregate fees billed for services rendered by the principal accountant, other than the services covered in paragraphs (e)(1) and (e)(2) of this section, for the most recent fiscal year. For purposes of this disclosure item, registrants that are investment

companies must disclose fees billed for services rendered to the registrant, the registrant's investment adviser (not including any sub-adviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser), and any entity controlling, controlled by, or under common control with the adviser that provides services to the registrant.

(4) Disclose whether the audit committee of the board of directors, or if there is no such committee then the board of directors, has considered whether the provision of the services covered in paragraphs (e)(2) and (e)(3) of this section is compatible with

maintaining the principal accountant's independence.

(5) If greater than 50 percent, disclose the percentage of the hours expended on the principal accountant's engagement to audit the registrant's financial statements for the most recent fiscal year that were attributed to work performed by persons other than the principal accountant's full-time, permanent employees.

Dated: November 21, 2000.

By the Commission.

Jonathan G. Katz,
Secretary.

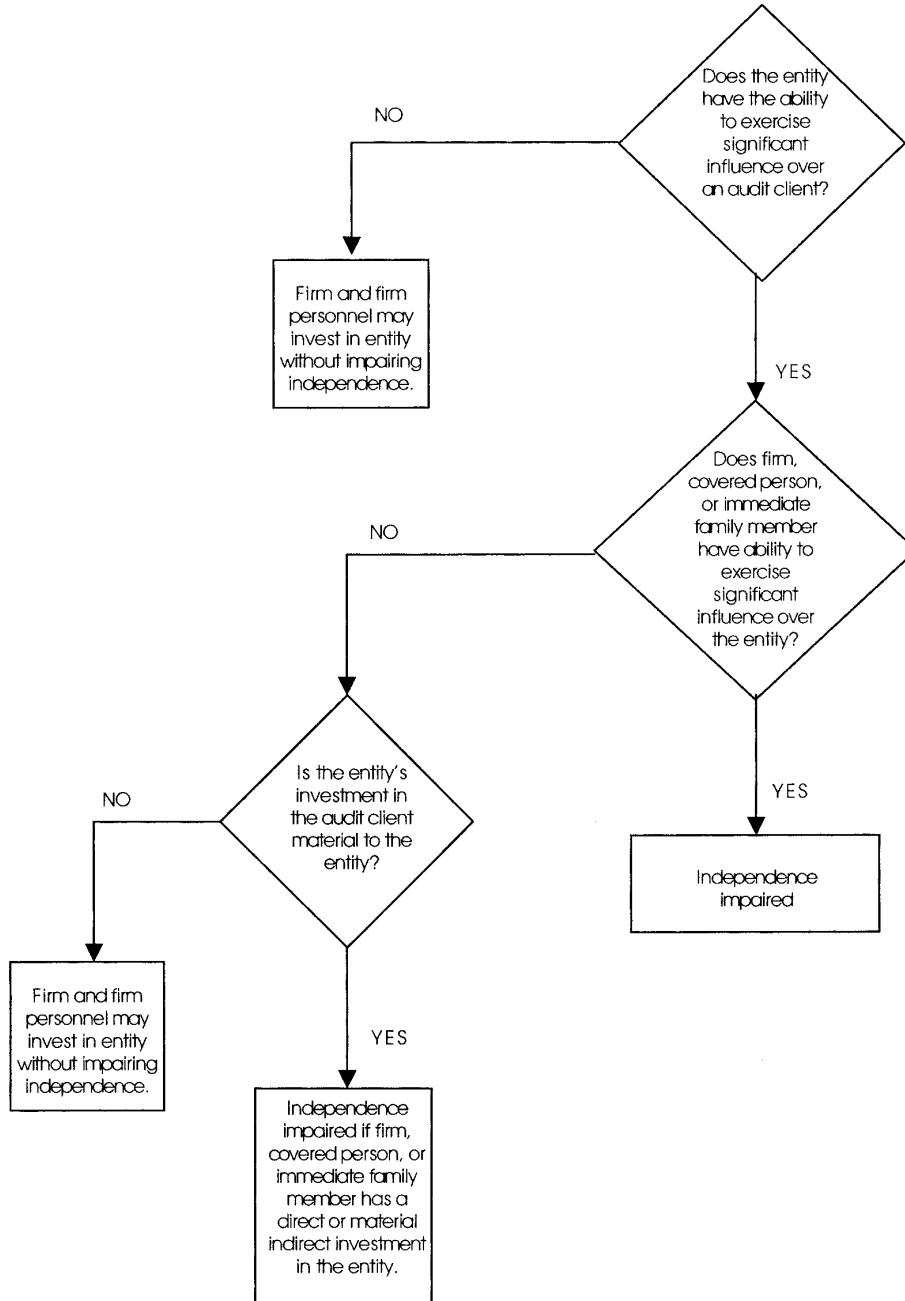
BILLING CODE 8010-01-P

Note: The Appendices to the Preamble will not appear in the Code of Federal Regulations.

APPENDIX A

Investing in Entities that Invest in Audit Clients

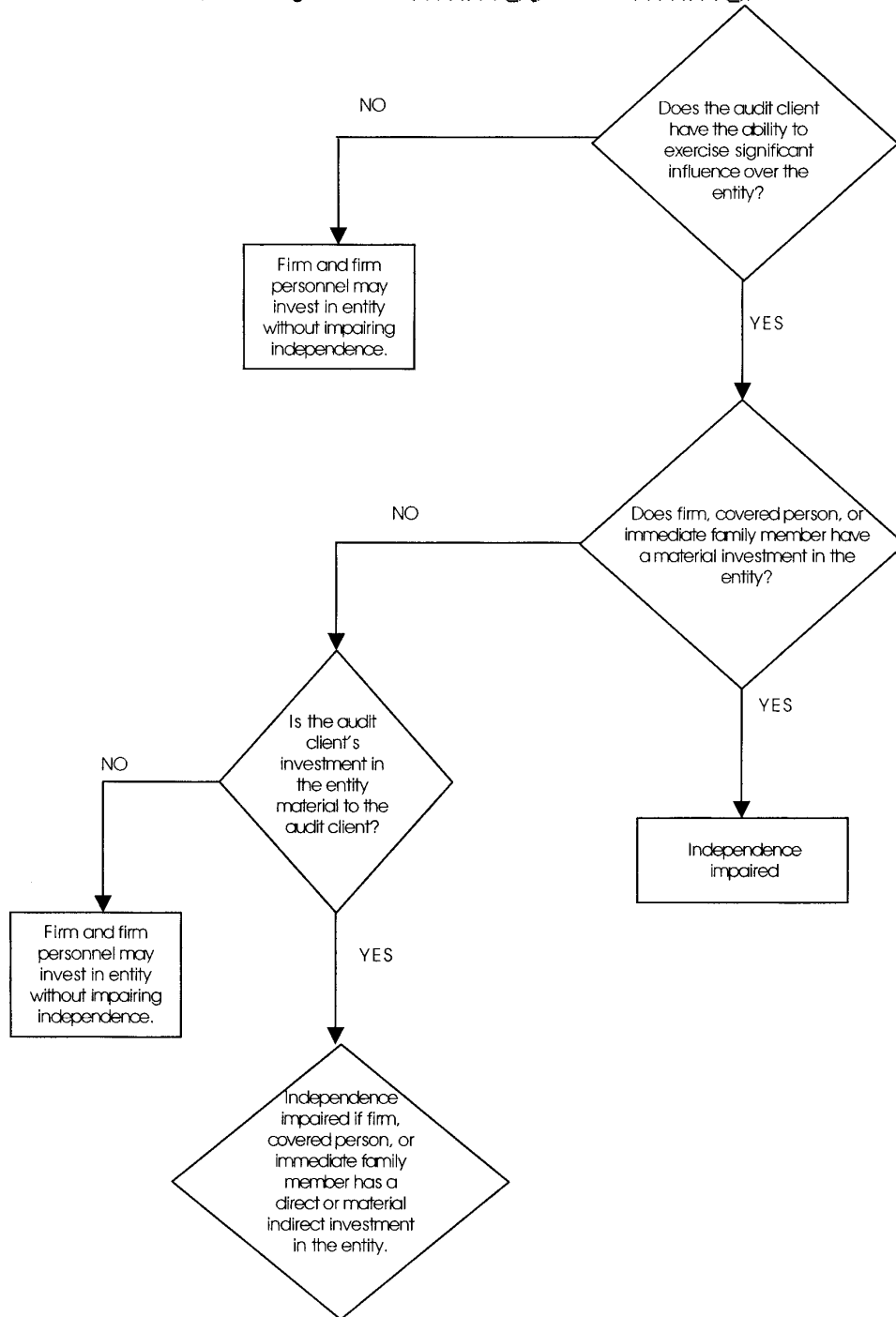
(Illustrating Rules 2-01(c)(1)(i)(E)(1)(i) and 2-01(c)(1)(i)(E)(3))



APPENDIX B

Investing in Entities in which Audit Clients Invest

(Illustrating Rules 2-01(c)(1)(i)(E)(1)(i) and 2-01(c)(1)(i)(E)(2))



FOR IMMEDIATE RELEASE

2001-4

Levitt Sends Letter to Audit Committees

Washington, DC, January 5, 2001 - Securities and Exchange Commission Chairman Arthur Levitt today sent the following letter to the audit committee chairmen of the top 5,000 public companies.

Dear Members of the Audit Committee:

Almost a year ago, the Commission, our major markets and standard setters -- building on the work of the Blue Ribbon Committee on Audit Committee Effectiveness--adopted rules that strengthen the audit committee's independence, and give its members the tools and the wherewithal to fulfill their duty to the investing public. In addition, the rules improve communications, through greater disclosure, among the board, outside auditors and management.

When auditors and the board engage in frank and meaningful discussions about the significant, but sometimes gray areas of accounting, both the company's and its shareholders' interests are served. In this way, the board, including the audit committee, management, and outside auditors form a "three-legged stool" of responsible disclosure and active oversight.

In recent months, the Commission and the accounting profession have been engaged in a discussion on the vital issue of auditor independence. Among other reasons, increased economic pressures on the profession, coupled with greater competition and consolidation, mandated that we modernize and further clarify independence requirements. This discussion has led to a combination of rules and disclosures that establish clear guidelines on the non-audit services an auditor may provide to an audit client, as well as the meaningful involvement of the audit committee in consideration of consulting services that may impair independence. More specifically, the Commission's rules require companies to state in their proxy statement whether the audit committee has considered whether the provision of the non-audit services is compatible with maintaining the auditor's independence.

In August, the Panel on Audit Effectiveness issued its final report recommending that, among other things, audit committees obtain annual reports from management assessing the company's internal controls, specify in their charters that the outside

auditor is ultimately accountable to the board of directors and audit committee, inquire about time pressures on the auditor, and pre-approve non-audit services provided by the auditor.

The Panel, more specifically, provided guidance an audit committee can use to determine the appropriateness of a service. This guidance includes:

1. Whether the service is being performed principally for the audit committee.
2. The effects of the service, if any, on audit effectiveness or on the quality and timeliness of the entity's financial reporting process.
3. Whether the service would be performed by specialists (e.g., technology specialists) who ordinarily also provide recurring audit support.
4. Whether the service would be performed by audit personnel, and if so, whether it will enhance their knowledge of the entity's business and operations.
5. Whether the role of those performing the service would be inconsistent with the auditors' role (e.g., a role where neutrality, impartiality, and auditor skepticism are likely to be subverted).
6. Whether the audit firm personnel would be assuming a management role or creating a mutual or conflicting interest with management.
7. Whether the auditors, in effect, would be "auditing their own numbers."
8. Whether the project must be started and completed very quickly.
9. Whether the audit firm has unique expertise in the service.
10. The size of the fee(s) for the non-audit service(s).

I encourage your audit committee to discuss the Panel's recommendations as well as these ten factors and consider them in relevant discussions with your auditor. The Panel's report can be found at www.pobauditpanel.org/. I also encourage you to

read the Commission's rule release at
www.sec.gov/rules/final/33-7919.htm.

During my almost eight years at the Commission, I have come to believe that one of the most reliable guardians of the public interest is a competent, committed, independent and tough-minded audit committee. The audit committee stands to protect and preserve the integrity of America's financial reporting process. I encourage your committee to take every step possible to ensure that the integrity of the financial statements, and by extension, the interest of shareholders, remains second to none.

Sincerely,

Arthur Levitt

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Speech by SEC Acting Chairman:
This Year's Proxy Season: Sunlight Shines on Auditor Independence and Executive Compensation

Remarks by

Acting Chairman Laura S. Unger

U.S. Securities & Exchange Commission

Center for Professional Education, Inc.
Washington, D.C.

June 25, 2001

Good morning. For those in the crowd who are securities lawyers, you've no doubt heard the phrase "sunlight is the best disinfectant." In other words, full disclosure makes our securities markets fairer and more efficient. I'd like to use my time this morning to prove that this old adage continues to ring true today - not just as it relates to the purchase or sale of securities, but to corporate governance matters as well. If there was ever any doubt that sunlight is the best disinfectant, the results from this year's recently-ended proxy season prove it. Our eyes were opened wide in two particular areas: auditor independence and executive compensation.

For the first time, as a result of our new auditor independence rules, public companies were required to disclose in their proxy statements their expenditures for both audit and non-audit consulting services. The numbers disclosed leave no doubt that the Commission's concern about the potential for auditors' conflicts of interest to affect the integrity of financial statements was justified. In fact, the numbers appear to demonstrate that the problem may be larger than we originally thought, but I'll get to that in a minute.

Some disclosures about executive compensation were also startling. Along with many investors, we were taken aback at some of the compensation packages awarded to executives. Executive compensation disclosure is not new. What is new is looking at this information against the backdrop of current economic conditions. It's no secret that the pay of top executives has skyrocketed in the last decade. But you have to scratch your head at seeing these salaries continue to go sky-high during the recent leaner times in the market, when companies don't appear to be doing as well and shareholders are suffering losses. Obviously it's not the Commission's role to judge these packages. Rather, it is our role to ensure that the packages are put on full display for shareholders. A related area benefiting from more sunlight that I'll touch upon is options repricing - what companies are doing about "underwater" stock options.

Let's Start with the Auditor Independence Rules.

As you are all well aware, the Commission adopted new auditor independence rules last year after months of heated debate. The rules were designed to limit the scope of consulting services offered by audit firms to SEC audit clients, and to direct sunlight on

the types and magnitude of other services being provided by audit firms to SEC audit clients.

At the time of the rulemaking and during the public hearings, the Commission was very interested in learning the extent to which accounting firms were providing non-audit services to SEC audit clients, but no one offered any concrete data. Many in the accounting industry argued that the Commission should not go forward with the rulemaking because of a lack of evidence demonstrating that providing non-audit services to an audit client could impair the integrity of the financial statements.

The Commission had good reason, however, for forging ahead. As early as 1988, large public accounting firms were looking to enter into joint ventures, limited partnership agreements, and other similar arrangements with audit clients. According to the Commission's estimates, consulting was contributing to half of the Big Five's revenue - and was growing three times as fast as their basic auditing business. Public companies such as Waste Management, Cendant, Sunbeam and Microstrategy were announcing accounting irregularities all too often, and raising concerns at the Commission about the integrity of financial statements.

The Commission was also seeing many companies restate their financial statements: 104 in 1997, 116 in 1998, and 142 in 1999. The growing trend in the number of restatements did not abate in 2000. According to a recent study, there were 156 restatements last year. The study further reports that the restatements resulted in total market losses of \$31.2 billion in 2000, \$24.2 billion in 1999 and \$17.7 billion in 1998.

The final auditor independence rules meet to a large degree the Commission's original goals. We could have engaged in substantive regulation and banned non-audit services. We didn't. Rather, we put faith in the fact again that sunlight would serve as the best disinfectant and adopted a disclosure-based approach. The new rules charge public companies with disclosing in their annual proxy statements the fees for audit, IT consulting and all other services provided by their auditors during the last fiscal year. In addition, they require the audit committee to state that it has considered whether providing non-audit services is compatible with maintaining the auditor's independence.

The Commission's Office of Chief Accountant recently released data based on the latest proxy filings from more than half of the Fortune 1000 companies regarding fees paid for audit and non-audit services. The data is illuminating.

It shows that, on average, for every dollar of audit fee audit clients paid to their independent accountants, they paid \$2.69 for non-audit services. On average, non-audit fees comprised 73% of total fees companies paid to their accounting firms. The ten companies that paid the most in IT fees paid their independent accountants between \$3.57 and \$32.33 for non-audit services for each dollar of the audit fee paid.

What is the significance of this information? Although the numbers we're seeing as a result of the new disclosure obviously don't prove that the audits for these companies have been impaired, I think we were all quite surprised by the disparity between the auditing and consulting fees.

Disclosure in this context serves a number of purposes. First, and most apparent, investors will now receive information on the amount of non-audit services provided by their companies' auditors. This will enable investors to decide for themselves whether the auditor of the company they've invested in - who, after all, is supposed to be their watchdog - is really in a situation to bark should the company attempt to steal some biscuits. I think that if we've learned anything from this first proxy season under the new rules, it is that these disclosures will receive plenty of attention.

Second, disclosure requirements have the capacity to shape the behavior of the company required to make the disclosure. Companies may perceive disclosing the ratio of fees for non-audit to audit services will decrease investor confidence in the validity of their financial statements. In that case, we can expect companies to take steps to improve that ratio - if doing so costs less than finding another service provider to perform those non-audit services. Disclosure will create market discipline regarding the size of the fees for non-audit services in a flexible and efficient way.

Third, the disclosures required by the final rules promote effective corporate governance. As I mentioned before, under the Commission's final rules, audit committees must state that they have considered whether the provision of non-audit services is compatible with maintaining the auditor's independence.

The financial reporting process is often analogized to a three-legged stool - with the public company's management, outside auditors and audit committee comprising the three legs. In the last few years, a number of steps have been taken to make sure that audit committees are holding up their end of the stool; including the recommendations of Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, new SRO audit committees rules, new Commission rules, Standard No.1 of the Independence Standards Board, and the recommendations of the O'Malley Panel. The audit committee disclosure required by the Commission's final rules complements these other initiatives. It encourages audit committees to focus particular attention on the effect of non-audit services on the auditor's independence.

Fourth, and finally, the new disclosures lay the groundwork for future study of the effect of non-audit services on auditor independence. Even casual observers of the Commission's recent rulemaking probably know that certain accounting firms argued that there was no empirical evidence to show that providing non-audit services affect audit quality. What accounting firms didn't talk about was that such "evidence" would be hard to come by. Among other things, accounting firms and their audit clients did not have to disclose the audit and non-audit fees charged to individual clients. Indeed, some of the most useful recent studies of the relationship of non-audit services to audit failures are based on U.K. companies, where disclosures similar to those in the Commission's final rules have been required for the last several years. I hope that the Commission's new disclosure rules will enable improved study and better empirical information on the effect of various non-audit services in the future.

One last word on auditor independence. During our rulemaking, many argued the problem was only in our minds, as we couldn't cite examples of audit failures where the auditors had also provided significant consulting or other non-audit services. We put this notion to rest last week when we sued Arthur Andersen for having issued false and

misleading audit reports in the Waste Management debacle. Although the Commission did not charge Andersen with a violation of the auditor independence rules, the Commission's order did summarize some of the factors that may have played into Andersen's failure to make the hard decisions, including:

1. Andersen regarded Waste Management as a "crown jewel" client;
2. Until 1997, every CFO and CAO had previously worked for Andersen; and
3. Between 1991-97, Andersen billed Waste Management approximately \$7.5 million in audit fees and \$11.8 million in non-audit fees.

In my mind, this is the sort of information that should be disclosed to investors. The case should silence many of the critics of our new rules.

Executive Compensation

This past proxy season has also shed quite a bit of sunlight on executive compensation. As a result of Commission initiatives over the last decade, we have seen improved disclosure of executive compensation. Few investors seemed to take issue with executive compensation during the bull market. So long as shareholders profited from the rising value of their stock, it seemed acceptable that corporate executives be rewarded - in many cases, amply so - for their companies' performance.

But times have changed. This past year has generally brought about leaner times in the market. Yet while stocks have gone down in value, many officers' salaries continue to trend upwards. Now seems the time to realize the true value of our disclosure rules. How will shareholders react to lavish executive salaries when their share value no longer appreciates?

The current edition of Fortune magazine adds grist to the mill. The cover story contains the glaring headline: "Inside the Great CEO Pay Heist." According to the article, the number one earners in each of the past five years received compensation packages valued cumulatively at nearly \$1.4 billion. Despite paying their executives a staggering average of \$274 million a year, four of the five companies have under-performed. Last year, the CEO with the largest pay package received \$381 million, if you include the \$90 million Gulfstream jet. Now that is pay that I'd like SEC staffers to have parity with!

If you are offended by this data, then all I can say is that our execution compensation disclosure rules have succeeded. Such is the beauty of disclosure. The Commission need not make a judgment about the appropriate level of compensation for any given CEO - the marketplace will make that judgment. But it is our place to ensure that the marketplace has the relevant data to make a well-informed judgment. If I were a shareholder of a company that was lagging, I would want to know that my CEO was being paid \$381 million. And thanks to SEC rules, as a shareholder of that company, I have a right to know.

On a related but separate note, I worry that some directors do not always fully discharge their duties. In the same issue of Fortune, several directors who sit on executive compensation committees anonymously admitted that the executive compensation committees were essentially "in the pocket of the CEOs." The article tells the story of an

executive who ran his division into the ground. He was, according to the article, "the architect of some terrible deals" and "never seemed to have a handle on what was going on." He nonetheless received a large bonus. The chairman of the compensation committee admitted "this stuff is wrong" but said "we've got to do it." As elaborated on in the article, the committee believed it had to go along with management or else risk losing favor. Another compensation committee member tells the story that he wouldn't give the CEO the pay that the CEO wanted. Later, all the people on the board were rotated to new committees.

These admissions trouble me. Directors have an obligation to the company and its shareholders, not the CEO. Kow-towing to management and blindly signing off on large compensation packages is not a proper discharge of a director's duties. An individual too scared or shy to ask the tough questions and take tough - but justified - action, should not serve on the compensation committee and perhaps the board itself.

I remain curious to see how investors react to this year's proxy disclosures about executive compensation.

Option Repricings

The market decline has forced many companies, primarily high tech companies, to address the problem of "underwater" stock options. As a result, we have seen many companies reprice their employees' stock options. Some of the repricings we've all read about in the press have been done unilaterally. However, many issuers have structured the repricings as option "exchanges," that may come within the issuer tender offer rules under the Securities Exchange Act of 1934. These covered exchange offers generally involve options issued under "broad-based" plans that are open to rank-and-file employees as well as executive or senior officers of the issuer.

Unlike the situation where an issuer reprices its options unilaterally, option holders in an exchange offer have to make difficult and individual decisions. For example, the exchange offer may invite options holders to relinquish a fully or partially vested option in exchange for a new option to be granted, and priced, in six months time. Clearly this decision is an investment decision, not just a compensation decision, and the option holder is entitled to full and satisfactory disclosure.

Issuers conducting broad-based exchanges as tender offers have run into problems with some tender offer requirements. Their need to treat option holders differently in order to accomplish their compensation objectives makes it difficult for them to comply with the "all holders" and "best price" conditions under the issuer tender rules. To alleviate this situation, the Commission's Division of Corporation Finance issued an order this spring that exempts issuers from compliance with these two requirements under certain circumstances.

The treatment of broad-based option exchanges as tender offers has brought sunlight to the repricings, improving both the extent and the timing of public disclosure about these transactions.

Conclusion

While the long-term impact of recent rules and guidance calling for increased disclosure cannot be predicted, the Commission's goal is to help establish the foundation for a reliable accounting and financial reporting system. The new information coming to light empowers audit committees and investors by providing them with additional tools with which to engage in active and vigilant corporate governance - activity that is essential to promoting the quality and integrity of financial reporting. Ultimately, greater sunlight on corporate actions and decisions will brighten all of corporate America.

<http://www.sec.gov/news/speech/spch502.htm>

BERKSHIRE HATHAWAY INC.**1440 Kiewit Plaza
Omaha, NE 68131**

May 17, 1999

Via Federal Express

Mr. Richard A. Grasso
Chairman and CEO
New York Stock Exchange, Inc.
11 Wall Street
New York, NY 10005

Dear Dick::

You have asked me to comment on the recommendations that the Blue Ribbon Committee made in respect to the activities and composition of audit committees. Based upon my service on the boards of nineteen public companies, I believe that, in aggregate, the recommendations are a mistake and would add cost and liability to the activities of the audit committee without improving either the quality of financial statements or the effectiveness of internal controls.

An audit committee that meets for a few hours several times a year is simply not going to pick up anything that is missed by the outside auditors. What they need to do is learn what those auditors know — a result that frequently does not occur, even (perhaps especially) when major shortcomings exist. Therefore, the task of the audit committee should be to hold the feet of the outside auditors to the fire. This does not require members that are independent of management or financially sophisticated. What it requires is focus.

The audit committee should simply ask the outside auditors to reply specifically and in detail to three questions:

Mr. Richard A. Grasso
May 17, 1999
Page 2

1. If the auditor were solely responsible for preparation of the company's financial statements, would they have been prepared in any way differently than the manner selected by management? They should inquire as to both material and nonmaterial differences. If the auditor would have done anything differently than management, an explanation should be made of management's argument and the auditor's response.
2. If the auditor were an investor, would he have received the information essential to a proper understanding of the company's financial performance during the reporting period?
3. Is the company following the same internal audit procedure that would be followed if the auditor himself were CEO? If not, what are the differences and why?

The answers to these questions should be spelled out fully in the minutes of the committee. By doing so auditors would be putting themselves on the line for liability if accounting or controls have been faulty.

Simply put, audit committees cannot act as auditors. Their true job — and I would argue the only important function that they can adequately discharge — is to make sure that the auditors *do* their job instead of becoming subservient to management. Monetary liability is what will prevent this subservience. Absent some liability - or with the shifting of liability to the audit committee - auditors will continue to tread very lightly in challenging management's presentation of financial results. A competitive world insures this: "Whose bread I eat, whose song I sing."

Dick, I'll be happy to further elaborate on these views if it win be helpful.

Sincerely,

Warren E. Buffet

cc: Arthur Levit: (via Federal Express)

AUDIT COMMITTEES

A Practical Guide

Published by
The National Association of Corporate Directors
and
The Center for Board Leadership

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NATIONAL ASSOCIATION OF CORPORATE DIRECTORS, WASHINGTON, D.C.

Appendix D

Sample Audit Committee Calendar

	Quarter			Year	As
	1st	2nd	3rd	End	Necessary
Continuing Education					
Orientation—new members					X
Key business/financial risk areas		X	X		
Critical business process controls		X	X		
Evolving important industry issues					X
New regulatory/financial reporting matters					X
visits to selected operating divisions					X
Expectations					
Meet with and confirm specific understanding of mutual expectations with management and auditors				X	
Review and Asses~(See Charter)					
The company's risk management process	X				
Auditor independence and the overall scope and focus of the annual/interim external audit program	X				
The overall scope and focus of the internal audit plan	X				
Year-end financial statements and report on Form 10-K				X	
Other regulatory reports					X
Auditor independence and the results of the annual external audit, including key risks and controls, compliance issues, and quality of overall reporting				X	X
The results of the external auditor quarterly interim reviews	X	X	X	X	
The external audit management letter and company response				X	
The results of the internal audit program, including key risks and controls and compliance issues	X		X		X
SEC inquiries and the results of examinations by other regulatory authorities					X

	1st	Quarter 2nd	3rd	Year End	As Necessary
Review, Assess, and Approv~See Charter)					
The code of ethical conduct	x				
The internal audit charter		x			
Changes in important accounting principles and the application thereof				x	x
Significant conflicts of interest and related-party transactions				x	x
External auditor performance and changes in external audit firm	x				x
Internal auditor performance and changes in internal audit leadership and key financial management					x
Self-Assessment / Committee Reporting					
Perform periodic self-assessment, including review of committee charter					x
Prepare committee reports to shareholders and the full board				x	x

Note: The committee calendar contemplates committee chairperson leadership in:

- the development of a detailed agenda for each meeting with input from management and auditors
- maintaining regular, ongoing contact with internal and external auditors and management
- maintaining awareness of management communications with analysts and other users of financial information, and
- initiating and coordinating activities related to expectations and self assessment.

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SCHEDULE 14A

(RULE 14A-101)

INFORMATION REQUIRED IN PROXY STATEMENT

SCHEDULE 14A INFORMATION
PROXY STATEMENT PURSUANT TO SECTION 14(A) OF THE SECURITIES
EXCHANGE ACT OF 1934 (AMENDMENT NO.)

Filed by the Registrant [X]

Filed by a Party other than the Registrant []

Check the appropriate box:

- [] Preliminary Proxy Statement
- [] Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))
- [X] Definitive Proxy Statement
- [] Definitive Additional Materials
- [] Soliciting Material Pursuant to Rule 240.14a-12

The Coca-Cola Company

(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

- [X] No fee required.
- [] Fee computed on table below per Exchange Act Rules 14a-6(i)(1) and 0-11.

(1) Title of each class of securities to which transaction applies:

(2) Aggregate number of securities to which transaction applies:

(3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (set forth the amount on which the filing fee is calculated and state how it was determined):

(4) Proposed maximum aggregate value of transaction:

(5) Total fee paid:

[] Fee paid previously with preliminary materials:

[] Check box if any part of the fee is offset as provided by Exchange Act Rule

0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

(1) Amount Previously Paid:

(2) Form, Schedule or Registration Statement No.:

(3) Filing Party:

(4) Date Filed:

REPORT OF THE AUDIT COMMITTEE

For many years, the Company has had an Audit Committee composed entirely of non-management directors. The members of the Audit Committee meet the independence and experience requirements of the New York Stock Exchange. In 2000, the Committee met three times. Our Audit Committee has long followed the substance of the procedures recommended in the report of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, sponsored by the major securities markets, issued in February 1999, and our Committee has long been advised by independent legal counsel, in its role of overseeing financial reporting and internal control matters. Thus, when last year the SEC and the Exchange adopted new audit committee requirements, no significant changes in the practices of our Audit Committee were required. The Committee has adopted, and in February 2001 our Board of Directors reapproved, a charter outlining the practices it follows; a copy of the charter is attached as Appendix I to this proxy statement.

During the year 2000, at each of its meetings, the Committee met with the senior members of the Company's financial management team, our director of internal audit, the Company's general counsel and our independent auditors. The Committee's agenda is established by the Committee's chairman and the

director of internal audit. The Committee had private sessions, at each of its meetings, with the Company's independent auditors and, separately, with the director of internal audit, at which candid discussions of financial management, accounting and internal control issues took place.

The Committee recommended to the Board of Directors the engagement of Ernst & Young LLP as our independent auditors and reviewed with the Company's financial managers, the independent auditors, and the director of internal audit, overall audit scopes and plans, the results of internal and external audit examinations, evaluations by the auditors of the Company's internal controls and the quality of the Company's financial reporting.

Management has reviewed the audited financial statements in the Annual Report with the Audit Committee including a discussion of the quality, not just the acceptability, of the accounting principles, the reasonableness of significant judgments, and the clarity of disclosures in the financial statements. In addressing the quality of management's accounting judgments, members of the Audit Committee asked for management's representations that the audited consolidated financial statements of the Company have been prepared in conformity with generally accepted accounting principles, and have expressed to both management and auditors their general preference for conservative policies when a range of accounting options is available.

In its meetings with representatives of the independent auditors, the Committee asks them to address, and discusses their responses to several questions that the Committee believes are particularly relevant to its oversight. These questions include:

- Are there any significant accounting judgments made by management in preparing the financial statements that would have been made differently had the auditors themselves prepared and been responsible for the financial statements?

- Based on the auditors' experience, and their knowledge of the Company, do the Company's financial statements fairly present to investors, with clarity and completeness, the Company's financial position and performance for the reporting period in accordance with generally accepted accounting principles, and SEC disclosure requirements?

- Based on the auditors' experience, and their knowledge of the Company, has the Company implemented internal controls and internal audit procedures that are appropriate for the Company?

The Committee believes that, by thus focusing its discussions with the independent auditors, it can promote a meaningful dialogue that provides a basis for its oversight judgments.

The Committee also discussed with the independent auditors other matters required to be discussed by the auditors with the Committee under Statement on Auditing Standards No. 61 (communication with audit committees). The Committee received and discussed with the auditors their annual written report on their independence from the Company and its management, which is made under Independence Standards Board Standard No. 1 (independence discussions with audit committees), and considered with the auditors whether the provision of financial information systems design and implementation and other non-audit services provided by them to the Company during 2000 was compatible with the auditors' independence.

In performing all of these functions, the Audit Committee acts only in an oversight capacity. The Committee does not complete its reviews prior to the Company's public announcements of financial results and, necessarily, in its oversight role, the Committee relies on the work and assurances of the Company's management, which has the primary responsibility for financial statements and reports, and of the independent auditors, who, in their report, express an opinion on the conformity of the Company's annual financial statements to generally accepted accounting principles.

In reliance on these reviews and discussions, and the report of the independent auditors, the Audit Committee has recommended to the Board of Directors, and the Board has approved, that the audited financial statements be included in the Company's Annual Report on Form 10-K for the year ended December 31, 2000, for filing with the Securities and Exchange Commission.

Peter V. Ueberroth, Chairman
Ronald W. Allen
Cathleen P. Black
Warren E. Buffett

APPENDIX I

AUDIT COMMITTEE CHARTER

ORGANIZATION

This charter governs the operations of the Audit Committee (the "Committee") and furthers its description in the Company's By-laws. The charter will be reviewed and reassessed by the Committee and will be approved by the Board of Directors (the "Board"), at least annually. The Committee shall be appointed by the Board and shall comprise at least three directors, each of whom are independent of management and the Company. Members of the Committee will be considered independent if, in the determination of the Board they meet the New York Stock Exchange definition of "independence." All committee members will be financially literate, or will become financially literate within a reasonable period of time after appointment to the committee, and at least one member will have accounting or related financial management expertise as determined by the Board.

The Committee will meet as often as may be deemed necessary or appropriate in its judgment, generally at least three times each year, and at such times and places and in such manner as the Committee shall determine. The Committee shall report to the Board with respect to its meetings. The Board will designate a Chairperson for the Committee. The majority of the members of the Committee shall constitute a quorum.

STATEMENT OF POLICY

The Committee will provide assistance to the Board in fulfilling its oversight responsibility to the share owners and others relating to the Company's financial statements and the financial reporting process, the systems of internal accounting and financial controls, the internal audit function, the annual independent audit of the Company's financial statements, and the legal compliance and ethics programs as established by management and the Board, including the Company's Code of Business Conduct. In so doing, it is the responsibility of the Committee to maintain free and open communication between the Committee, independent auditors, the internal auditors and management of the Company. In discharging its oversight role, the Committee is empowered to investigate any matter brought to its attention with full access to all books, records,

facilities, and personnel of the Company and the power to retain outside counsel or other experts for this purpose.

RESPONSIBILITIES AND PROCESSES

The primary responsibility of the Committee is to oversee the Company's financial reporting process on behalf of the Board and report the results of its activities to the Board. Management is responsible for preparing the Company's financial statements, and the independent auditors are responsible for auditing those financial statements. The Committee in carrying out its responsibilities believes its policies and procedures should remain flexible, in order to best react to changing conditions and circumstances. The Committee should take the appropriate actions to set the overall corporate "tone" for quality financial reporting, sound business risk practices, and ethical behavior.

The following shall be the principal recurring processes of the Committee in carrying out its oversight responsibilities. The processes are set forth as a guide with the understanding that the Committee may supplement them as appropriate.

- The Committee shall have a clear understanding with management and the independent auditors that the independent auditors are ultimately accountable to the Board and the Committee, as representatives of the Company's share owners. The Committee and the Board shall have the ultimate authority and responsibility to evaluate and, where appropriate, replace the independent auditors. The Committee shall discuss the auditors' independence from management and the Company and the matters included in the written disclosures required by the Independence Standards Board. Annually, the Committee will review and recommend to the Board the selection of the Company's independent auditors, subject to share owner approval.

- The Committee shall discuss with the internal auditors and the independent auditors the overall scope and plans for their respective audits including the adequacy of staffing and the compensation. Also, the Committee will discuss with management, the internal auditors, and the independent auditors the adequacy and effectiveness of the accounting and financial controls, including the Company's system to monitor and manage business risk, and legal and ethical compliance programs, including the Code of Business Conduct. Further, the Committee will meet separately with the internal auditors and the independent auditors, with and without management present, to discuss the results of their examinations and will provide

sufficient opportunity for the internal auditors and the independent auditors to meet privately with the members of the Committee to discuss any matters the internal auditors or the independent auditors wish to discuss in the absence of management.

- The Committee shall review the interim financial statements with management and the independent auditors prior to the filing of the Company's Quarterly Report on Form 10-Q. Also, the Committee will discuss the results of the quarterly review and any other matters required to be communicated to the Committee by the independent auditors under generally accepted auditing standards. The Chairman of the Committee may represent the entire Committee for the purposes of this review.

- The Committee shall review with management and the independent auditors the financial statements to be included in the Company's Annual Report on Form 10-K, (or the annual report to share owners if distributed prior to the filing of the Form 10-K) including their judgment about the quality, not just acceptability, of accounting principles, the reasonableness of significant judgments, and the clarity of the disclosures in the financial statements. The Committee will review with management and the independent auditors significant changes in the accounting policies of the Company and accounting and financial reporting proposals that may have a significant impact on the Company's financial reports. Also, the Committee will discuss the results of the annual audit and any other matters required to be communicated to the Committee by the independent auditors under generally accepted auditing standards. Based on these reviews, the Committee will make a recommendation to the Board as to whether the audited financial statements should be included in the Company's Annual Report on Form 10-K.

AMERICAN INTERNATIONAL GROUP, INC.
70 Pine Street, New York, N.Y. 10270

NOTICE OF ANNUAL MEETING OF SHAREHOLDERS
TO BE HELD MAY 16, 2001

April 9, 2001

To the Shareholders of AMERICAN INTERNATIONAL GROUP, INC.:

The Annual Meeting of Shareholders of AMERICAN INTERNATIONAL GROUP, INC. ('AIG') will be held at the offices of AIG at 72 Wall Street, Eighth Floor, New York, New York, on Wednesday, May 16, 2001, at 11:00 o'clock A.M., for the following purposes:

1. To elect 18 directors of AIG to hold office until the next annual election and until their successors are elected and qualified;
2. To act upon a proposal to select PricewaterhouseCoopers LLP as independent accountants for 2001;
3. To act upon a shareholder proposal requesting AIG to change the Board nomination process;
4. To act upon a shareholder proposal requesting AIG to provide a report on executive compensation;
5. To act upon a shareholder proposal requesting AIG to distribute certain statistical data on employees;
6. To act upon a shareholder proposal requesting AIG to adopt a policy requiring a majority of independent directors; and
7. To transact any other business that may properly come before the meeting.

Shareholders of record at the close of business on March 23, 2001 will be entitled to vote at the meeting. During the ten days prior to the meeting, a list of the shareholders will be available for inspection at the offices of AIG at 70 Pine Street, New York, New York.

By Order of the Board of Directors
KATHLEEN E. SHANNON

Secretary

REPORT OF THE AUDIT COMMITTEE

The role of the Audit Committee, comprised of Mrs. Hills and Messrs. Aidinoff, Conable, and Hoenemeyer for the year ended December 31, 2000, is to assist the Board of Directors in its oversight of AIG's financial reporting process. The Board of Directors, in its business judgment, has determined that all members of the Committee are 'independent', as required by applicable listing standards of the New York Stock Exchange. The Committee operates pursuant to a Charter that was last amended and restated by the Board on March 13, 2001, a copy of which is attached to this Proxy Statement as an Appendix. As set forth in the Audit Committee's Charter, the management of AIG is responsible for the preparation, presentation and integrity of AIG's financial statements, AIG's accounting and financial reporting principles and internal controls and procedures designed to assure compliance with accounting standards and applicable laws and regulations. The independent auditors are responsible for auditing AIG's financial statements and expressing an opinion as to their conformity with generally accepted accounting principles.

In the performance of its oversight function, the Committee has considered and discussed the audited financial statements with management and the independent auditors. The Committee has also discussed with the independent auditors the matters required to be discussed by Statement on Auditing Standards No. 61, Communication with Audit Committees, as currently in effect. Finally, the Committee has received the written disclosures and the letter from the independent auditors required by Independence Standards Board Standard No. 1, Independence Discussions with Audit Committees, as currently in effect, has considered whether the provision of non-audit services by the independent auditors to AIG is compatible with maintaining the auditors' independence and has discussed with the auditors the auditors' independence.

The members of the Audit Committee are not professionally engaged in the practice of auditing or accounting and are not experts in the fields of accounting or auditing, including in respect of auditor independence. Members of the Committee rely without independent verification on the information provided to them and on the representations made by management and the independent accountants. Accordingly, the Audit Committee's oversight does not provide an independent basis to determine that management has maintained appropriate accounting and

financial reporting principles or appropriate internal controls and procedures designed to assure compliance with accounting standards and applicable laws and regulations. Furthermore, the Audit Committee's considerations and discussions referred to above do not assure that the audit of
AIG's financial statements has been carried out in accordance with generally accepted auditing standards, that the financial statements are presented in accordance with generally accepted accounting principles or that AIG's auditors are in fact
'independent'.

Based upon the reports and discussions described in this report, and subject to the limitations on the role and responsibilities of the Committee referred to above and in the Charter, the Committee recommended to the Board that the audited financial statements be included in AIG's Annual Report on Form 10-K for the year ended December 31, 2000 to be filed with the Securities and Exchange
Commission.

Audit Committee
American International Group, Inc.

M. Bernard Aidinoff
Barber B. Conable, Jr.
Carla A. Hills
Frank J. Hoenemeyer

APPENDIX

AMERICAN INTERNATIONAL GROUP, INC.
AUDIT COMMITTEE CHARTER

I. Composition of the Audit Committee: The Audit Committee shall be comprised of at least three directors, each of whom shall have no relationship to American International Group, Inc. ('AIG') that may interfere with the exercise of their independence from management. AIG shall otherwise satisfy the applicable listing requirements under the rules of the New York Stock Exchange, Inc., as such requirements are interpreted by the Board of Directors in its business judgment.

II. Purposes of the Audit Committee: The purposes of the Audit Committee are to assist the Board of Directors:

1. in its oversight of AIG's accounting and financial reporting principles and policies and internal audit controls and procedures;
2. in its oversight of AIG's financial statements and the independent audit thereof;
3. in selecting, evaluating and, where deemed appropriate, replacing the outside auditors (or nominating the outside auditors to be proposed for shareholder approval in any proxy statement); and
4. in evaluating the independence of the outside auditors.

The function of the Audit Committee is oversight. The management of AIG is responsible for the preparation, presentation and integrity of AIG's financial statements. Management is responsible for maintaining appropriate accounting and financial reporting principles and policies and internal controls and procedures designed to assure the effectiveness and efficiency of operations, the reliability of financial reporting and compliance with accounting standards and applicable laws and regulations. The internal auditing department is responsible for reviewing the adequacy and effectiveness of the system of internal controls.

The outside auditors are responsible for planning and carrying out a proper audit of AIG's annual financial statements, reviews of AIG's quarterly financial statements prior to the filing of each quarterly report on Form 10-Q, and other procedures to ensure, among other things, that such financial statements are in accordance with generally accepted accounting principles. In fulfilling their responsibilities hereunder, it is recognized that members of the Audit Committee are not full-time employees of AIG or its subsidiaries and are not, and do not represent themselves to be, accountants or auditors by profession or experts in the fields of accounting or auditing including in respect of auditor independence. As such, it is not the duty or responsibility of the Audit Committee or its members to conduct 'field work' or other types of auditing or accounting reviews or procedures or to set auditor independence standards. Each member of the Audit Committee shall be entitled to rely on (i) the integrity of those persons and organizations within and outside AIG from which it receives information, (ii) the accuracy of the financial and other information provided to the Audit Committee by such persons or

organizations absent actual knowledge to the contrary (which shall be promptly reported to the Board of Directors) and (iii) representations made by management as to any information technology, internal audit and other non-audit services provided by the auditors to AIG or its subsidiaries.

The outside auditors for AIG are ultimately accountable to the Board of Directors, as assisted by the Audit Committee. The Board of Directors, with the assistance of the Audit Committee, has the ultimate authority and responsibility to select the outside auditors for nomination, to nominate the outside auditors to be proposed for shareholder approval in the proxy statement, evaluate and, where appropriate, replace the outside auditors.

The outside auditors shall submit to AIG annually a formal written statement delineating all relationships between the outside auditors and AIG and its subsidiaries ('Statement as to Independence'), addressing the non-audit services provided to AIG or its subsidiaries and the matters set forth in Independence Standards Board Standard No. 1.

The outside auditors shall submit to AIG annually a formal written statement of the fees billed for each of the following categories of services rendered by the outside auditors: (i) the audit of AIG's annual financial statements for the most recent fiscal year and the reviews of the financial statements included in AIG's Quarterly Reports on Form 10-Q for that fiscal year; (ii) information technology consulting services for the most recent fiscal year, in the aggregate and by each service (and separately identifying fees for such services relating to financial information systems design and implementation); and (iii) all other services rendered by the outside auditors for the most recent fiscal year, in the aggregate and by each service.

III. Meetings of the Audit Committee: The Audit Committee shall meet four times annually, or more frequently if circumstances dictate, to discuss with management the annual audited financial statements and quarterly financial statements. In addition to such meetings of the Audit Committee as may be required to discuss the matters set forth in Article IV, the Audit Committee should meet separately at least annually with management, the director of the internal auditing department and the outside auditors to discuss any matters that the Audit Committee or any of these persons or firms believe should be

discussed privately. The Audit Committee may request any officer or employee of AIG or its subsidiaries or AIG's outside counsel or outside auditors to attend a meeting of the Audit Committee or to meet with any members of, or consultants to, the Audit Committee. Members of the Audit Committee may participate in a meeting of the Audit Committee by means of conference call or similar communications equipment by means of which all persons participating in the meeting can hear each other.

IV. Duties and Powers of the Audit Committee: To carry out its purposes, the Audit Committee shall have the following duties and powers:

1. with respect to the outside auditor,

(i) to provide advice to the Board of Directors in selecting, evaluating or replacing outside auditors;

(ii) to review the fees charged by the outside auditors for audit and non-audit services;

(iii) to ensure that the outside auditors prepare and deliver annually a Statement as to Independence (it being understood that the outside auditors are responsible for the accuracy and completeness of this Statement), to discuss with the outside auditors any relationships or services disclosed in this Statement that may impact the objectivity and independence of AIG's outside auditors and to recommend that the Board of Directors take appropriate action in response to this Statement to satisfy itself of the outside auditors' independence;

(iv) if applicable, to consider the effect of the outside auditors' provision of (a) information technology consulting services relating to financial information systems design and implementation and (b) other non-audit services to AIG or its subsidiaries on the independence of the outside auditors; and

(v) to instruct the outside auditors that the outside auditors are ultimately accountable to the Board of Directors and Audit Committee;

2. with respect to the internal auditing department,

(i) to review the appointment and replacement of the director of the internal auditing department; and

(ii) to advise the director of the internal auditing department that he or she is expected to provide to the Audit Committee summaries of and, if requested, the significant reports to management prepared by the internal auditing department and management's responses thereto;

3. with respect to financial reporting principles and policies and internal audit controls and procedures,

(i) to advise management, the internal auditing department and the outside auditors that they are expected to provide to the Audit Committee a timely analysis of significant financial reporting issues;

(ii) to consider any reports or communications (and management's and/or the internal audit department's responses thereto) submitted to the Audit Committee by the outside auditors required by or referred to in SAS 61 (as codified by AU Section 380), as may be modified or supplemented, including reports and communications related to: deficiencies noted in the audit in the design or operation of internal controls; consideration of fraud in a financial statement audit; detection of illegal acts; the outside auditor's responsibility under generally accepted auditing standards; significant accounting policies; management judgments and accounting estimates; adjustments arising from the audit; the responsibility of the outside auditor for other information in documents containing audited financial statements; disagreements with management; consultation by management with other accountants; major issues discussed with management prior to retention of the outside auditor; difficulties encountered with management in performing the audit; the outside auditor's judgments about the quality of the entity's accounting principles; and reviews of interim financial information conducted by the outside auditor;

(iii) to meet with management, the director of the internal auditing department and/or the outside auditors: to discuss the scope of the annual audit; to discuss the audited financial statements; to discuss any significant matters arising from any audit or report or communication referred to in items 2(ii) or 3(ii) above, whether raised by management, the internal auditing department or the outside auditors, relating to AIG's financial statements; to review the form of opinion the outside auditors propose to render to the Board of Directors and shareholders; to discuss significant changes to AIG's auditing and accounting principles, policies, controls, procedures and practices proposed or contemplated by the outside auditors, the

internal auditing department or management; and to inquire about significant risks and exposures, if any, and the steps taken to monitor and minimize such risks;

(iv) to obtain from the outside auditors assurance that the audit was conducted in a manner consistent with Section 10A of the Securities Exchange Act of 1934, as amended, which sets forth certain procedures to be followed in any audit of financial statements required under the Securities Exchange Act of 1934; and

(v) to discuss with AIG's General Counsel any significant legal matters that may have a material effect on the financial statements, AIG's compliance policies, including material notices to or inquiries received from governmental agencies; and

4. with respect to reporting and recommendations,

(i) to prepare any report or other disclosures, including any recommendation of the Audit Committee, required by the rules of the Securities and Exchange Commission to be included in AIG's annual proxy statement;

(ii) to review this Charter at least annually and recommend any changes to the full Board of Directors; and

(iii) to report its activities to the full Board of Directors and to make such recommendations with respect to the above and other matters as the Audit Committee may deem necessary or appropriate.

V. Resources and Authority of the Audit Committee: The Audit Committee shall have the resources and authority appropriate to discharge its responsibilities, including the authority to engage outside auditors for special audits, reviews and other procedures and to retain special counsel and other experts or consultants.

INTEL CORPORATION
2200 Mission College Blvd.
Santa Clara, CA 95052-8119
(408) 765-8080

April 11, 2001

Dear Stockholder:

Intel's 2001 Annual Stockholders' Meeting will be held on May 24, 2001 at the Santa Clara Convention Center in Santa Clara, California, and we look forward to your attendance either in person or by proxy. For your convenience, the company is also pleased to offer a Webcast of the annual meeting at www.intc.com/intel/fmance/presentations.

The notice of annual meeting, proxy statement and proxy card from the Board of Directors are enclosed. Intel is also pleased to offer its stockholders the opportunity to receive stockholder communications electronically. You may access the notice of annual meeting and the proxy statement on the Internet at www.intel.com/intel/financel/proxy01. For more information, see "Electronic Delivery of Intel Stockholder Communications" on page 2.

At this year's annual meeting, the agenda includes the annual election of directors and a proposal to ratify the appointment of our independent auditor. The Board of Directors recommends that you vote FOR election of the slate of director nominees and FOR ratification of appointment of the independent auditor. Please refer to the proxy statement for detailed information on each of the proposals. If you have any further questions concerning the annual meeting or any of the proposals, please contact Intel Investor Relations at (408) 765-4994. For questions regarding your stock ownership, you may contact our transfer agent, Computershare Investor Services, LLC, by e-mail at web.queries@computershare.com or by phone at (800) 298-0146 (within the U.S. and Canada) or (312) 360-5123 (outside the U.S. and Canada, call collect). For questions relating to voting, you may contact D.F. King & Co., Inc., our proxy solicitors, at (800) 347-4750 (within the U.S. and Canada) or (212) 269-5550 (outside the U.S. and Canada, call collect).

Sincerely yours,

Andrew S. Grove
Chairman of the Board

**EXCERPTED FROM INTEL CORPORATION NOTICE OF ANNUAL STOCKHOLDERS' MEETING
REPORT OF THE AUDIT COMMITTEE**

The Securities and Exchange Commission rules now require the company to include in its proxy statement a report from the Audit Committee of the Board. The following report concerns the Committee's activities regarding oversight of the company's financial reporting and auditing process.

The Audit Committee is comprised solely of independent directors, as defined in the Marketplace Rules of The Nasdaq Stock Market, and it operates under a written charter adopted by the Board of Directors, a copy of which is attached to this proxy statement as Exhibit A. The composition of the Audit Committee, the attributes of its members and the responsibilities of the Committee, as reflected in its charter, are intended to be in accordance with applicable requirements for corporate audit committees. The Committee reviews and assesses the adequacy of its charter on an annual basis.

As described more fully in its charter, the purpose of the Audit Committee is to assist the Board of Directors in its general oversight of the company's financial reporting, internal control and audit functions. Management is responsible for the preparation, presentation and integrity of the company's financial statements, accounting and financial reporting principles, internal controls and procedures designed to ensure compliance with accounting standards, applicable laws and regulations. Ernst & Young LLP the company's independent auditing firm, is responsible for performing an independent audit of the consolidated financial statements in accordance with generally accepted auditing standards.

The Audit Committee members are not professional accountants or auditors, and their functions are not intended to duplicate or to certify the activities of management and the independent auditor, nor can the Committee certify that the independent auditor is "independent" under applicable rules. The Committee serves a board-level oversight role, in which it provides advice, counsel and direction to management and the auditors on the basis of the information it receives, discussions with management and the auditors and the experience of the Committee's members in business, financial and accounting matters.

Among other matters, the Audit Committee monitors the activities and performance of the company's internal and external auditors, including the audit scope, external audit fees, auditor independence matters and the extent to which the independent auditor may be retained to perform non-audit services. The Audit Committee and the Board have ultimate authority and responsibility to select, evaluate and, when appropriate, replace the company's independent auditor. The Audit Committee also reviews the results of the internal and external audit work with regard to the adequacy and appropriateness of the company's financial, accounting and internal controls. Management and independent auditor presentations to and discussions with the Audit Committee also cover various topics and events that may have significant financial impact or are the subject of discussions between management and the independent auditor. In addition, the Audit Committee generally oversees the company's internal compliance programs.

The Committee has reviewed and discussed the consolidated financial statements with management and the independent auditor, management represented to the Committee that the company's consolidated financial statements were prepared in accordance with generally accepted accounting principles, and the independent auditor represented that its presentations included the matters required to be discussed with the independent auditor by Statement on Auditing Standards No.61, as amended, "Communication with Audit Committees."

The company's independent auditor also provided the Committee with the written disclosures required by Independence Standards Board Standard No.1, "Independence Discussions with Audit Committees," and the Committee discussed with the independent auditor that firm's independence.

Following the Committee's discussions with management and the independent auditor, the Committee recommended that the Board of Directors include the audited consolidated financial statements in the company's annual report on Form 10-K for the year ended December 30, 2000.

Audit Committee:

Winston H. Chen, Chairman
John P Browne

D. James Guzy
David S. Pottruck

EXCERPTED FROM INTEL CORPORATION NOTICE OF ANNUAL STOCKHOLDERS' MEETING

EXHIBIT A

AUDIT COMMITTEE CHARTER

The Purpose of the Audit Committee

The purpose of the Audit Committee is to assist the Board of Directors in its general oversight of the company's financial reporting, internal control and audit functions. Management is responsible for the preparation, presentation and integrity of the company's financial statements, accounting and financial reporting principles, internal controls and procedures designed to assure compliance with accounting standards, applicable laws and regulations. The company's independent auditing firm is responsible for performing an independent audit of the consolidated financial statements in accordance with generally accepted auditing standards.

The Audit Committee members are not professional accountants or auditors, and their functions are not intended to duplicate or to certify the activities of management and the independent auditor, nor can the Committee certify that the independent auditor is "independent" under applicable rules. The Committee serves a board-level oversight role in which it provides advice, counsel and direction to management and the auditors on the basis of the information it receives, discussions with the auditors and the experience of the Committee's members in business, financial and accounting matters.

Membership

The Audit Committee is comprised of at least three directors who meet the independence and qualification requirements as provided in the applicable Marketplace Rules of The Nasdaq Stock Market. Appointment to the Committee, including the designation of the Chair of the Committee, shall be made on an annual basis by the full Board upon recommendation of the Nominating Committee.

Responsibilities

The Audit Committee:

- and the Board of Directors have ultimate authority and responsibility to select, evaluate and, when appropriate, replace the independent auditor. The Audit Committee recommends the selection and the discharge of the independent auditor to the Board of Directors. The independent auditor, in its capacity as an independent public accounting firm, is to be informed that it is responsible to the Board of Directors and the Audit Committee as representatives of the stockholders.
- on at least an annual basis obtains from the independent auditor a formal written statement delineating all relationships between the independent auditor and the company, consistent with standards set by the Independence Standards Board. The Audit Committee discusses with the independent auditor relationships and services that in the view of the Committee may affect auditor objectivity or independence. If the Committee is not satisfied with the auditor's assurances of independence, the Committee takes or recommends to the full Board appropriate action to ensure the independence of the independent auditor.
- reviews the audit fee, the independent auditor's non-audit services and factors related to the independence of the auditor such as the extent to which non-audit services have been performed.
- meets with the internal and external auditors to review their audit plans, the audit scope, and the results of their audit work with regard to the adequacy and appropriateness of the accounting and financial controls of the corporation.
- reviews annually the performance of both the internal audit group and the independent auditor in executing these plans and meeting their objectives.
- reviews the use of auditors other than the independent auditor in cases such as management's request for second opinions.

- reviews with the independent auditor its judgments as to the quality, not just the acceptability, of the company's accounting principles and such matters as are required to be discussed with the Committee under generally accepted auditing standards
- reviews and discusses with management the audited financial statements, management's evaluations of the company's internal controls, overall quality of the company's financial reporting, related auditor views and the basis for audit conclusions, and, if deemed appropriate, recommends to the Board of Directors that the audited financial statements be included in the Annual Report on Form 10-K for the year.
- reviews and discusses management and independent auditor presentations to the Audit Committee with regard to various topics and events that may have significant financial impact or are the subject of discussions between management and the independent auditor.
- reviews matters related to the corporate compliance activities of the corporation, including the review of reports from the corporation's Compliance Oversight Committee and other related groups.
- reviews and reassesses the adequacy of its charter annually and determines whether to recommend to the full Board if the Audit Committee charter should be reaffirmed or modified.
- publishes the report required by the rules of the Securities and Exchange Commission to be included in the company's annual proxy statement.

when appropriate, is authorized to designate one or more of its members to perform certain of its duties on its behalf, subject to such reporting to or ratification by the Committee as the Committee shall direct.

The Chairman of the Audit Committee is to be contacted directly by the Internal Audit Director or the independent auditor (1) to review items of a sensitive nature that can impact the accuracy of financial reporting or (2) to discuss significant issues relative to the overall Board responsibility that have been communicated to management but, in their judgment, have not been adequately addressed.



Citigroup Inc.
399 Park Avenue
New York, NY 10043

March 16, 2001

Dear Stockholder:

We cordially invite you to attend Citigroup's annual stockholders' meeting. The meeting will be held on Tuesday, April 17, 2001, at 9 AM at Carnegie Hall, 881 Seventh Avenue in New York City. The entrance to Carnegie Hall is on 57th Street just east of Seventh Avenue.

In the short time since our historic merger, Citigroup has emerged as a premier financial services company where clients want to do business and employees want to build their futures. Our intense focus on our clients and employees has resulted in record performance for our stockholders.

At the meeting, stockholders will vote on a number of important matters. Please take the time to carefully read each of the proposals described in the attached proxy statement.

Thank you for your support of Citigroup.

Sincerely,

A handwritten signature in black ink that reads "Sanford I. Weill".

Sanford I. Weill
*Chairman of the Board
and Chief Executive Officer*

This proxy statement and the accompanying proxy card are being mailed to Citigroup stockholders beginning about March 16, 2001.

Audit Committee Report

In accordance with its written charter, which was approved in its current form by the Board of Directors on April 17, 2000, the Audit Committee assists the Board in oversight of the quality and integrity of the accounting, auditing, and financial reporting practices of Citigroup. A copy of the Audit Committee charter is attached to Citigroup's proxy statement as Annex A.

The Audit Committee consists of six independent members (as independence is defined by the rules of the New York Stock Exchange and the Federal Deposit Insurance Corporation).

In performing its oversight function, the Audit Committee reviewed and discussed the audited consolidated financial statements of Citigroup as of and for the year ended December 31, 2000 with management and Citigroup's independent accountants. The Audit Committee also discussed with Citigroup's independent auditors all matters required by generally accepted auditing standards, including those described in Statement on Auditing Standards No. 61, as amended, "Communication with Audit Committees" and, with and without management present, discussed and reviewed the results of the independent auditors' examination of the financial statements.

The Audit Committee obtained from the independent auditors a formal written statement describing all relationships between the auditors and

Citigroup that might bear on the auditors' independence consistent with Independence Standards Board Standard No. 1, "Independence Discussions with Audit Committees." The Audit Committee discussed with the auditors any relationships that may have an impact on their objectivity and independence and satisfied itself as to the auditors' independence. The Audit Committee also considered whether the provision of information technology services and other non-audit services by KPMG LLP, Citigroup's principal independent accountants, to Citigroup is compatible with maintaining KPMG's independence.

Based on the above-mentioned review and discussions with management and the independent auditors, the Audit Committee recommended to the Board of Directors that Citigroup's audited consolidated financial statements be included in Citigroup's Annual Report on Form 10-K for the fiscal year ended December 31, 2000, for filing with the Securities and Exchange Commission.

THE AUDIT COMMITTEE:

Dudley C. Mecum (Chairman)
C. Michael Armstrong
Alain J.P. Belda
Kenneth T. Derr
John M. Deutch
Reuben Mark

ANNEX A
CITIGROUP INC.
CHARTER OF THE AUDIT COMMITTEE

Mission

The Audit Committee of Citigroup Inc. is a standing committee of the Board of Directors. Through an interactive process with Citigroup's senior management, Audit and Risk Review, and independent auditors, the Audit Committee receives information on and oversees the adequacy of the internal control environment established by management. Given the large size and complexity of Citigroup, the Audit Committee will apply reasonable materiality standards to all of its activities.

Although the Audit Committee has the responsibilities and powers set forth in this Charter, the function of the Audit Committee is oversight. The members of the Audit Committee are not full-time employees of Citigroup and may not be, and may not represent themselves to be or to serve as, accountants or auditors by profession or experts in the fields of accounting or auditing. Consequently, in carrying out its oversight responsibilities, the Audit Committee is not providing any expert or special assurance as to Citigroup's financial statements or any professional certification as to the work of the independent auditors.

The independent auditors are ultimately accountable to the Board of Directors and the Audit Committee. The Board of Directors, on the basis of the recommendation of the Audit Committee, has the ultimate authority and responsibility to select, evaluate and, where appropriate, replace the independent auditors (or to select the independent auditors to be proposed for shareholder ratification in the proxy statement).

Membership

The Audit Committee shall be comprised of at least three members of the Board of Directors who shall satisfy the independence, financial literacy and experience requirements of the New York Stock Exchange and any other regulatory requirements. The Audit Committee members and the Audit Committee Chairman shall be designated by the Board of Directors.

Subcommittees

The Board of Directors and the Audit Committee shall each have the authority to establish subcommittees of the Audit Committee, including but not limited to, a Global Consumer Audit Committee, a Global Corporate and Investment Bank Audit Committee and an Insurance Audit Committee. Each subcommittee shall be comprised of at least three members, all of whom shall be appointed by the Audit Committee or the Board of Directors. Each subcommittee shall have the full power and authority of the full Audit Committee. To the extent that Citigroup has majority-owned subsidiaries with equity listed on a public securities exchange, the boards of directors of such subsidiaries shall appoint audit committees which satisfy the rules of the applicable securities exchange and other applicable regulatory requirements.

Duties and Responsibilities

Specifically, the Audit Committee shall:

- With respect to accounting and financial control policy:
 - receive an annual report from the Chief Financial Officer and/or the Controller relating to accounting policies used in the preparation of the Citigroup financial statements (specifically those policies for which management is required to exercise discretion or judgement regarding the implementation thereof);
 - receive periodic reports from the Chief Financial Officer and/or the Controller relating to significant accounting developments and issues, particularly with respect to reserves, accounting changes and other financial information; and
 - review the possible impact of any impending significant changes in accounting standards or rules as promulgated by the FASB, SEC or others.
- With respect to the independent auditors:
 - recommend to the Board of Directors the principal independent auditor, subject to ratification by the stockholders;
 - approve the fees to be paid to the independent auditors;
 - review on an annual basis the performance of the independent auditors; and
 - monitor the independence of Citigroup's independent auditor(s), including a review and discussion of the annual statement as to independence delivered by the independent auditors (ISBS 98-1);
 - a review of non-audit services provided and related fees received,
 - a delineation of all relationships between the independent auditors and Citigroup that may impact the objectivity and independence of the independent auditors; and
 - to recommend that the Board of Directors take appropriate action in response to any concerns raised in the annual statement as to independence or the related Audit Committee discussions.
- With respect to Audit and Risk Review (ARR):
 - review and concur in the appointment and replacement of Citigroup's Chief Auditor;
 - review, based upon the recommendation of the independent auditor(s) and the Chief Auditor, the scope and plan of the independent audit, and the scope and plan of the work to be done by ARR;
 - review and evaluate the adequacy of the work performed by the Chief Auditor and ARR, which shall encompass the examination and effectiveness of Citigroup's internal control and quality of performance in carrying out assigned control responsibilities;
 - address itself to specific issues or problems that arise, with the objective of identifying which processes need to be enhanced, if any, and satisfy itself that management has timely and reasonable corrective action plans; and

- review the report of the Chief Auditor regarding the expenses of, the perquisites paid to, and the conflicts of interest, if any, of members of Citigroup's senior management.
- Review with management and the independent auditor(s):
 - Citigroup's annual financial statements and related footnotes and the independent auditor's report thereon including their report on the adequacy of Citigroup's systems of internal control and any significant recommendations they may offer to improve controls;
 - any significant reserves, accruals or estimates which may have a material impact on the financial statements;
 - any serious difficulties or disputes with management encountered by the independent auditor(s) during the course of the audit and any instances of second opinions sought by management;
 - other matters related to the conduct of the independent audit, which are communicated to the Audit Committee under generally accepted auditing standards; and
 - to the extent required under appropriate auditing standards or securities laws, rules or regulations, certain matters relating to Citigroup's interim financial statements.
- Consider and review with management and the Chief Auditor:
 - the adequacy of Citigroup's system of internal controls over financial reporting and the safeguarding of assets and compliance with laws and regulations;
 - any difficulties encountered by ARR in the course of their audits, including any restrictions on the scope of their work or access to required information; and
 - the adequacy of ARR's organization, resources and skills.
- With respect to risk and control issues, in coordination with the Risk, Capital and Subsidiaries Committee of the Citigroup Board of Directors (the Risk Committee), satisfy itself that:
 - management has appropriate procedures, practices and processes in place to reasonably assure adherence to policies and limits relating to the assumption of risk, as established by the Risk Committee; and
 - the risks assumed by Citigroup are appropriately reflected in the books and records of Citigroup and that procedures are in place to assure the timeliness and integrity of the reporting thereof.
- Review the findings of the independent auditors and ARR and primary regulatory agencies, including any annual report of exam/inspections provided by such agencies, and monitor responses to those findings and the related corrective action plans.
- Review legal, regulatory and compliance matters that may have a material impact on the financial statements, and any material reports received from regulators.
- Receive and consider reports from management on an annual and/or as needed basis relating to:
 - tax developments and issues;
 - technology control issues and status;
 - fraud and operating losses.

- Evaluate the adequacy of this Audit Committee Charter on an annual basis and recommend revisions, if any, to the Board of Directors.
- Prepare any report required by the rules of the Securities and Exchange Commission to be included in Citigroup's annual proxy statement.
- Perform other oversight functions as requested by the Board of Directors.

Meetings

The Audit Committee shall meet four times a year, or more frequently if circumstances dictate.

The Audit Committee shall meet with and without management present. Separate meetings with the independent auditor(s) and the Chief Auditor shall be called as the Audit Committee deems necessary. At least once a year, the Audit Committee shall meet alone with the independent auditors (no members of management shall be present), and alone with the Chief Auditor (no other members of management or the independent auditors shall be present).

Corporate Headquarters:
10400 Fernwood Road
Bethesda, Maryland 20817



Mailing Address:
Marriott Drive
Washington, D.C. 20058

**NOTICE OF ANNUAL MEETING OF SHAREHOLDERS
TO BE HELD FRIDAY, MAY 4, 2001**

To our Shareholders:

March 30, 2001

The 2001 annual meeting of shareholders of Marriott International, Inc. (the "Company") will be held at the J.W. Marriott Hotel, 1331 Pennsylvania Avenue, N.W., Washington, D.C. on Friday, May 4, 2001, beginning at 10:30 a.m. Doors to the meeting will open at 9:30 a.m. At the meeting, shareholders will act on the following matters:

- (1) Election of three directors, each for a term of three years;
- (2) Ratification of the appointment of Arthur Andersen LLP as the Company's independent auditors for fiscal 2001;
- (3) Consideration of one shareholder proposal; and
- (4) Any other matters that properly come before the meeting.

Shareholders of record at the close of business on March 13, 2001 will be entitled to notice of and to vote at this meeting.

For the convenience of our shareholders, proxies may be given either by telephone, electronically through the Internet, or by completing, signing and returning the enclosed proxy card. In addition, shareholders may elect to receive future shareholder communications, including proxy materials, through the Internet. Instructions for each of these options can be found in the enclosed materials.

By order of the Board of Directors,

A handwritten signature in black ink that reads "Dorothy M. Ingalls".

Dorothy M. Ingalls
Secretary

**PLEASE REFER TO THE OUTSIDE BACK COVER FOR DIRECTIONS TO THE MEETING
AND INFORMATION ON PARKING, PUBLIC TRANSPORTATION AND LODGING.**

APPENDIX A
AUDIT COMMITTEE REPORT

The Audit Committee reviews the Company's financial reporting process on behalf of the Board of Directors. Management has the primary responsibility for the financial statements and the reporting process. The Company's independent auditors are responsible for expressing an opinion on the conformity of our audited financial statements to generally accepted accounting principles.

In this context, the Audit Committee has reviewed and discussed with management and the independent auditors the Company's audited financial statements for the three fiscal years ended December 29, 2000. The Audit Committee has discussed with the independent auditors the matters required to be discussed by Statement on Auditing Standards No. 61 (Communication with Audit Committees). In addition, the Audit Committee has received from the independent auditors the written disclosures required by Independence Standards Board Standard No. 1 (Independence Discussions with Audit Committees) and discussed with them their independence from the Company and its management. Finally, the Audit Committee has considered whether the independent auditors provision of non-audit services to the Company is compatible with the auditor's independence.

Relying on the reviews and discussions referred to above, the Audit Committee recommended to the Board of Directors, and the Board has approved, that the Company's audited financial statements for the three fiscal years ended December 29, 2000 be included in the Company's Annual Report on SEC Form 10-K for the year ended December 29, 2000, for filing with the Securities and Exchange Commission.

Members of the Audit Committee

Lawrence M. Small, Chair
Gilbert M. Grosvenor
W. Mitt Romney
Roger W. Sant

APPENDIX C

AUDIT COMMITTEE CHARTER

I. *Composition and Terms of Office*

- A. The Audit Committee (the “Committee”) shall be appointed by the Board of Directors and shall be composed of at least three Directors, all of whom have no relationship to the Company that may interfere with the exercise of their independence from management and the Company (“Independent”). In addition to the definition of Independent provided here, additional restrictions apply to every Committee member as outlined in the Corporate Governance Listing Standards of the New York Stock Exchange and currently filed with the Securities and Exchange Commission.
- B. Each member of the Committee shall be financially literate as interpreted by the Board of Directors, or must become financially literate within a reasonable period of time after his or her appointment to the Committee. At least one member of the Committee must have accounting or related financial management expertise, as interpreted by the Board of Directors.
- C. The Chairman of the Committee shall be appointed by the Board of Directors. Members of the Committee shall serve until the next Annual Meeting of the Board of Directors or until their successors are appointed.

II. *Meetings*

The Committee shall hold at least three regular meetings each year and such additional meetings as may be deemed necessary by the Committee Chairman. Minutes of each Committee meeting shall be submitted to the Board of Directors, and the Chairman of the Committee will report verbally to the full Board of Directors on matters discussed or any actions taken at the most recent Committee meeting.

To provide access to the Committee for the internal auditors, independent accountants and key financial management, the Committee shall request, as deemed appropriate, attendance at its regular meetings or otherwise, of financial management, the head of Internal Audit (“Chief Audit Executive”) and such other members of the Company’s management as circumstances require. At least annually, the Committee shall meet separately with management, the Chief Audit Executive, and the independent accountants in separate executive sessions to discuss any matters that the Committee or these groups believe should be discussed privately.

III. *Duties and Responsibilities*

A. *Risk Assessment and Control Environment*

The Committee shall:

1. Periodically inquire of management, the independent accountants, and the Chief Audit Executive about significant risks or exposures and assess the steps management has taken to minimize such risk to the Company.
2. Consider and review with the independent accountants and Chief Audit Executive:
 - The adequacy of the Company’s internal controls including information systems controls and security.
 - Related findings and recommendations of the independent accountants and Internal Audit together with management’s responses.

3. Review audit plans with the Chief Audit Executive and independent accountants and evaluate adequacy of proposed audit scope.
4. Review appointment and dismissal of Chief Audit Executive.
5. Periodically review progress of the annual internal audit plan and key findings.
6. Review with appropriate management, in-house counsel and the Chief Audit Executive, programs to ensure compliance with the Company's Ethical Conduct Policy (CP-1) and Business Conduct Guide.

B. Financial Reporting

The Committee shall:

1. Review the Company's Quarterly Report on Form 10-Q with financial management and the independent accountants prior to release of information to the public. The Committee may delegate this review responsibility to its Chairman.
2. Review the Company's annual financial statements and, as appropriate, any other reports or other financial information submitted to any governmental body, or the public, including any certification, report, opinion, or review rendered by the independent accountants.
3. Following completion of the annual audit, review with the independent accountants (and management, as appropriate) the following:
 - Their judgments of the quality and appropriateness of accounting principles and financial disclosure practices of the Company (including how the public's and shareholders' views of the Company may be affected by its choice of accounting principles and its financial disclosure practices).
 - Any disagreements with management over the application of accounting principles.
 - Accounting principles applied, especially significant estimates made by management or changes in accounting methods.
 - Significant related party transactions or other significant conflicts of interest.
 - Significant audit adjustments.
 - Any difficulties encountered during the audit, including any restrictions on the scope of work or access to required information.
 - Any other matters related to the conduct of the audit to be communicated to the Committee under Generally Accepted Auditing Standards.
4. Meet regularly with in-house counsel to discuss legal matters that may have a material impact on the financial statements. Meet with outside counsel as appropriate.
5. Prepare the Audit Committee Report for annual inclusion in the Company's proxy statement, as required by the Securities and Exchange Commission. Submit the draft Report to the Board of Directors for approval.
6. Prepare the Written Affirmation, as required by the Corporate Governance Listing Standards of the New York Stock Exchange, regarding the Committee members' independence and qualifications and the adequacy of the Audit Committee charter. Submit the draft letter to the Board of Directors for approval.

C. *Relationship with Independent Accountants*

The Committee shall:

1. Review the independent accountants' letter regarding independence (required by Independence Standards Board Standard No. 1, as it may be modified or supplemented). Discuss with the independent accountants their independence. Consider management's plans to engage the independent accountants to perform management advisory services, types of services to be rendered, estimated fees and actual fees charged.
2. Annually confirm management's recommendation of the Company's independent accountants. Recommend appointment of independent accountants annually to the Board of Directors for submission to shareholders for approval. Ascertain that the independent accountant's annual arrangement letter, with respect to the audit of the Company's consolidated financial statements, is addressed to the Board of Directors.

D. *Other Responsibilities*

1. Institute investigations of suspected improprieties on any material matter selected by the Committee, using special counsel or outside experts when necessary.
2. Review with the Chief Audit Executive and appropriate management the effectiveness of controls relating to officer expenses and perquisites.
3. At least annually, review and assess the adequacy of the Audit Committee Charter. Submit proposed revisions to the Board of Directors for approval. This should occur in conjunction with the Committee's preparation of the written affirmation to the New York Stock Exchange, as described in Section III. B. 6. above.



2001
Notice of Annual Meeting
and
Proxy Statement

Wednesday, May 23, 2001
at 9:30 a.m. local time
Cincinnati Convention Center
525 Elm Street
Cincinnati, Ohio 45202

REPORT OF THE AUDIT COMMITTEE OF THE BOARD OF DIRECTORS

I. MEMBERSHIP AND ROLE OF THE AUDIT COMMITTEE

The Audit Committee ("Committee") consists of the following members of the Company's Board of Directors: Michael I. Sovern (Chairman), Kenneth T. Derr, Ralph S. Larsen, M. Kathryn Eickhoff, Donald F. McHenry, and Louis A. Simpson. Each member of the Committee is independent as defined under the New York Stock Exchange listing standards. The Committee operates under a written charter adopted by the Board of Directors, which is included in this proxy statement as Appendix A.

The primary function of the Committee is to assist the Board of Directors in fulfilling its oversight responsibilities with respect to the Corporation's financial matters. The Committee's primary responsibilities are to: (1) monitor the integrity of AT&T's financial reporting processes and systems of internal controls regarding finance, accounting, security, environmental and legal compliance, and information systems; (2) monitor the independence and performance of AT&T's independent public accountants and the Internal Audit department; (3) provide direction and oversight of the Business Ethics and Conduct function; and (4) facilitate and maintain an open avenue of communication among the Board of Directors, Senior Management, the Internal Audit department, and the independent public accountants.

II. REVIEW OF THE COMPANY'S AUDITED FINANCIAL STATEMENTS

The Committee has reviewed and discussed the audited financial statements of the Company for the year ended December 31, 2000, with the Company's management. The Committee has discussed with PricewaterhouseCoopers LLP, the Company's independent public accountants, the matters required to be discussed by Statement on Auditing Standards No. 61 (Communication with Audit Committees).

The Committee has also received the written disclosures and the letter from PricewaterhouseCoopers LLP required by Independence Standards Board Standard No. 1 (Independence Discussion with Audit Committees) and the Committee has discussed the independence of PricewaterhouseCoopers LLP with that firm.

Based on the Committee's review and discussions noted above, the Committee recommended to the Board of Directors that the Company's audited financial statements be included in the Company's Annual Report to Shareholders, which is incorporated by reference in its Annual Report on Form 10-K for the year ended December 31, 2000, for filing with the Securities and Exchange Commission.

III. PRICEWATERHOUSECOOPERS LLP INFORMATION

Fees related to services performed by PricewaterhouseCoopers LLP in 2000 are as follows:

	(\$ in thousands)
Audit Fees	\$ 7,860
Financial Information System Design and Implementation	1,525
All Other Fees	
– Tax services, statutory services, and regulatory and other SEC filing requirements and matters	28,184
– Other	18,656
Total	<u>\$56,225</u>

The Audit Committee has considered whether the provision of the above services other than audit services is compatible with maintaining PricewaterhouseCoopers LLP's independence and has concluded that it is.

Submitted by:

Michael I. Sovern (Chairman)
Kenneth T. Derr
Ralph S. Larsen

M. Kathryn Eickhoff
Donald F. McHenry
Louis A. Simpson

APPENDIX A**AUDIT COMMITTEE CHARTER****I. PURPOSE**

The Audit Committee ("Committee") is appointed by the Board of Directors ("Board") of AT&T ("Company") to assist the Board in fulfilling its oversight responsibilities. The Committee's primary responsibilities are to:

- Monitor the integrity of AT&T's financial reporting processes and systems of internal controls regarding finance, accounting, security, environmental and legal compliance, and information systems.
- Monitor the independence and performance of AT&T's independent accountants and the Internal Audit department.
- Provide direction and oversight of the Business Ethics and Conduct function.
- Facilitate and maintain an open avenue of communication among the Board of Directors, Senior Management, the Internal Audit department, and the independent accountants.

II. ORGANIZATION/COMPOSITION

The Committee shall be comprised of three or more independent, non-executive directors, as determined by the Board of Directors, each of whom meets the requirements of the New York Stock Exchange. Each member will be free from any financial, family, or other material relationship that, in the opinion of the Board of Directors, would interfere with the exercise of his or her independent judgment. All members of the Committee will have a general understanding of basic finance and accounting practices and at least one member must have accounting or related financial management expertise.

III. MEETINGS

The Committee will meet at least four times annually. Additional meetings may occur more frequently as circumstances dictate. The Committee chairman shall approve an agenda in advance of each meeting.

The Committee shall meet privately in executive session at least annually with the Financial Vice President-Auditing & Security, the independent accountants, such other members of management as deemed appropriate, and as a committee to discuss any matters that the Committee believes are relevant to fulfilling its responsibilities.

IV. RESPONSIBILITIES AND DUTIES

The Committee believes its policies and procedures should remain flexible in order to best react to changing conditions and provide reasonable assurance to the Board of Directors that the accounting and reporting practices of the corporation meet applicable requirements and that an effective business ethics program exists.

A. REVIEWS AND PROCEDURES

- Adopt a formal written charter that is approved by the Board of Directors. The charter will be reviewed as necessary, but at least annually. The charter should be published at least every 3 years in accordance with Securities and Exchange Commission ("SEC") regulations.
- Review and approve the annual audited financial statements prior to filing or distribution. The review should include discussion with management and independent accountants of significant issues regarding accounting principles, practices, and judgments. Quarterly unaudited financial results should be reviewed by the Committee, or by the Committee chairman acting on behalf of the Committee, before their release or submission to the SEC.
- Prepare a report to shareholders as required by the SEC to be included in the Company's annual proxy statement.
- Maintain minutes or other records of meetings and activities.
- Keep the Board of Directors informed of the Committee's activities.
- Conduct or authorize investigations into any matters within the Committee's scope of responsibilities. The Committee has direct access to anyone in the Company and shall be empowered to retain independent counsel, accountants, or others to assist it in the conduct of any investigation.

B. INDEPENDENT ACCOUNTANTS

- Select and recommend independent accountants to the Board of Directors for ratification by the shareholders. When conditions warrant, approve discharge of independent accountants. At the time of a change in partner assigned to the Company, the Committee will review the selection of independent accountants, including possible selection of new independent accountants.
- Approve fees to be paid to the independent accountants.
- Ensure that a formal statement delineating all relationships between the independent accountants and the Company is received from the independent accountants annually. The Committee shall discuss with the independent accountants all significant relationships the accountants have with the corporation to determine the accountants' independence.
- Meet with the independent accountants and financial management of the Company to review the scope of the proposed external audit for the current year. The external audit scope shall include a requirement that the independent accountants inform the Committee of any significant changes in the independent accountant's original audit plan and that the independent accountants will conduct an interim financial review prior to the Company's quarterly filing with the SEC.
- Instruct the independent accountants that they are ultimately accountable to the Committee and the Board of Directors.

C. INTERNAL CONTROLS

- Make inquiries of management and the independent accountants concerning the adequacy of the Company's system of internal controls.
- Advise financial management and the independent accountants to discuss with the Committee their qualitative judgments about the quality, not just the acceptability, of accounting principles and financial disclosure practices used or proposed to be adopted by the Company.

D. BUSINESS ETHICS AND CONDUCT

- Provide oversight to the Business Ethics and Conduct program.
- Require management to report on procedures that provide assurance that the corporation's mission, values, and code of conduct are properly communicated to all employees on at least a biannual basis.
- Review the corporation's code of conduct program annually and direct management to establish a system reasonably designed to assure compliance with the code.



Notice of 2001
Annual Meeting
and
Proxy Statement



INDEPENDENT AUDITORS FEES

In addition to retaining KPMG LLP to audit the consolidated financial statements for 2000, the Company and its affiliates retained KPMG, as well as other accounting and consulting firms, to provide various consulting services in 2000, and expect to continue to do so in the future. The aggregate fees billed for professional services by KPMG in 2000 for these various services were:

- *Audit Fees:* \$23.9 million for services rendered for the annual audit of the Company's consolidated financial statements for 2000 and the quarterly reviews of the financial statements included in the Company's Forms 10-Q;
- *Financial Information Systems Design and Implementation Fees:* \$11.5 million for services rendered in connection with the design or implementation of hardware or software systems that aggregate source data underlying the financial statements or generate information that is significant to the financial statements taken as a whole; and
- *All Other Fees:* \$13.8 million for tax services; \$15.5 million for non-financial statement audit services such as due diligence procedures associated with mergers and acquisitions; and \$38.9 million for all other services consisting primarily of information technology consulting and assistance for systems not associated with the financial statements.

Although the Company expects to continue to retain KPMG and other firms to assist in the design and implementation of its financial information systems, GE managers make all management decisions with respect to such systems, and are responsible for evaluating the adequacy of such systems and for establishing and maintaining the Company's system of internal accounting controls.

AUDIT COMMITTEE REPORT

The Audit Committee of the Board of Directors (the Committee) is comprised of the eight directors named below. Each member of the Committee is an independent director as defined by New York Stock Exchange rules. The Committee has adopted a written charter which has been approved by the Board of Directors, and which is set forth in Appendix A of this Proxy Statement. The Committee has reviewed and discussed the Company's audited financial statements with management, which has primary responsibility for the financial statements. KPMG LLP, the Company's independent auditor for 2000, is responsible for expressing an opinion on the conformity of the Company's audited financial statements with generally accepted accounting principles. The Committee has discussed with KPMG the matters that are required to be discussed by Statement on Auditing Standards No. 61 (*Communication With Audit Committees*). KPMG has provided to the Committee the written disclosures and the letter required by Independence Standards

Board Standard No. 1 (*Independence Discussions with Audit Committees*), and the Committee discussed with KPMG that firm's independence. The Committee also considered whether KPMG's provision of non-audit services, including financial information systems design and implementation services, to GE and its affiliates is compatible with KPMG's independence.

Based on the considerations referred to above, the Committee recommended to the Board of Directors that the audited financial statements be included in the Company's Annual Report on Form 10-K for 2000 and that KPMG be appointed independent auditors for the Company for 2001. The foregoing report is provided by the following independent directors, who constitute the Audit Committee:

Gertrude G. Michelson (Chairman)
Silas S. Cathcart
Ann M. Fudge
Claudio X. Gonzalez

Roger S. Penske
Frank H.T. Rhodes
Andrew C. Sigler
Douglas A. Warner III

• APPOINTMENT OF INDEPENDENT AUDITORS

KPMG LLP have been recommended by the Audit Committee of the Board for reappointment as the Independent Auditors for the Company. KPMG LLP were the Independent Auditors for the Company for the year ended December 31, 2000. The Firm is a member of the SEC Practice Section of the American Institute of Certified Public Accountants. Subject to share owner approval, the Board of Directors has appointed this Firm as the Company's Independent Auditors for the year 2001.

Representatives of the Firm are expected to attend the 2001 Annual Meeting. They will have an opportunity to make a statement if they desire to do so and will be available to respond to appropriate share owner questions.

Your Board of Directors recommends a vote FOR the following proposal:

Resolved that the appointment by the Board of Directors of the Firm of KPMG LLP, Stamford Square, Stamford, Connecticut, as Independent Auditors for the Company for the year 2001 is hereby approved.

APPENDIX A**AUDIT COMMITTEE CHARTER**

The Audit Committee (Committee) shall consist of a minimum of three directors. As determined by the Board of Directors in accordance with applicable requirements, all members of the Committee shall be independent directors having no relationship that may interfere with the exercise of their objective judgment in discharging the responsibilities set forth below. As also determined by the Board of Directors, all members of the Committee shall have sufficient financial experience and ability to enable them to discharge such responsibilities, and at least one member shall have accounting or related financial management expertise. The Committee shall have the following responsibilities with respect to the Company, which term shall include without limitation its subsidiaries General Electric Capital Services, Inc., and General Electric Capital Corporation:

1. To recommend to the Board of Directors, for share owner approval, the independent auditor to examine the Company's accounts, controls and financial statements. The independent auditor is ultimately accountable to the Board of Directors and to the Committee, and the Board of Directors and the Committee have the ultimate authority and responsibility to select, evaluate and if necessary replace the independent auditor.
 2. To review and approve the scope of the examination to be conducted by the independent auditor. In addition, the Committee shall at least annually obtain from the independent auditor a formal written statement delineating all relationships between the independent auditor and the Company, and shall at least annually discuss with the independent auditor any relationship or services which may impact the independent auditor's objectivity or independence, and shall take or recommend that the Board take appropriate actions to ensure such independence.
 3. To review and approve the Corporate Audit Staff functions, including: (i) purpose, authority and organizational reporting lines; (ii) annual audit plan, budget and staffing; and (iii) concurrence in the appointment, removal and compensation of the Vice President – Corporate Audit Staff.
 4. To review results of the examinations of the financial statements of the Company by the independent auditors, their evaluation of the Company's internal system of audit and financial controls, and their annual report on the Company's financial statements.
-

5. To review, with the Senior Vice President-Finance, the Vice President – Corporate Audit Staff or such others as the Committee deems appropriate the Company's internal system of audit and financial controls and the results of internal audits.

6. To review the Company's financial reporting, the accounting standards and principles followed by the Company and significant changes in such standards or principles or in their application.

7. To review and investigate any matters pertaining to the integrity of management, including conflicts of interest, or adherence to standards of business conduct as required in the policies of the Company. In connection therewith, the Committee will meet, as deemed appropriate, with the General Counsel and other Company officers or employees.

In discharging its responsibilities, the Committee will periodically meet with the Company's auditors without the presence of any Company officer or employee.

AOL Time Warner

March 27, 2001

Dear Stockholder:

You are cordially invited to attend the 2001 Annual Meeting of Stockholders of AOL Time Warner Inc. on Thursday, May 17, 2001, beginning at 10:00 A.M., local time, at the Apollo Theatre, 253 West 125th Street, New York, New York 10027. We look forward to greeting those of you who are able to attend this first meeting of stockholders of AOL Time Warner.

Please vote on all the matters listed in the enclosed Notice of Annual Meeting of Stockholders. Your Board of Directors recommends a vote “**FOR**” the proposals listed as items 1 and 2 in the Notice and described in the enclosed Proxy Statement.

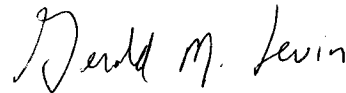
Whether or not you plan to attend in person, it is important that your shares be represented and voted at the Meeting. After reading the enclosed Notice and Proxy Statement, please submit your proxy or voting instructions by telephone, over the Internet or by using a traditional proxy or instruction card. If you submit your proxy over the Internet, you will have the opportunity to agree to receive future stockholder documents electronically, via e-mail, and we encourage you to do so. If you choose to vote this year by traditional proxy or instruction card, please sign, date and mail the card in the envelope provided.

All stockholders of record on March 23, 2001 are invited to attend the Annual Meeting. No ticket is required for admission. The Annual Meeting will be audiocast live on the Internet at <http://www.aoltimewarner.com/investors>.

Sincerely,



Stephen M. Case
Chairman of the Board



Gerald M. Levin
Chief Executive Officer

**YOUR VOTE IS IMPORTANT. PLEASE PROMPTLY SUBMIT YOUR PROXY
BY MAIL, TELEPHONE OR INTERNET.**

Non-employee directors are reimbursed for expenses incurred in attending Board and committee meetings, including those for travel, food and lodging.

Directors who are officers of or employed by the Company or any of its subsidiaries are not additionally compensated for their Board and committee activities.

Report of the Audit and Finance Committee

In accordance with a written charter adopted by the Company's Board of Directors, the Audit and Finance Committee of the Company's Board of Directors (the "Committee") assists the Board of Directors in fulfilling its responsibility for oversight of the quality and integrity of the Company's financial reporting processes. Management has the primary responsibility for the financial statements and the reporting process, including the system of internal controls. The independent auditors are responsible for performing an independent audit of the Company's consolidated financial statements in accordance with generally accepted auditing standards and for issuing a report thereon.

In this context, the Committee has met and held discussions with management and the independent auditors. Management represented to the Committee that the Company's consolidated financial statements were prepared in accordance with generally accepted accounting principles, and the Committee has reviewed and discussed the consolidated financial statements with management and the independent auditors. The Committee discussed with the independent auditors matters required to be discussed by Statement on Auditing Standards No. 61 (Communications with Audit Committees), as amended.

In addition, the Committee has discussed with the independent auditors the auditors' independence from the Company and its management, including the matters in the written disclosures required by the Independence Standards Board Standard No. 1 (Independence Discussions with Audit Committees) and also considered whether the provision of the non-audit related services included below under "Fees of Accountants" is compatible with maintaining their independence.

The Committee discussed with the Company's internal and independent auditors the overall scope and plans for their respective audits. The Committee meets with the internal and independent auditors, with and without management present, to discuss the results of their examinations, the evaluations of the Company's internal controls and the overall quality of the Company's accounting principles.

The aggregate fees billed by the principal auditors (Ernst & Young LLP) to each of America Online and Time Warner for the year ended December 31, 2000 are as follows:

Fees of Accountants		
	<u>America Online</u>	<u>Time Warner</u>
Audit Fees	\$1,353,000	\$ 6,507,000
Financial Information Systems Design and Implementation Fees(1)	-	7,226,000
All Other Fees		
Audit-Related	1,561,000	13,264,000(2)
Other	597,000	28,408,000(3)
Total All Other Fees	<u>2,158,000</u>	<u>41,672,000</u>
Total Fees	<u>\$3,511,000</u>	<u>\$55,405,000</u>

(1) Consists of fees billed by the Ernst & Young LLP consulting group prior to its sale on May 23, 2000 to Cap Gemini S.A., a separate French public company.

(2) Consists principally of fees related to outsourcing the implementation of Time Warner's internal audit plan and international statutory audit requirements.

(3) Consists principally of fees related to tax compliance and planning.

In reliance on the reviews and discussions referred to above, the Committee recommended to the Board of Directors, and the Board has approved, that the audited financial statements of America Online, as the predecessor to AOL Time Warner Inc. for accounting purposes, for the three years ended December 31, 2000 be included in the Company's Annual Report on Form 10-K for the period ended December 31, 2000 for filing with the Securities and Exchange Commission. The Committee has also recommended to the Board of Directors, subject to stockholder ratification, the selection of Ernst & Young LLP as the Company's independent auditors for 2001, and the Board concurred in its recommendation.

Members of the Audit and Finance Committee

Daniel F. Akerson
 Stephen F. Bollenbach (Chair)
 Franklin D. Raines
 Francis T. Vincent, Jr.

SECURITY OWNERSHIP

Security Ownership of the Board of Directors and Executive Officers

The following table sets forth as of January 31, 2001 for each current director, each nominee for election as a director, each of the executive officers named in the Summary Compensation Table below and for all current directors and executive officers as a group, information concerning the beneficial ownership of Common Stock.

Name	Common Stock Beneficially Owned(1)		
	Number of Shares	Option Shares(2)	Percent of Class
Daniel F. Akerson	3,356	323,918	*
James L. Barksdale (3)	6,673,334	0	*
Stephen F. Bollenbach	4,687	13,500	*
Stephen M. Case (4)	10,829,473	19,973,700	*
Frank J. Caufield (5)	33,435	1,882,200	*
Miles R. Gilburne	0	2,259,053	*
Carla A. Hills	16,039	18,000	*
Gerald M. Levin (6)(12)	2,654,536	9,066,254	*
Reuben Mark	38,239	18,000	*
Michael A. Miles	34,780	18,000	*
Kenneth J. Novack (7)	4,196	5,093,969	*
Richard D. Parsons (8)(12)	38,020	3,250,003	*
Robert W. Pittman (9)	14,601	6,572,255	*
Franklin D. Raines	0	250,000	*
R.E. Turner (10)(12)	155,081,921	6,475,003	3.80%
Francis T. Vincent, Jr. (11)	60,890	18,000	*
All current directors and executive officers (23 persons) as a group (2)-(12)	176,092,917	62,443,132	5.54%

* Represents beneficial ownership of less than one percent of issued and outstanding Common Stock on January 31, 2001.

- (1) Beneficial ownership as reported in the above table has been determined in accordance with Rule 13d-3 of the Securities Exchange Act of 1934. Unless otherwise indicated, beneficial ownership represents both sole voting and sole investment power. This table does not include, unless otherwise indicated, any shares of Common Stock or other equity securities of the Company which may be held by pension and profit-sharing

Annex A**AOL TIME WARNER INC.****AUDIT AND FINANCE COMMITTEE CHARTER**

This Charter supplements the authority of the committee of the Board of Directors (the “Board”) known as the Audit and Finance Committee (the “Committee”) as such delegation of authority is set forth from time to time in the By-laws of AOL Time Warner Inc. (the “Company”). The Committee shall review and reassess this Charter at least annually. The Committee has oversight responsibilities regarding (1) the integrity of the Company’s financial reporting functions and related financial information provided to the public and (2) the Company’s external and internal audit processes and systems of internal control and compliance. The Committee also has responsibilities related to the Company’s financial structure and policies.

Statement of Policy and Responsibilities

The Committee shall provide assistance to the directors in fulfilling their responsibility to the shareholders, potential shareholders, and investment community relating to the oversight and monitoring of the accounting practices of the Company, as well as the quality and integrity of financial reports of the Company. While the Committee has the responsibilities and powers set forth in this Charter, it is not the duty of the Committee to plan or conduct audits or to determine that the Company’s financial statements are complete and accurate and are in accordance with generally accepted accounting principles. Nor is it the duty of the Committee to conduct investigations, to resolve disagreements, if any, between management and the independent auditors or to assure compliance with laws and regulations and the Company’s compliance program. In performing its functions, the Committee will endeavor to facilitate free and open communication between the directors, the independent auditors, the internal auditors and the management of the Company. The Committee’s policies and procedures should remain flexible in order to best assist the Board in fulfilling its oversight responsibilities.

Composition

The Committee shall be comprised of at least three directors each of whom has been appointed and determined by the Board to be independent and financially literate and at least one of whom has been found to have accounting or related financial management expertise, each as prescribed by the New York Stock Exchange.

Meetings

The Committee will meet at such times as deemed necessary to perform its required duties. The Committee may ask members of management or others to attend meetings and provide pertinent information as necessary.

Authority of the Committee

In carrying out its responsibilities, the Committee has the authority to:

Finance Matters

- Review and make recommendations to the Board concerning the financial structure, condition and strategy of the Company and its subsidiaries, including with respect to annual budgets, long-term financial plans, corporate borrowings, investments, capital expenditures, long-term commitments and the issuance and/or repurchase of stock.

- Approve such matters that are consistent with the general financial policies and direction from time to time determined by the Board.

Financial Reporting and Related Financial Information

- In consultation with the independent auditors and management, review the Company's interim financial statements and, prior to filing each of the Company's Quarterly Reports on Form 10-Q with the Securities and Exchange Commission, discuss the results of the quarter covered by the Report on Form 10-Q and any other matters required to be communicated to the Committee by the independent auditors under generally accepted auditing standards. The chair of the Committee may represent the entire Committee for purposes of this review and discussion.
- In consultation with management and the independent auditors, review the Company's annual financial statements and the auditor's opinion and MD&A to be contained in the annual report on Form 10-K (or the annual report to shareholders if distributed prior to the filing of the Form 10-K) prior to the filing of the Form 10-K.
- Review with management and the independent auditors (a) the results of their analysis of significant financial reporting issues and practices, including material changes in, or adoptions of, accounting principles and disclosure practices and standards and (b) material questions of choice with respect to the appropriate accounting principles and practices used and to be used in the preparation of the Company's financial statements, including judgments about the quality, not just acceptability, of accounting principles, the reasonableness of significant judgments and the clarity of the disclosure in the financial statements. In addition, discuss any other matters required to be communicated to the Committee by the outside auditors under generally accepted auditing standards.

External and Internal Audit Processes and Internal Controls

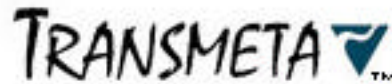
- Review and recommend to the Board the selection (and, when appropriate, replacement) of the independent auditors to audit the financial statements of the Company and have a clear understanding with the independent auditors that they are ultimately accountable to the Board of Directors and the Committee, as the shareholders' representatives.
- Review with the independent auditors and management of the Company the plan and scope of the proposed annual external audit and quarterly reviews for the current year, including the procedures to be utilized and the independent auditor's compensation.
- In consultation with the independent auditors and management, review the results of the annual external audit of the Company, significant findings thereof, and any other matters required to be communicated by the independent auditors under generally accepted auditing standards, including, if applicable, the independent auditors' summary of any significant accounting, auditing and internal control issues, along with recommendations and management's corrective action plans, if applicable (management letter). Such review should also address any significant changes to the original audit plan and any significant disputes with management during the audit or review. Management should notify the Committee when it seeks a second opinion on a significant accounting issue.
- Review at least annually the overall professional services, independence and qualifications of the independent auditors, including the periodic receipt from the independent auditors of a written communication delineating any and all relationships between the Company and such auditors (including any significant fees for any anticipated non-audit services), most importantly, those required by Independence Standards Board Standard No. 1, Independence Discussions with Committees. In addition, review with the independent auditors the nature

and scope of any disclosed relationships or professional services and their impact on, and compatibility with, such auditors' objectivity and independence and, if it finds it advisable, take, or recommend that the Board take, appropriate action to satisfy itself of the independence of the auditors.

- In consultation with the Company's independent auditors and chief internal auditor, review the plan and scope of the internal audit function and the adequacy of the Company's internal accounting controls and the significant findings of the Company's internal audits and meet separately with the Company's internal auditors and independent auditors, with and without management present, to discuss the results of their reviews.
- Oversee the Company's Corporate Compliance Program, including any significant compliance findings.

Reporting by the Committee and Other Matters

- If required by the rules and regulations of the Securities and Exchange Commission, provide a report that complies with such rules and regulations to be included in the Company's proxy statement.
- Report the results of the annual external audit to the Board.
- Investigate any matter within the scope of its responsibilities that it determines appropriate.



April 16, 2001

To our stockholders:

You are cordially invited to attend the 2001 Annual Meeting of Stockholders of Transmeta Corporation to be held at the Westin Hotel at 5101 Great America Parkway, Santa Clara, California, on Thursday, May 17, 2001 at 8:00 a.m., local time.

The matters to be acted upon at the meeting are described in detail in the accompanying Notice of Annual Meeting of Stockholders and Proxy Statement.

Please use this opportunity to take part in Transmeta's affairs by voting on the business to come before this meeting. **Whether or not you plan to attend the meeting in person, please complete, date, sign and promptly return the enclosed proxy card in the enclosed postage-paid envelope before the meeting so that your shares will be represented at the meeting.** Returning the proxy does not deprive you of your right to attend the meeting and to vote your shares in person.

We hope to see you at the meeting.

Sincerely,

Mark K. Allen
Chief Executive Officer and President

the non-employee director remains a director or consultant. In the event of our dissolution, liquidation or a change in control transaction, options granted to our non-employee directors under the plan will vest and be exercisable in full.

The board recommends a vote *for* the election of each nominated director.

PROPOSAL NO. 2: RATIFICATION OF SELECTION OF INDEPENDENT AUDITORS

Subject to ratification by the stockholders, the board has reappointed Ernst & Young LLP as independent auditors to audit the financial statements of the company for the current fiscal year. Fees for the last fiscal year were \$218,000 for the annual audit and \$700,000 for audit related services.

Representatives of the firm of Ernst & Young LLP are expected to be present at the meeting and will have an opportunity to make a statement if they so desire and will be available to respond to appropriate questions.

The board recommends a vote *for* ratification of the selection of Ernst & Young LLP

REPORT OF THE AUDIT COMMITTEE

The following is the report of the audit committee with respect to Transmeta's audited financial statements for fiscal year 2000. It shall not be deemed to be incorporated by reference by any general statement incorporating this proxy statement by reference into any filing under the Securities Act of 1933 or under the Securities Exchange Act of 1934, except to the extent that we specifically incorporate this information by reference. Also, it shall not otherwise be deemed soliciting material or filed under these Acts.

The audit committee's purpose is to assist the board in its oversight of Transmeta's financial accounting, reporting and controls. The committee operates under a charter approved by the board in August 2000. A copy of the current charter is in the Appendix to this proxy statement.

Management is responsible for the preparation, presentation and integrity of Transmeta's financial statements, accounting and financial reporting principles and internal controls and procedures designed to assure compliance with accounting standards and applicable laws and regulations. The independent auditors, Ernst & Young LLP, are responsible for performing an independent audit of the consolidated financial statements in accordance with generally accepted auditing standards. The audit committee discusses with our independent auditors the overall scope and plans for the audit. The audit committee meets with our internal finance staff and our independent auditors, with and without management present, to discuss the results of their examinations, their evaluations of Transmeta's internal controls and the overall quality of Transmeta's accounting principles.

In performing its oversight role, the audit committee considered and discussed the audited financial statements with management and the independent auditors. The committee also discussed with the independent auditors the matters required to be discussed by Statement on Auditing Standards No. 61, *Communication with Audit Committees*. The committee received the written disclosures and the letter from the independent auditors required by Independence Standards Board Standard No. 1, *Independence Discussions with Audit Committees*. The committee also considered whether the provision of non-audit services by the independent auditors is compatible with maintaining the auditors' independence and has discussed with the auditors the auditors' independence. Based on the reports and discussions described in this report, and subject to the limitations on the role and responsibilities of the committee referred to below and in its charter, the audit committee recommended to the board that the audited financial statements be included in the Annual Report on Form 10-K for fiscal year 2000. The audit committee and the board also recommended, subject to stockholder approval, the selection of Ernst & Young LLP as independent auditors.

Audit Committee:

Murray A. Goldman, Chairman
Larry R. Carter
William P. Tai

TRANSMETA CORPORATION**CHARTER OF THE AUDIT COMMITTEE OF THE BOARD OF DIRECTORS****I Purpose**

The purpose of the Audit Committee (the "Committee") of the Board of Directors (the "Board") of Transmeta Corporation (the "Company") is to assist the Board in fulfilling its statutory and fiduciary oversight responsibilities relating to the Company's financial accounting, reporting and controls. The Committee's principal functions are to:

- ? monitor the periodic reviews of the adequacy of the accounting and financial reporting processes and systems of internal control that are conducted by the Company's independent auditors, the Company's financial and senior management;
- ? review and evaluate the independence and performance of the Company's independent auditors; and
- ? facilitate communication among the Company's independent auditors, the Company's financial and senior management, and the Board.

The Committee will fulfill these functions primarily by carrying out the activities enumerated in Part IV of this charter. In order to serve these functions, the Committee shall have unrestricted access to Company personnel and documents, and shall have authority to direct and supervise an investigation into any matters within the scope of its duties, including the power to retain outside counsel in connection with any such investigation.

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

II Membership

All members of the Committee will be appointed by, and shall serve at the discretion of, the Board. Unless a chair is elected by the full Board, the members of the Committee may designate a Chair by majority vote of the Committee membership.

As of the date this charter is adopted, the Committee shall consist of three or more members of the Board, with the exact number being determined by the Board. Each member of the Committee shall be "independent" as defined by the rules of The Nasdaq Stock Market, as they may be amended from time to time (the "Rules"), except as otherwise permitted by such Rules. Each member of the Committee shall have the ability to read and understand fundamental financial statements (or become able to do so within a reasonable time after joining the Committee) and at least one member shall have prior experience in accounting, financial management or financial oversight, as required by the Rules.

III Meetings

Meetings of the Committee shall be held from time to time as determined by the Board and/or the members of the Committee. The Committee should periodically meet with the independent auditors out of the presence of management about internal controls, the fullness and accuracy of the Company's financial statements and any other matters that the Committee or these groups believe should be discussed privately with the Committee. The Committee members, or the Chairman of the Committee on behalf of all of the Committee members, should communicate with

management and the independent auditors on a quarterly basis in connection with their review of the Company's financial statements.

IV. Responsibilities and Duties

The following shall be the principal recurring processes of the Committee in carrying out its oversight responsibilities. These processes are set forth as a guide with the understanding that the Committee may supplement them as appropriate and may establish policies and procedures from time to time that it deems necessary or advisable in fulfilling its responsibilities.

1. Review the Company's quarterly and annual financial statements, including any report or opinion by the independent auditors, prior to distribution to the public or filing with the Securities and Exchange Commission.
2. In connection with the Committee's review of the annual financial statements:
 - ?? Discuss with the independent auditors, management the financial statements and the results of the independent auditors' audit of the financial statements.
 - ?? Discuss any items required to be communicated by the independent auditors in accordance with SAS 61, as amended. These discussions should include the independent auditors' judgments about the quality and appropriateness of the Company's accounting principles, the reasonableness of significant judgments, the clarity of the disclosures in the Company's financial statements and any significant difficulties encountered during the course of the audit, including any restrictions on the scope of work or access to required information.
3. In connection with the Committee's review of the quarterly financial statements:
 - ?? Discuss with the independent auditors and management the results of the independent auditors' SAS 71 review of the quarterly financial statements.
 - ?? Discuss significant issues, events and transactions and any significant changes regarding accounting principles, practices, judgments or estimates with management and the independent auditors, including any significant disagreements among management and the independent auditors.
4. Discuss any comments or recommendations of the independent auditors outlined in their annual management letter. Approve a schedule for implementing any recommended changes and monitor compliance with the schedule.
5. Discuss with the independent auditors, management their periodic reviews of the adequacy of the Company's accounting and financial reporting processes and systems of internal control, including the adequacy of the systems of reporting to the audit committee by each group.
6. Periodically consult with the independent auditors out of the presence of management about internal controls, the fullness and accuracy of the Company's financial statements and any other matters that the Committee or these groups believe should be discussed privately with the Committee.
7. Review the independence and performance of the independent auditors. Recommend to the Board of Directors the appointment or discharge of the independent auditors.
8. Communicate with the Company's independent auditors about the Company's expectations regarding its relationship with the auditors, including the following: (i) the independent auditors' ultimate accountability to the Board and the Committee, as representatives of the Company's stockholders; and (ii) the ultimate authority and responsibility of the Board and the Committee to select, evaluate and, where appropriate, replace the independent auditors.
9. Review and approve processes and procedures to ensure the continuing independence of the Company's independent auditors. These processes shall include obtaining and reviewing, on an annual basis, a letter from the

independent auditors describing all relationships between the independent auditors and the Company required to be disclosed by Independence Standards Board Standard No. 1, reviewing the nature and scope of such relationships and discontinuing any relationships that the Committee believes could compromise the independence of the auditors.

10. Review the independent auditors' audit plan.
11. Approve the fees and other significant compensation to be paid to the independent auditors.
12. Periodically review the status of any legal matters that could have a significant impact on the Company's financial statements.
13. Annually prepare a report to the Company's stockholders for inclusion in the Company's annual proxy statement as required by the rules and regulations of the Securities and Exchange Commission, as they may be amended from time to time.
14. Maintain minutes of meetings and periodically report to the Board of Directors on significant matters related to the Committee's responsibilities.
15. Review and reassess the adequacy of the Committee's charter at least annually. Submit the charter to the Company's Board of Directors for review and include a copy of the charter as an appendix to the Company's proxy statement as required by the rules and regulations of the Securities and Exchange Commission, as they may be amended from time to time (currently, once every three years).
16. Perform any other activities required by applicable law, rules or regulations, including the rules of the Securities and Exchange Commission and any stock exchange or market on which the Company's Common Stock is listed, and perform other activities that are consistent with this charter, the Company's Bylaws and governing laws, as the Committee or the Board deems necessary or appropriate.

INTIMATE
brands

**Three Limited Parkway
Columbus, Ohio 43230
(614) 415-8000**

April 20, 2001

Dear Stockholder:

You are cordially invited to attend our 2001 annual meeting of stockholders to be held at 10:30 a.m., Eastern Daylight Time, on May 21, 2001, at the offices of Bath & Body Works, Inc. located at Seven Limited Parkway East, Reynoldsburg, Ohio. Should you require assistance in finding the location of the meeting, please call (614) 415-6900. The formal Notice of Annual Meeting of Stockholders and Proxy Statement are attached. I hope that you will be able to attend and participate in the meeting, at which time I will have the opportunity to review the business and operations of Intimate Brands.

The matters to be acted upon by our stockholders are discussed in the Notice of Annual Meeting of Stockholders. It is important that your shares be represented and voted at the meeting. Accordingly, after reading the attached Proxy Statement, would you kindly sign, date and return the enclosed proxy card or vote by telephone or by Internet as described on the enclosed proxy card. Your vote is important regardless of the number of shares you own.

Sincerely yours,

Leslie H. Wexner

A handwritten signature in black ink, appearing to read "Leslie H. Wexner". The signature is fluid and cursive, written over a light blue horizontal line.

Chairman of the Board

REPORT OF THE AUDIT COMMITTEE

In accordance with our written charter adopted by the Board in 2000 (a copy of which is filed as Appendix A to this proxy statement), the Audit Committee assists the Board in fulfilling its oversight responsibilities with respect to the following matters: the system of internal control, the audit process, the financial reporting process and the process for monitoring compliance with applicable laws and regulations and our code of business conduct. We and the Board have the ultimate authority and responsibility to select, evaluate and, where appropriate, replace our independent public accountants. We also annually review our independent public accountants' qualifications and fees. In addition, we (i) ensure that Intimate Brands' independent public accountants submit, on a periodic basis, a formal written statement delineating relationships between the accountants and Intimate Brands, (ii) actively engage in dialogue with the accountants with respect to any disclosed relationships or services that may impact their objectivity and independence and (iii) recommend that the Board take appropriate action in response to the foregoing to satisfy itself of the accountants' independence.

Management is responsible for the financial reporting process, including the system of internal control, and for the preparation of consolidated financial statements in accordance with generally accepted accounting principles. The Company's independent accountants are responsible for auditing those financial statements. Our responsibility is to monitor and review the output of these processes. However, we are not professionally engaged in the practice of accounting and auditing and are not experts in the fields of accounting and auditing. We rely on the information provided to us and on the representations made by management and the independent accountants.

We have reviewed and discussed Intimate Brands' audited financial statements as of and for the year ended February 3, 2001 and met with both management and our independent accountants to discuss the financial statements. Management has represented to us that the financial statements were prepared in accordance with generally accepted accounting principles. We have reviewed with the internal auditors and independent accountants the overall scope and plans for their respective audits. We also met with the internal auditors and independent accountants, with and without management present, to discuss the results of their examinations and their evaluations of the Company's internal controls.

We have also discussed with the independent accountants all matters required to be discussed with audit committees by Statement on Auditing Standards No. 61 (Communication with Audit Committees). The Company's independent accountants also provided to us the written disclosures and the letter required by Independence Standards Board Standard No. 1 (Independence Discussions with Audit Committees), and we discussed with the independent accountants their independence from the Company. When considering the accountants' independence, we considered whether the provision of information technology consulting services relating to financial information systems design and implementation and other non-audit services by the independent accountants to the Company is compatible with maintaining their independence.

Based on the reviews and discussions summarized in this Report, and subject to the limitations on our role and responsibilities, certain of which are referred to above and in the Audit Committee charter, we recommended to the Board that Intimate Brands' audited financial statements be included in our Annual Report on Form 10-K for the fiscal year 2000 for filing with the Securities and Exchange Commission.

Audit Committee

Roger D. Blackwell, Chair
William E. Kirwan

March 16, 2001

APPENDIX A

INTIMATE BRANDS, INC.

Audit Committee Charter

The Audit Committee assists the Board of Directors in fulfilling its oversight responsibilities with respect to the following matters: the system of internal control; the audit process; the financial reporting process; and the process for monitoring compliance with applicable laws and regulations and the Corporation's code of business conduct.

The Audit Committee shall consist of not less than three nor more than five members, who shall be elected by the Board of Directors from the directors who are not employees of the Corporation and who have no other relationship to the Corporation that may interfere with the exercise of their independence from management and the Corporation. The Board shall designate one member of the Committee to serve as its Chair. Each member of the Committee shall be financially literate, and at least one member shall have accounting or related financial management expertise. All determinations relating to the eligibility of directors to serve on the Committee shall be made by the Board in the exercise of its business judgment and in a manner consistent with the requirements of the New York Stock Exchange.

The Audit Committee shall meet as often as it deems necessary, but in no event less than four times per year. The Committee shall have the power to adopt its own operating rules and procedures and to request that members of management, representatives of the Corporation's independent public accountants, and others attend meetings and provide pertinent information. The Committee may also meet in executive session with any of such persons.

The Corporation's independent public accountants are ultimately accountable to the Audit Committee and the Board of Directors. The Committee and the Board have the ultimate authority and responsibility to select, evaluate and, where appropriate, replace the Corporation's independent public accountants. The Committee will also annually review their qualification and fees. In addition, the Committee shall (i) ensure that the independent public accountants submit, on a periodic basis, a formal written statement delineating all relationships between such accountants and the Corporation, (ii) actively engage in dialogue with such accountants with respect to any disclosed relationships or services that may impact their objectivity and independence, and (iii) recommend that the Board take appropriate action in response to the foregoing to satisfy itself of such accountants' independence.

On an annual basis, the Audit Committee will review and reassess the adequacy of this charter.

Purchase, New York 10577-1444

NOTICE OF ANNUAL MEETING OF SHAREHOLDERS

PepsiCo will hold its Annual Shareholders' Meeting at the headquarters of Frito-Lay, Inc., 7701 Legacy Drive, Plano, Texas, on Wednesday, May 2, 2001, at 10:00 A.M. local time, to:

- * Elect directors.
- * Approve the appointment of independent auditors.
- * Act upon four shareholder proposals described in the attached Proxy Statement.
- * Transact any other business that may properly come before the Meeting.

If you own shares of PepsiCo Capital Stock as of the close of business on March 9, 2001 (the Record Date), you can vote those shares by mailing the enclosed proxy card or voting at the Meeting. Shareholders of record may also submit their proxies electronically or by telephone as follows:

- * By visiting the web site at <http://proxy.shareholder.com/pep> and following the instructions; or
- * By calling 800.650.4886 in the United States, Canada or Puerto Rico on a touch-tone phone and following the recorded instructions.

If you plan to attend the Meeting, please check the box on your proxy card, so that we may send you an admission card.

Whether or not you plan to attend the Meeting, please complete the enclosed proxy card, and sign, date and return it promptly in the enclosed postage-paid envelope so that your shares will be represented. The holders of record of a majority of the outstanding shares must be present in person or represented by proxy at the Annual Meeting in order to hold the Meeting. Any shareholder returning a proxy may revoke it by voting at the Meeting.

March 23, 2001

ROBERT F. SHARPE, JR.

Secretary

Audit Committee Report

PepsiCo's Audit Committee consists entirely of directors who meet the independence and financial experience requirements of the New York Stock Exchange.

In fulfilling its responsibilities under its charter during 2000, the Committee reviewed and discussed the Company's audited financial statements with management, which has primary responsibility for the financial statements, and the Company's independent auditors, KPMG, who are responsible for expressing an opinion on the conformity of the audited financial statements with generally accepted accounting principles. The discussions included the quality, not just the acceptability, of the accounting principles utilized, the reasonableness of significant accounting judgments, and the clarity of disclosures.

The Committee reviewed with the Company's internal and independent auditors the overall scope and plans for their respective audits for 2000. The Committee also reviewed all fees paid to the independent auditors; these fees are described at the end of this report.

The Committee also discussed with the independent auditors other matters required to be discussed with the Committee under generally accepted auditing standards.

The Committee reviewed KPMG's independence and, as part of that review, received the written disclosures and letter required by the Independence Standards Board, and considered whether KPMG's provision of non-audit services to the Company was compatible with the auditor's independence.

In reliance on the reviews and discussions referred to above, the Committee recommended to the Board of Directors, and the Board has approved, that the audited financial statements be included in the Annual Report on Form 10-K for the fiscal year ended December 30, 2000, for filing with the Securities and Exchange Commission. The Committee and the Board have also recommended to shareholders the election of KPMG as the Company's independent auditors for fiscal 2001.

THE AUDIT COMMITTEE

JOHN F. AKERS
ROBERT E. ALLEN
PETER FOY
RAY L. HUNT
ARTHUR C. MARTINEZ
JOHN J. MURPHY

FRANKLIN D. RAINES
SHARON PERCY ROCKEFELLER
FRANKLIN A. THOMAS
CYNTHIA M. TRUDELL
SOLOMON D. TRUJILLO

Appendix A

Audit Committee Charter

(As amended effective April 1, 2000)

The primary responsibilities of the Audit Committee of the Board of Directors are to:

- * Monitor the Corporation's financial reporting process and internal control system.
- * Monitor the audit processes of the Corporation's independent accountants and internal audit department.
- * Provide an open avenue of communication among the Corporation's independent accountants, financial and senior management, the internal auditing department, and the Board of Directors.

The Audit Committee shall consist entirely of independent directors. Each member shall be free of any relationship that, in the judgment of the Board of Directors, would interfere with the exercise of his or her independent judgment. The members of the Committee shall also satisfy, in the judgment of the Board, the New York Stock Exchange's financial qualification requirements.

In fulfilling its responsibilities, the Committee shall:

1. Review this Charter on an annual basis and update it as conditions dictate.
2. Review with management the Corporation's annual financial statements, including significant changes in accounting principles or their application.
3. Review with the independent accountants their audit report on the annual financial statements, including the application of the Corporation's accounting principles; and discuss with the independent accountants and management their judgment as to the quality of the Corporation's accounting principles.
4. Based on the Committee's review and discussion of the Corporation's annual financial statements with management and the independent accountants, recommend to the Board that the annual financial statements be included in the Corporation's 10-K Annual Report.
5. With respect to the independent accountants audit of the Corporation's annual financial statements and review of its quarterly financial statements, discuss with the independent accountants those matters described in Statement on Auditing Standards 61, as amended from time to time.
6. Review the audit plans and activities of the independent accountants and the internal auditors, and the coordination of their audit efforts.
7. Recommend to the Board the selection or replacement of the independent accountants, taking into consideration independence and effectiveness. As part of such process, obtain from such accountants, and discuss with them, the disclosures regarding independence required by Independence Standards Board Standard No. 1, as amended or supplemented from time to time.
8. Approve the fees paid to the independent accountants with respect to all services.
9. Review and concur in the appointment or replacement of the director of internal auditing.
10. Review with management, the independent accountants and internal auditor the adequacy of the Corporation's internal controls and management's responses with respect to recommendations for internal control improvements.
11. Review the internal audit department's staffing, budget and responsibilities.

12. Review with the internal auditor and independent accountants the results of their reviews of (a) officers' expense accounts and use of corporate assets and (b) key employees' compliance with the Corporation's Code of Worldwide Business Conduct.
13. Meet with the director of internal auditing and the independent accountants in separate executive sessions to discuss any matters which the Committee or these groups believe should be discussed privately with the Committee.
14. Report Committee actions to the Board of Directors, with such recommendations as the Committee deems appropriate.
15. Report to stockholders in the Corporation's annual proxy statement on those matters required by Securities and Exchange Commission Rules.
16. Conduct or authorize investigations into any matters within the Committee's scope of responsibilities.
17. Consider such other matters with respect to the Corporation's financial affairs, internal controls and the internal and external audits as the Committee may deem advisable.

Ernest Ten Eyck, CPA, CFE
Ten Eyck Associates, Inc.

LEGAL AND REGULATORY DEVELOPMENTS AFFECTING THE AUDIT COMMITTEE

Points for Counsel to Ponder

- n It is a registrant's responsibility to engage an auditor that is independent. What the auditing firm thinks is "OK", in terms of consulting services is of interest, but not necessarily dispositive of anything. The task of assessing potential independence issues should receive careful attention from the audit committee.
- n The "transition period" provided in the SEC's rules regarding certain non-audit services is not a license to perform those services during the transition period without regard to specific facts and circumstances.
- n A recent academic study suggests that there is indeed a correlation between significant consulting fees paid to the audit firm and the accommodative attitude (or lack thereof) of the auditors regarding "cookie jar" reserves. That clearly provides a reason for the audit committee to take a hard look.
- n Where financial reporting issues are complex and/or highly judgmental, an audit committee whose inputs are limited to management and the auditor necessarily undertakes a risk it might be better advised to avoid. Complying with the audit committee "rules" and overseeing the company's financial reporting may not be synonymous.
- n Auditor/audit committee meetings on a quarterly basis, and before quarterly financial information is released, still seems more the exception than the rule. Counsel and the audit committee should consider whether the frequency and timing of meetings are consistent with the committee's charge.
- n It is at best unclear whether the auditor's "qualitative" assessment of accounting principles employed is providing useful information to audit committees. In some cases, the most valuable input comes only after the audit committee learns to ask the right questions.