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Analysis of the Proposed NYSE Corporate Governance and Audit Committee Listing Requirements

Jillian M. Lutzy*

I. INTRODUCTION

In response to the financial disasters of 2002, various regulatory groups have proposed and begun to implement new regulations aimed at enhancing the reliability of public financial reporting. Congress has passed the Sarbanes-Oxley Act ("S.O."), which provides for the creation of a Public Accounting Oversight Board to be run under the umbrella of the Securities and Exchange Commission ("SEC").1 Furthermore, the SEC has requested that the self-regulatory public exchanges ("SROs") revise and tighten their listing requirements in order to decrease the potential for future financial failures.

It is hypothesized that the audit committee is the best means of regulating public information flow and minimizing the risk of future financial misstatements and fraud.2 Thus, among their proposed listing requirement modifications the SROs (the Exchanges) have proposed heightened and more specific requirements regarding audit committees’ membership and responsibilities. Furthermore, through the Sarbanes-Oxley Act and general SEC oversight authority, the SEC has promulgated several new or amended rules, which audit committees of issuer companies must also meet.

This paper will focus on and present a comparative analysis of the current 1999 and the proposed 2002 New York Stock Exchange ("NYSE") listing requirements for audit committees; it will also present a brief analysis of the SEC and Sarbanes-Oxley Act rules that implicate the audit committee and the resulting additional audit com-

* The Author is a recent graduate of The Harvard Law School. She is an associate at Jones Day in New York pending bar admission in NY and NJ. She is a former auditor and a New York CPA. Please note that "the views set forth herein are the personal views of the author and do not necessarily reflect those of the law firm."

1. Sarbanes-Oxley Act, H.R. 3763, 10 [hereinafter S.O.].
mittee requirements for NYSE listed companies. In addition, it will examine if either, or both, foster the goals of enhanced reliability and accuracy in financial reporting for public companies, and suggest additional relevant topics that the NYSE may want to address going forward.

II. HISTORY AND DEVELOPMENT OF THE AUDIT COMMITTEE

Audit committees initially developed in large companies where the size of the board required specialized committees. As early as 1939, a report issued by the New York Stock Exchange ("NYSE") entitled *Independent Audits and Audit Procedures* acknowledged that to ensure outside auditor independence corporate directors should nominate or select the independent auditors where practicable through a special committee of the board composed of directors who were not officers. Formal Securities and Exchange Commission ("SEC") endorsement of the audit committee can be traced to a 1940 investigation of *McKesson & Robbins*. However, despite the SEC's endorsement of such committees, between 1940 and the 1970s various committees of Congress and business industries criticized the SEC for its failure to require audit committees for all publicly held companies. A series of business failures and mistakes in the 1960-70s brought the audit committee back to the forefront of corporate governance proposals. In July 1967, the American Institute of Certified Public Ac-
countants ("AICPA") issued a statement recommending that publicly owned companies appoint standing committees of outside directors responsible for nominating the independent auditors, and other outside advisors, and communicating with the independent auditors whenever management could not satisfactorily resolve a question.⁸

As the size of board of directors grew between the 1940s and the 1970s, many corporations realized that an audit committee could be a viable mechanism for directors to meet their oversight responsibilities in the internal control and financial reporting areas.⁹ As early as 1973, the NYSE white papers on financial reporting expressed the belief that audit committees had become a necessity.¹⁰ Finally, in January 1977, the NYSE adopted the listing requirement that domestic companies have audit committees as a prerequisite to listing on the exchange.¹¹ This requirement left the determination of whom could serve on the audit committee largely to the discretion of the company’s board, with the board’s decisions on eligibility governing in the absence of strictly stated rules.¹² For example, a director who was a close relative of someone who would not qualify for audit committee membership also would not normally qualify, but if there were valid countervailing reasons to have the individual on the audit committee, the board’s decision to allow such an individual to serve would govern.¹³


⁹. Bacon, supra note 3, at 1; Braiotta, supra note 10, at vii, 4-9; Conference Audit Proceedings, supra note 4, at 43. Harold Williams, then Chairman of SEC noted "[t]he audit committee is the most important development in corporate structure and governance in decades." Id.


¹¹. New York Stock Exchange, Statement of the New York Stock Exchange on Audit Committee Policy (Jan. 6, 1977) [hereinafter NYSE Statement]. NYSE added a requirement, approved by the SEC, that as of June 30, 1978, each domestic company listed on the NYSE must establish and maintain "an audit committee comprised solely of directors independent of management and free from any relationship that, in the opinion of the board of directors, would interfere with its exercise of independent judgment as a committee member." Id.

¹². Id. at 10. Even a director who was partner, officer, or director of an organization with a relationship with the listed company that was carried on in the ordinary course of business on an arms-length basis could qualify for membership unless the board determined that such person was not independent or the relationship would interfere with his exercise of independent judgment as a committee member. See also Mautz & Neumann, supra note 8, at 18; Conference Audit Proceedings, supra note 4, at 68.

¹³. NYSE Statement, supra note 11. This is the case unless the relative was an employee who was not an executive officer. Id.
The audit committee has always stood at a crucial intersection between management, independent auditors, internal auditors, and the board of directors. Initial objectives behind establishing an audit committee were to: help the board of directors meet their responsibilities, provide better avenues of communication, enhance the outside auditor's independent position, increase the reliability and objectivity of financial reports, and to strengthen the role of outside directors.

Along with the general demand for greater organizational accountability, the responsibilities of the audit committee have evolved throughout the 20th century. Now, both investors and directors generally consider the audit committees’ oversight role to include: (1) reviewing and supervising the work of the organization’s accounting and internal auditing staff, and that of the independent auditors; (2) reviewing recommendations and discussions regarding the financial reporting process with the internal and external auditors, managements’ responses to financial reporting issues, and the annual and interim financial reporting process; (3) obtaining assurances regarding the timeliness and accuracy of all reports filed with the regulatory authorities, the control and risk environments of the company, and the adequacy of the accounting and control systems in place.

III. EXISTING NYSE CORPORATE GOVERNANCE AND AUDIT COMMITTEE LISTING REQUIREMENTS

Pending SEC approval of and transition to the NYSE August 1, 2002 proposed Corporate Governance listing requirements, the audit committee listing requirements found in § 303 of the New York Stock Exchange Listed Company Manual will continue to govern the exchange. Under § 303 each listed company must have a qualified audit committee that meets the requirements delineated below.

14. MAUTZ & NEUMANN, supra note 8, at 115 (noting that the audit committee is viewed as a bridge between the board of directors and the auditors); Conference Audit Proceedings, supra note 4, at 87; BRAIOTTA, supra note 10, at 5-8.

15. BRAIOTTA, supra note 10, at 5-8 (noting that the individual investor is of paramount importance to the nation's capital markets and the audit committee provides an additional avenue of accountability to external users of the financial statements).

16. MODEL BUS. CORP. ACT § 33 (2002). Case law has developed to delineate the duties of the board of directors and the audit committee.

17. APOSTOLOU & JEFFORDS, supra note 4, at 37; RICHARD M. STEINBERG & CATHERINE L. BROMILLOW, AUDIT COMMITTEE EFFECTIVENESS - WHAT WORKS BEST, 1 (Pricewaterhouse Coopers, 2d ed. 2000).

18. NYSE LISTING STAND. § 303 (1999) [hereinafter NYSE 1999 Standards, and the applicable section number]. This section deals with Corporate Responsibility.
A. Independence

Existing 1999 NYSE listing standards require independence for audit committee members only. Essentially, members must be free from any relationship that would interfere with the exercise of unbiased judgment as a committee member. Independence is required in both mental attitude and in appearance, and thus members are precluded from having any relationship with the company that might interfere with the exercise of a director’s independence from management and from the company.

Section 303.01(B)(3) of the New York Stock Exchange Listed Company Manual includes more specific restrictions on audit committee membership. First, any director who is an employee of the listed company or its affiliate may not serve on the audit committee until three years after termination of employment or the affiliate relationship. Additionally, a director whose immediate family member is an executive officer of the listed company or an affiliate cannot serve on the audit committee until three years following the termination of such employment or affiliation relationship. A director who is not considered independent due to the three year restrictions, may be appointed to the audit committee if the company’s board of directors determines in its business judgment that membership on the committee by that director is in the best interests of the company and its shareholders.

Next, a director who is a partner, controlling shareholder, or executive officer of an organization that has a relationship with the company, or who has a direct business relationship with the company may not serve on the audit committee unless the board of directors determines in its business judgment that membership on the committee by that director is in the best interests of the company and its shareholders.

Finally, a director who is part of an inter-locking directorate and is employed as an executive of another

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19. Id. § 303.01(B)(2)(a). Relationship laid out as defined in the § 303.01 and § 303.02 prohibitions.
20. Apostolou & Jeffords, supra note 4, at 27; NYSE 1999 Standards, supra note 18, § 303.01(B)(2)(a).
21. NYSE 1999 Standards, supra note 18, § 303.01(B)(3). These requirements apply to each member of the audit committee. Id.
22. Id. § 303.01(B)(3)(d). “Immediate Family” as defined in § 303.02.
23. Id. § 303.02(D) (note: only one such director shall be approved).
24. Id. § 303.01(B)(3)(b). In using its business judgment to make such a determination the board should consider among all factors: the materiality of the relationship to the company, to the director, and to the organization the director is affiliate with. Id. Business relationship can include among others commercial, industrial, banking, consulting, legal, and accounting relationships. Id. Only in extreme cases will a mere employee/employer relationship with such an organization prohibit audit committee serviced. Id.
corporation, for which an executive of the listed company serves on the compensation committee, may not serve on the listed company’s audit committee. If any of the independence requirements above are waived, the relationship at issue must be disclosed in the company’s proxy statement. A director may serve without the board’s determination on the audit committee at any time more than three years after the termination of any employment or business relationships prohibited by the requirements. Written confirmation regarding each director’s independence must be provided to the NYSE at initial listing, when any changes are made to the audit committee, or at a minimum yearly.

B. Composition

Under the 1999 NYSE listing requirements, the audit committee must meet certain composition/expertise requirements. The committee must have a minimum of three directors that are each independent from the company. Additionally, each member must be financially literate or become literate within a reasonable time after appointment to the committee; and at least one member of the audit committee must have accounting or related financial management expertise. Furthermore, each listed company must provide written affirmation regarding the financial literacy of the audit committee members, and

25. Id. § 303.01(B)(3)(c).
26. Id. § 303.02 (stating that the company must “disclose in the next annual proxy statement subsequent to such determination, the nature of the relationship and the reasons for the determination”); Steinberg & Bromilow, supra note 17, at 37.
27. NYSE 1999 Standards, supra note 18, § 303.01(B)(3)(b) (stating “(1)[T]he 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.”).
28. Id. § 303.02(C)(4). Note: the language of § 303.02 does not specify who within the company is responsible for providing such written affirmations. This ambiguity also applies to the written affirmation requirements for the board of director independence determinations and the annual review and reassessment of the adequacy of the audit committee charter. Note that this requirement is also delineated in SEC Release No. 34-42266, Audit Committee Disclosure, Exchange Act Release No. 42266, 64 Fed. Reg. 73389 (Dec. 22, 1999), available at http://www.sec.gov/rules/final/33-8220.htm. [hereinafter SEC Release No. 34-42266], which requires proxy disclosure regarding the audit committee, its composition, and the determination of member’s independence.
29. NYSE 1999 Standards, supra note 18, § 301.01(B)(2)(a) (stating “[E]ach 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 (‘Independency’).”)
30. Id. § 301.01(B)(2)(b) (stating “Financially literate” as interpreted and defined by the board of directors in its business judgment); NYSE 1999 Standards, supra note 18, § 301.01(B)(2)(c) (stating “Financial management expertise” as interpreted by the board of directors in its business judgment).
the determination that at least one member has accounting or related financial management expertise to the NYSE at initial listing, when any changes are made to the audit committee, or at a minimum yearly.\(^{31}\)

C. Written Charter

An audit committee is formed by resolution of a company's board of directors or by amending the company's bylaws.\(^{32}\) After formation, the board of directors must adopt and approve a formal written charter for the audit committee, which the company must annually review, reassess, and provide written confirmation to the NYSE regarding the reassessment and adequacy.\(^{33}\) Although charter specified duties and responsibilities should not be so narrow that special inquiries and investigations cannot be incorporated, the 1999 NYSE listing requirements direct the board of directors to specify the scope of the audit committee's responsibilities and its manner of carrying out those responsibilities. The requirements include the committee's structure, processes, and membership requirements.\(^{34}\)

The charter must specify the following: (1) the scope of the committee's responsibilities and how it intends to carry out those responsibilities, which include defining the committee's structure, processes, and membership requirements; (2) a statement that the outside auditor is ultimately accountable to the board of directors and the audit committee and that both have ultimate authority and responsibility to select, evaluate, and if appropriate replace the external auditor; (3) a statement that the audit committee is responsible for ensuring that the outside auditor periodically submits to it a formal written statement delineating all relationships between the auditor and the company, and discussing with the outside auditor any disclosed relationship or services that may impact the objectivity and independence of the outside auditor, and recommending the board take appropriate action in response to the outside auditor's report in order to satisfy itself regarding the outside auditor's independence.\(^{35}\)

\(^{31}\) Id. § 303.02(C)(1)-(4). See supra text accompanying note 29.

\(^{32}\) Braiotta, supra note 10, at 4.

\(^{33}\) NYSE 1999 Standards, supra note 18, § 303.02(C); see discussion supra note 29.

\(^{34}\) NYSE 1999 Standards, supra note 18, § 303.01B(1)(a).

\(^{35}\) Id. § 303.01(B)(1)(a)-(c). The board and audit committee also have discretion to nominate the outside auditor, but the nominations may be proposed for shareholder approval in a proxy statement. Steinberg & Bromilow, supra note 17, at 24.
D. Fees

The 1999 NYSE listing requirements make no mention of specific restrictions on audit committee fees.

E. Rotation

The 1999 NYSE rotation requirements make no specific mention of rotation of the audit committee members, or of the independent auditor. However, under their joint responsibility for evaluating and approving the outside auditor and responsibilities under state corporate law, the audit committee and board of directors are responsible for overseeing that any external auditor rotation requirements, or other specific requirements, imposed by state corporate or federal securities law are met.36

IV. PROPOSED NYSE CORPORATE GOVERNANCE AND AUDIT COMMITTEE LISTING REQUIREMENTS

In response to the recent wave of corporate scandals and fraud, the NYSE has proposed substantial changes to its listing requirements. The proposed changes include expanded director and audit committee independence requirements. The NYSE submitted the proposed listing requirements approved by its board of directors to the SEC on August 16, 2002. The proposals were open to public comment through October 2002 and are now subject to review and approval by the SEC. Once approved, the proposed additions and modifications will be codified in the new § 303A of the New York Stock Exchange Listed Company Manual. The new section will include both rules that must be implemented and suggested practices the Exchange believes should be followed.

The modified requirements will apply to all companies listing common stock, and to business organizations in non-corporate forms such as limited partnerships, business trusts, and Real Estate Investment Trusts ("REITS").37 Some of the new requirements will be effective


37. Corporate Governance Rules Proposals Reflecting Recommendations from the NYSE Corporate Accountability and Listing Standards Committee As Approved by the NYSE Board of Directors Aug. 1, 2002, at 3, available at http://www.nyse.com/pdfs/corp_gov_pro_b.pdf (subsequently accepted and approved by the NYSE Board of Directors and codified at § 303A) [hereinafter NYSE 2002 Standards]. As in the past, the Exchange will not apply the standards to passive business organization in the form of trusts, to derivative or special purpose securities.
within six months of SEC approval, and others will be implemented over a twenty-four month period. As in past practices, there are likely to be special considerations and exceptions given to foreign listed companies regarding compliance with these new standards. The proposed § 303A includes the requirements applicable to audit committees discussed below. The requirements in this section should also be compared to the enacted Sarbanes-Oxley requirements discussed in Section V. of this paper. Note that both sets of requirements must be met by audit committee members on the board of a company listed on any of the major exchanges.

A. Independence

First, perhaps the most significant proposed change to the NYSE listing requirements is the tightening of the definition of “independent director,” combined with the application of the new definition to the entire board rather than just the audit committee. In addition to maintaining the requirement that each listed company have an audit committee composed of at least three independent directors, proposed § 303A requires that listed companies have a majority of independent directors on their full board of directors. This requirement is meant to increase the quality of board oversight and lessen the possibility of damaging conflicts of interest. Additionally, the proposed standards add several general qualifications for director independence. First, no director will qualify as independent unless the board affirmatively determines that the director has no material relationship with the listed company directly or as a partner, shareholder, or director or officer of an organization that has a relationship with the listed company; such determinations must be disclosed in the company’s annual proxy statement. When making

38. Id. § 303A & cmts., at 3. For example, within six months the following will be required regarding the audit committee: increased authority and responsibility of the committee through adoption of a charter meeting the new requirements. However, those companies that do not already have majority independent boards will have twenty-four months to recruit and place qualified directors to comply with the new standards.

39. See supra section V.D. for a discussion of the special consideration and exceptions given to foreign listed companies under S.O., supra note 1, at § 301 SEC Releases.

40. NYSE 2002 Standards, supra note 37, § 303A1 & cmts., at 5. There will be an exception to this requirement for closely-held companies but the exchange expects this exception to affect only a small percentage of its listed companies. Id.

41. Id. § 303A1.

42. Id. § 303A2. The proposal specifies that material relationships can include but are not limited to commercial, industrial, banking, consulting, legal, accounting, charitable, and familial relationships. Id. See also, Standards Relating to Listed Company Audit Committees, Exchange Act Release No. 33-8220 [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) § 86,902, at 87,402
such determinations, significant stock ownership, while a factor to be considered, is not alone considered a bar to a determination of independence; however, one business relationship with the listed company could independently render a director non-independent if the relationship is determined by the board to be material to the director or his business. With respect to the disclosure of such determinations, a company may adopt and disclose categorical standards to use in making independence determinations. If a company chooses to use this method of disclosure, only the determination of independence for directors who do not meet the categorical standards and the basis for such determination, must be specifically disclosed.

Second, § 303A2(b) of the proposed requirements expands the cooling-off period from certain prohibited relationships from three to five years. A former employee of the company, a director who has been affiliated with or employed by a present or former auditor of the company or an affiliate, or a director who has been part of an interlocking directorate - in which an executive officer of the listed company serves on the compensation committee of another company that concurrently employs the director, will not be independent until five years after the termination of the employment, affiliation, auditing, or interlocking relationship. Directors with immediate family members in any of the above categories are likewise subject to a five-year cooling off period.

Finally, in order to utilize the new requirements to implement what is hoped to be a more effective check over management activities and policies, the proposed listing requirements also require non-management directors to meet at regularly scheduled meetings without management.


43. NYSE 2002 Standards, supra note 39, § 303A2(a) & cmts., at 5.
44. Id.
45. Id.
46. Id. § 303A1(b)(i) – (iii) (stating that the definition of “former employee” excludes an interim Chairman or CEO).
47. Id. § 303A1(b)(iv) & cmts., at 6. “Immediate family” as defined in current § 303.02 includes a spouse, parent, child, sibling, 1st generation in-laws, and anyone else who is a non-employee and shares the directors’ home. Id. § 303.02. Employment of a family member in a non-officer position does not preclude a board from determining independence. Id. § 301. If a director dies or becomes incapacitated his immediate family members, if otherwise independent, will be deemed immediately independent. Id.
48. NYSE 2002 Standards, supra note 37, § 303A3 & cmt., at 6 (stating “Non-management” includes those directors who are not company officers, and those who are not independent by virtue of a material relationship, former status or family membership).
B. Composition

The proposed listing requirements incorporate the 1999 pre-existing composition requirements. Thus, listed companies must continue to have an audit committee composed of at least three independent directors; each member is required to be or become financially literate within a reasonable time of committee appointment; and each audit committee must have at least one member with accounting or related financial management expertise.49 These requirements have been incorporated due to the belief that knowledgeable audit committee members will be more likely to recognize estimates and susceptibility to manipulation and give them the necessary scrutiny.50

Draft versions of the NYSE listing proposals recommended that the audit committee chair be required to have accounting or financial related expertise. However this requirement was dropped in light of the congressional adoption of the Sarbanes-Oxley Act of 2002,51 particularly § 301.52 In addition, although the exchange considered addressing the conflict between a controlling shareholder and public shareholder by recommending that an affiliate of a twenty-percent, or greater, shareholder may only be a non-voting member of the audit committee, this provision was not proposed in light of the Sarbanes-Oxley provision that disqualifies affiliated persons from any service on an audit committee.53 The NYSE has reserved the right to further revise its listing requirements in the future if it does not think the Sarbanes-Oxley Act adequately addresses these issues once it is fully implemented.

C. Written Charter

While maintaining most of the responsibilities included in the 1999 listing requirements, the proposed listing requirements significantly increase the responsibility and autonomy of the audit committee by...

49. Id. § 303A6 & cmt., at 9 (stating "financially literate" and "financial management expertise" as interpreted by the company's board in its business judgment). See supra Section V.A. of this paper for a discussion regarding additional "audit committee financial expert" requirements promulgated under the Sarbanes-Oxley Act.

50. STEINBERG & BROMILOW, supra note 17.


granting it the sole authority to hire and fire independent external auditors, and to approve all significant non-audit relationships with independent auditors. 54 While the audit committee cannot delegate responsibility for this task to management or the board of directors, it is not precluded from obtaining management input regarding the independent auditor. 55

Under § 303A7, the requirement that each listed company have a written charter for its audit committee is retained, and the noted list of specific items that the charter must include is expanded. Section 303A7 specifies that the written charter must address the committees’ purposes, duties and responsibilities, and its required annual performance evaluation of itself. 56

1. Purpose

Section 303A7 of the proposed listing requirements specifies that the audit committee’s written purpose must at minimum be to:

(A) assist board oversight of (1) the integrity of the financial statements, (2) the company’s compliance with legal and regulatory requirements, (3) the independent auditor’s qualifications and independence, and (4) the performance of the company’s internal audit function and independent auditors; and (B) prepare the report that SEC rules require to be included in the company’s annual proxy statement. 57

2. Duties and Responsibilities

Section 303A7 also specifies that the written charter must include at minimum the following ten duties and responsibilities of the audit committee. 58 First, sole responsibility for the retention and termination of the company’s independent auditors. 59 Second, performance of an annual review of the independent auditor and its report which must cover: the firm’s internal quality-control procedures; any material issues raised by the auditor’s most recent internal-quality control or peer review of the firm, or by an inquiry or investigation by governmental or other authorities within the preceding five years relating to one or more independent audits carried out by the auditing firm, and

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54. Id. § 303A7(a).
55. Id. § 303A7(a) & cmts., at 10.
56. Id. § 303A7. Note that § 303A7(c) also requires each listed company to have an internal audit function. Id.
57. Id. § 303A7(b)(i)(A-B).
58. NYSE 2002 Standards, supra note 37, § 303A7(b)(ii)(A)-(J). Note that (A)-(J) reference correspondingly to the first through tenth proposed duties and responsibilities.
59. Id. § 303A7(b)(ii)(A); STEINBERG & BROMILOW, supra note 17, at 24-25 (shareholders ratify the selection of the external auditor in many companies).
all steps taken to deal with any issues; and all relationships between the independent auditing firm and the listed company. This annual review should include an evaluation of the lead independent audit partner and verification of regular rotation of the lead partner as required by law; the audit committee should further consider whether there should be regular rotation of the audit firm itself. The audit committee should present its conclusions from this review to the full board.

Third, discuss the yearly audited and quarterly financial statements with management and the independent auditor, including the company’s disclosure under the Management’s Discussion and Analysis of Financial Condition and Results of Operations (“MD&A”). Fourth, engage in regular discussions about any earnings press releases and financial information and earnings guidance provided to analysts and rating agencies. Fifth, seek and obtain advice and assistance as appropriate from outside advisors including legal and accounting advisors, without seeking board approval. Sixth, discuss and review in a general manner the company policies and guidelines, which govern the process by which risk assessment and management, are handled. Seventh, periodically meet separately with management, internal auditors, and independent auditors. Eighth, review with the independent auditor any audit problems and managements’ response to such problems. Ninth, set and review hiring policies for current and former employees of the independent audit firm. Tenth, report regularly to the board of directors.

While most of these proposed duties and responsibilities are generally consistent with those delineated in the 1999 listing requirements and those performed in current practice, this will be the first time each is required to be laid out in the audit committee’s formal charter and performed annually with more specificity. Each will be analyzed in detail in Section VI.C. of this paper.

3. Annual Performance Evaluation

Section 303A7 also requires that the audit committee perform an annual performance evaluation of itself. This type of review is some-
thing each company should have previously been doing each year. However, there is no specific guidance in the listing requirements as to what this review should incorporate. Industry reports suggest that this type of annual performance review should be strengthened such that the audit committee can be required to prepare and present a formal evaluation of its own activities to the board; including a synopsis of the level of involvement and performance by each member. Possible topics such a review might include are: (1) a comparison of the committee's activities versus the charter; (2) a comparison of the committee's activities versus formal industry recommendations and rules; and (3) a comparison against best practices as provided in industry guidelines. However, as discussed in Section VII.B. of this paper, audit committees might be reluctant to document this type of information due to possible liability implications.

D. Fees

The proposed listing requirements specify that normal directors' fees must be the audit committee members' only form of compensation from the company. Normal fees generally include reasonable additional compensation for extra time spent on committee work. Furthermore, an otherwise independent director's receipt of a pension or other deferred compensation for prior services will not preclude that director from satisfying the fee limitation.

E. Rotation

The audit committee's annual review should include ensuring regular rotation of the lead independent auditor partners, as required by corporate law and SEC rules. However, the proposed listing requirements do not contain any new specific requirements regarding rotation of the independent auditor, or of the audit committee members.

63. STEINBERG & BROMILOW, supra note 17, at 42 (noting that according to best practices an audit committee should regularly evaluation its own performance).
64. Id. (noting that committee member's self-assessment reviews could be beneficial).
65. Id.
67. Id. § 303A6 & cmts., at 9.
68. Id.
69. BACON, supra note 3, at 9; SEC Release No. 33-8183 supra note 36.
V. SEC AND SARBANES-OXLEY RULES THAT DIRECTLY IMPLICATE NYSE LISTING REQUIREMENTS FOR AUDIT COMMITTEES

The SEC's recent development of a Public Oversight Board and the legislation adopted through the Sarbanes-Oxley Act directly implicate many of the same issues as the NYSE proposed listing requirements. While this paper focuses on the NYSE listing requirements for audit committees, it is necessary to note the interaction and distinctions among the New York Stock Exchange Rules and the applicable SEC Rules in order to provide a complete and realistic picture of the developing landscape for audit committees.\(^70\) In addition to meeting its individual listing requirements for audit committees, the NYSE will be prohibited from listing any security of an issuer that is not in compliance with certain SEC and Sarbanes-Oxley rules and amendments. Exchange Act Rule 10A-3 and the Sarbanes-Oxley Act §§ 301 and 407 will apply to issuers of any nationally listed securities not just voting securities.\(^71\)

A. Independence

Under Sarbanes-Oxley § 301 each member of the audit committee of the issuer must be independent according to specified criteria. The final rule requires that audit committee members may not: (1) accept directly or indirectly any consulting advisory or other compensatory fee from the issuer company or its subsidiaries (other than board and committee service fees); or (2) be an affiliated person of the company or any subsidiary of the company.\(^72\) The prohibition on acceptance of compensatory fees also precludes audit committee service if an immediate family member earns such fees.\(^73\) Preclusion does not apply to a director who holds a non-management position, similar to that of a limited partner in the entity, and who has no active role in providing

\(^70\) Note that while many additional provisions of the Sarbanes-Oxley Act overlap with audit committee requirements, these were the most currently applicable; a full analysis of the provisions of the Sarbanes-Oxley Act is outside the scope of this paper.

\(^71\) S.O., supra note 1, at § 301; see also SEC Release No. 33-8220, supra note 42 (for specifics and discussion regarding the implementation); Memorandum from Wachtell, Lipton, Rosen & Katz, Sarbanes-Oxley Update: SEC Adopts Final Rules Relating to Audit Committees of Listed Companies at 3 (Apr. 11, 2003) [hereinafter Wachtell Memorandum] available at http://www.realcorporatelawyer.com/pdfs/wlrk041103.PDF. Note that under this rule if a listed company does not establish an audit committee, its entire board will be considered the committee for purposes of application of these rules such that if the board does not meet the included rules the company may be de-listed or subject to alternative forms of punishment. SEC Release No. 34-42266, supra note 28.

\(^72\) Wachtell Memorandum, supra note 71, at 3.

\(^73\) Id.
services to the company; or to any non-financial commercial relationships between the issuer company and the entity with which a director has a prohibited relationship. In contrast to the stricter Self-Regulatory Organization requirements, the independence rules in this section apply to current relationships only; like the NYSE requirement, the fee limitation does not cover fixed amounts of compensation under a retirement plan for prior service.

With respect to the definitions of “affiliated person” for the purpose of this rule, an affiliate is “a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with,” the other person. “Controlled” is interpreted as having direct or indirect power to direct management and policies of the company. S.O. § 301 creates a safe-harbor from disqualification for persons who are not executive officers and do not beneficially own more than 10% of any voting class of securities. Finally, special exceptions and provisions are provided for directors who sit on the board of both a listed company and its affiliate but otherwise meet the independence standards, but for dual holding companies.

B. Responsibilities of Audit Committee Members

1. Selection and Oversight of the Independent Auditor

Under S.O. § 301 and SEC Release No. 33-8220, the audit committee of each listed company must be directly responsible for the selection of its independent auditor.

The audit committee of each issuer must be directly responsible for the appointment, compensation, retention and oversight of the work of any registered public accounting firm engaged for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the issuer, and each such registered public accounting firm must report directly to the audit committee.

The rule furthermore provides that the audit committee of a parent company may pre-approve the auditor and services for any consolidated subsidiaries. All listed companies must comply with these re-
requirements by the first shareholder meeting after January 15, 2004, or by October 31, 2004.81

2. Duties and Responsibilities over Management of Accounting Matters

Under S.O. § 301 "[e]ach audit committee must establish procedures for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls, or other auditing matters, including procedures for the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters."82 Like the NYSE listing requirements in this area, the rules here do not delineate or require specific procedures to be followed. Audit committees are thus left with the flexibility to develop procedures that work best for their company.83

C. Autonomy to Engage Advisors and Request Proper Funding for the Committee

Under S.O. § 301 "[e]ach audit committee must have the authority to engage independent counsel and other advisors, as it determines necessary to carry out its duties; and [e]ach issuer must provide appropriate funding for the audit committee."84 This autonomy to engage independent advisors is similar to that granted in the proposed listing requirements.

D. Exemptions are Provided for Foreign Private Issuers

The rules promulgated under S.O. § 301 provide exemptions for foreign private issuers that include allowing: (1) a non-executive employee on the audit committee where required by home company regulation or prior collective bargaining agreements; (2) one representative - who is not an executive officer and has not received other compensation from the listed company - of a controlling shareholder as a non-voting member of the audit committee; (3) a foreign governmental representative to be a member of the audit committee as long as no other compensation is earned by the representative from the company; and (4) the use of statutory auditors and board of audi-

81. Id. at 3.
82. Id.
83. Id.
84. S.O., supra note 1, § 301.
tors to perform the auditor oversight function when specified conditions are met.\textsuperscript{85}

E. Required Disclosures Regarding the Audit Committee

Under the new rules, issuers will have to disclose the following: whether they have an audit committee and if so the names of the members and if applicable which exception to the rule they are relying on.\textsuperscript{86} However, since the NYSE requires that each listed company have an audit committee, with no similar exception, this disclosure is somewhat irrelevant in the context of this paper.

F. Composition - Definition of and Requirements for the "Audit Committee Financial Expert"

The SEC adopted rules implementing Sarbanes-Oxley § 407 that will require public companies to disclose information about "audit committee financial experts."\textsuperscript{87} This disclosure is required in the annual reports, and a company may at its discretion also include it in other proxy or information statements.\textsuperscript{88} Under SEC Release No. 33-8177 a company subject to the 1934 Act will be required to annually disclose if it has at least one "audit committee financial expert" on its' committee, the name of the financial expert, and whether the expert is independent from management; alternatively, a company that does not have a "audit committee financial expert" will have to say why it does not.\textsuperscript{89}

The adopted rules define "audit committee financial expert" to mean:

[A] person who has the following attributes: (1) an understanding of financial statements and generally accepted accounting principles; (2) an ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves; (3) experience preparing, auditing, analyzing or evaluating financial

\textsuperscript{85} Id.; Wachtell Memorandum, supra note 71, at 3. Note that despite these exceptions, the SEC requires foreign listed companies to disclose in their annual reports the name of the audit committee "financial expert" and if that person meets the independence standards as defined by the applicable SRO listing standards.

\textsuperscript{86} S.O., supra note 1, § 301; Wachtell Memorandum, supra note 71, at 3.


\textsuperscript{89} S.O., supra note 1, § 406; SEC Release No. 33-8177, supra note 52; SEC Release No. 33-8177A, supra note 87.
statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities; (4) an understanding of internal controls and procedures for financial reporting; and (5) an understanding of audit committee functions.\textsuperscript{90}

The rules specify that an individual can acquire the required attributes through a variety of means including: (1) background education combined with past experience as a principal financial or accounting officer, controller, public accountant or auditor, or combined experiences in at least two other positions that involve similar functions; (2) experience actively supervising one of the above listed types of persons, or overseeing or assessing companies or public accountants in the preparation of auditing of financial statements; or (3) other similar relevant experience.\textsuperscript{91}

The commentary to the \$ 407 rule also provides guidance to companies when determining if an audit committee member qualifies as an "audit committee financial expert"; it lists twelve specific factors for companies to consider.\textsuperscript{92} However, despite application of some or all of these factors, it is important to note that to qualify, a director must possess all of the above listed attributes. Also note that under this rule, while an expert does not necessarily need personal experience in applying GAAP, the rules specify that she or he must have the acquired ability to assess the application of these principals.\textsuperscript{93}

The rule also provides a safe-harbor for liability in specifically noting that the title "audit committee financial expert" will not make an individual an expert for any other purpose and does not impose greater liability on such individual than that imposed on other members of the audit committee.\textsuperscript{94} This safe harbor is important to note in the current debate over the potential increased liability for audit committee members resulting from the proposed NYSE listing requirements.


VI. COMPARATIVE ANALYSIS OF THE ACTIVE 1999 AND PROPOSED 2002 NYSE CORPORATE GOVERNANCE AND AUDIT COMMITTEE LISTING REQUIREMENTS

A driving force behind the newly proposed NYSE listing requirements is the goal of enhancing the accountability, integrity and transparency of listed companies. The following section contains an analysis of the differences between the new and proposed listing requirements, combined with critical commentary regarding if the proposed listing requirements actually require anything more than that which is currently practiced by a majority of listed companies.95 Finally, this section also includes several suggestions of alternative methods or practices, which are either implicated by the new listing requirements, or are relevant industry concerns but are not mentioned in proposed listing requirements.96

A. Independence

1. Majority Independent Board of Directors

It appears that the proposed requirement that all listed companies must have a majority of independent directors is significant.97 However, according to industry studies and reports, many boards already have a majority of independent directors.98 For example, according to a 1988 survey by the American Society of Corporate Secretaries, 71% of member companies responded that their boards already had a majority of independent directors.99 Furthermore, several of the companies whose recent defaults in part triggered the current overhaul of the listing standards also had boards that had a majority of indepen-

95. This section will also include relevant commentary and notations when the SEC adopted Sarbanes-Oxley rules, discussed supra at Section V., are directly implicated.

96. See commentary to the proposed listing requirement cited in each specifically mentioned section below for example of how the suggested additional topics are implicated.


98. See BACON, supra note 3, at 8 (noting that a 1987 survey showed high compliance with independence guidelines even among non-exchange companies); Donald C. Langevoort, The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability, 89 GEO. L.J. 797, 798 (Apr. 2001) (noting that although widely followed as a guideline for audit committee membership, independence is a subjective concept).

99. Report from the N.Y.S.E. Corporate Accountability and Listing Standards Committee, available at http://www.nyse.com/pdfs/corp_govreport.pdf, A-9 (June 6, 2002) (note that this organization’s membership includes over 3,800 individuals whose professional responsibilities are focused on corporate governance and board-related matters) [hereinafter NYSE Report]; but see BACON, supra note 3, at 6 (noting that a 1978 survey showed that 90% of respondents did not consider their company to have independence problems).
dent members.\textsuperscript{100} Thus, perhaps the change in the definition of independence in the proposed listing requirements will prove more significant than the majority independence requirement.

Whether this new requirement will in fact help reach the Exchange’s goals of increasing accountability, integrity, and transparency will in part depend on how companies approach the requirement. If many companies have to hire new independent directors to replace or add to their current board, and thus significantly alter their board composition, this could have a significant impact on the state of corporate governance. As a positive sign, some such companies seem to be taking the requirement seriously even before the approval of the proposal. For example, General Motors has already announced its intentions to revise its board composition in order to achieve majority independence. Yet, it will be interesting to see how many listed companies simply try and “fit” their old directors into the new independence definitions using the boards’ “business judgment” and wisely worded categorical standards.

2. Definition of Independence

a. Time Frame for Cooling-Off from Prohibited Relationships

Although the proposed definition of independence seems tighter than the former, the ultimate determination remains with the business judgment of the board of directors, and the definition remains broad enough for the relevant facts and circumstances of each particular situation to be taken into account.\textsuperscript{101} The concrete difference between the two sets of listing requirements is the switch from a three-year to a five-year cooling-off period for the defined relationships.

Although statistically it makes sense that a longer time frame should work to catch more forbidden relationships, it is not evident any time frame will ever catch all pre-existing relationships. For example, if a former employee of the company is appointed to serve on the audit committee after the five-year cooling off period he will not necessarily have fewer loyalties than someone who only waits three

\textsuperscript{100} E.g. Enron; WorldCom – both met the official requirements for the NYSE 1999 listing requirements for audit committee membership and seemed to have a majority of independent directors. \textit{But see}, James S. Lubin, \textit{Inside, Outside Enron, Audit Panel Is Scrutinized, Links to Company Of Certain Members Are Called Too Cozy}, \textit{Wall St. J.}, Feb. 1, 2002, at C1 (noting the audit committee made up of prominent executives looks well qualified but corporate governance experts doubt they were all truly independent).

\textsuperscript{101} NYSE 2002 Standards, supra note 37, § 303A1 & § 303A2 (“unless the board affirmatively determines that the director has no material relationship with the listed company . . . ”).
Yet, the alternative of never allowing an individual who formerly had one of the relationships defined in § 303A2 to serve on the board of the company also seems excessive. Perhaps using a longer time frame such as ten years would significantly lower the risk of former employees, auditors, or affiliates, having relevant loyalties to the board, management, or auditors at the time they are appointed to the audit committee.

b. Substance of Independence Definition

While some commentators to the proposed requirements agree that leaving defined types of situations that require a finding of non-independence is better than specifying exact specialized relationships, others are against this type of approach to regulation; this debate comes down to a rules verses standards debate that is often seen in the accounting industry. Those who prefer standards claim that if the definition of independence is too specific and stringent it will be easier for companies to take the checklist approach of meeting the specified requirements without looking at the substance of the entire situation. They would advocate that it is better to have guidelines rather than specific rules; and that since the Exchange has provided specific guidance as to what may be considered a material relationship, it has provided adequate guidelines for companies to have notice of who will qualify as an independent director, without limiting potential non-independent relationships to those specific business relationships that have been previously identified.

The author agrees that if the Exchange had instead simply listed a set of specific relationships that would render a director non-independent, there could soon develop an onslaught of companies attempting to get around the form of the forbidden relationships without actually

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102. This would be a function of the rate of turnover of the company's management, its board, and its internal and external auditors.

103. Daniel L. Berger & Michael L. Cypers, Accountants Liability After Enron, in B-1209 Corporate Law and Practice Course Handbook Series, Gwyn Quillan, Trends and Current Issues in Professional Standards, GASS and GAAP, 11-13 (risk that movement away from check-the-box approach to reporting will result in wider range of judgments... SEC representatives are clearly concerned with articulating more standards based principles) (New York City, Practicing Law Institute 2002). But see Letter from Darla C. Stuckey, Corporate Secretary, to Jonathan G. Katz, Secretary, SEC, (Feb. 21, 2003), available at http://www.nyse.com/abouthome.html?query=/About/report.html (urging the NYSE to avoid the type of specificity that would lead to check-box type compliance).

104. Note: this is a complaint accountants hear time and time again regarding the U.S. rules based accounting system.

105. Berger & Cypers, supra note 103.
changing the substance.\textsuperscript{106} There is a risk that boards of directors will use minimum standards to act in such a manner, and lose sight of the big picture. With respect to independence, it seems to make more sense to look at each situation in its entirety rather than simply questioning if a director has met a checklist of forbidden relationships, in order to get to the substance of the relationship in question.

Finally, the substance of the proposed independence requirements, although an improvement on the previous, seems lacking in that it does not reach the topic of potential loyalties the directors may have to one and another due to their past relationships among themselves. This is a separate issue from examining each director's past relationship with the company, but it seems as if prior loyalties between different board or audit committee members could have an influential effect on the way in which they vote. Thus, the author recommends the NYSE address this issue in its next listings requirement revision.

3. Brief Comparison to the Independence Requirements Passed by the SEC under S.O. § 301

The independence rules promulgated under S.O. § 301 are more general than those proposed under the NYSE listing requirements. For example, SEC Release No. 33-8220 notes that there is an exception under S.O. § 301 for a director who holds a non-management position; there is no such expectation under the listing requirements. Next, while the listing requirement impose a five-year cooling-off period, the independence rules under the S.O. Act apply to current relationships only. Additionally, the "affiliate" definition under the S.O. Act is relatively vague and general, while the proposed listing requirements note specific types of relationships that are prohibited. Finally, the S.O. Act rules provide a safe-harbor for control for non-executive officers and those who own less than 10% of the issuer securities while the listing requirements focus on the interrelationships between the parties and do not afford a similar safe-harbor.

4. Heightened Disclosure as an Alternative to Heightened Independence Definitions

Regardless of the substance of the new definitions and requirements, the NYSE will not affect change unless the proposed changes effect the actions of boards and audit committees. Despite the tight-

\textsuperscript{106} Manuel A. Rodriguez, \textit{The Numbers Game: Manipulation of Financial Reporting By Corporations and their Executives}, U. MIAMI BUS. L. REV. 451, 453 (2002) (noting that the substance over form doctrine has been widely accepted as the prevailing standard in evaluating the nature of a transaction).
ening of the independence definitions and requirements, many organizations and investors feel as if the terminology itself is not the problem, and that simply changing the definition of "independent" will have little or no effect.\textsuperscript{107} Comments to the proposed rules suggest an alternative focus on changing disclosure rules rather than independence requirements.\textsuperscript{108} Through its proposed audit committee requirements, the Exchange has partially addressed the issue of disclosure.\textsuperscript{109}

The proposed rules allow listed companies to adopt and disclose categorical standards to assist in making independence determinations such that only determinations for directors who do not meet the standards must be specially explained and disclosed.\textsuperscript{110} Furthermore, S.O. § 301 requires listed companies to include in their proxy statements only certain disclosures about their audit committee along with a formal report of the audit committee.\textsuperscript{111} Thus, although the new rules have heightened disclosure requirements they still will not result in full public disclosure about every individual director; this is an issue that should continue to be addressed.

A prominent example showing how companies can get around categorical and non-individualized director independence disclosure requirements can be seen through the fall of Enron. One of the problems at Enron was that the company was able to claim the independence of their directors because the ties that existed were not ones that had to be specifically disclosed as they did not meet any categorically prohibited types of relationships. To avoid this type of situation,

\textsuperscript{107} NYSE Report, supra note 99, at A-49 (citing Nell Minow Editor, The Corporate Library "tinkering with the definitions of 'independence director' or removing non-independent directors on various committees will have no real impact. 'Independent' can mean 'indifference.'").

\textsuperscript{108} NYSE Report, supra note 99, at A-49; see also Stanley Keller, Disclosure & Other Lessons Learned After Enron: What you need to know to File Your 10-K & Other Forms, in CORPORATE LAW AND PRACTICE COURSE HANDBOOK SERIES 291 (Practicing Law Institute 2002) (implicating that both independence and disclosure standards for the board must be revisited).

\textsuperscript{109} Note: the proposed listing requirements for specific disclosures apart from § 303A are outside the scope of this paper. See Keller, supra note 108, for a detailed analysis of other disclosure proposals that have been discussed in response to Enron. Note that both the proposed listing requirements and S.O., supra note 1, § 301, require disclosure related to the independence status of audit committee members.

\textsuperscript{110} NYSE 2002 Standards, supra note 37, § 303A2(a). See also BRAIOTTA, supra note 10, at 54.

\textsuperscript{111} SEC Release No. 33-8220, supra note 42. See also, SEC Release No. 34-42266, supra note 28 (regarding specific audit committee disclosures that issuers must make in their proxy statements).
investors need to complete disclosure of all ties between board members, the company, and management.\textsuperscript{112}

Although a requirement that each company disclose all relevant information about each director (i.e. no categorical standards used) was shot down in part due to the time and effort that it would require, something in between may well be required.\textsuperscript{113} For example, perhaps the Exchange should consider requiring each listed company to update and disclose its standards for determining director independence annually, which would at least keep it from becoming complacent. Furthermore, perhaps each year, the oversight board (once in place) or SEC should come up with a novel list of topics and questions regarding each director’s independence that listed companies must address and develop different topics each year. This would at least work to keep companies on their toes if they did not know in advance exactly what they would have to answer and report on. Alternatively, perhaps some kind of spot check would work to keep companies honest. For example, as the IRS audits a random sample of returns each year, perhaps the SEC or Exchange can audit a certain percentage of listed company’s director independence disclosures each year.

5. More Information is Required

In the end, how the listed companies react to and implement the new independence requirements must be seen before any absolute conclusions can be made regarding the sufficiency of the proposed listing requirements. Yet, in the meantime, the suggestions mentioned above are areas that could be examined in more detail.

a. Hypothetical Example of the Type of Problematic Relationships that should be more fully Considered under the Proposed Listing Requirements

Suppose a former consultant who performed consulting services for Company X when working for a “Big Four” Corporation Y meets the new independence requirements for X’s audit committee membership five-years after leaving his consulting job. Suppose further, when the consultant was at his consulting job he developed a close relationship

\textsuperscript{112} This requirement should be met by the Sarbanes-Oxley Act to some extent. \textit{See also} NYSE Report, \textit{supra} note 99, at A-49 (noting the Comment from American Federation of Labor and Congress of Industrial Organizations).

\textsuperscript{113} NYSE 2002 Standards, \textit{supra} note 37, § 303A & cmts., at A6. I agree with the conclusion to allow disclosure of standards in lieu of disclosures regarding all directors on the grounds that an average investor would likely be overwhelmed by too much information. Yet, I think it is better to provide such information to the investor so they can chose to look at it and get help analyzing it if they chose to do so.
with the members of the audit team for the same client X. Now, the former consultant (who has the requisite independent and financial literacy) sits on the audit committee of X for which Y is still the current auditor.

b. Analysis

In the situation described above, the new rules are technically met but they have not preempted a situation where an audit committee member has a relationship with an external auditor. Furthermore, since the same independence definitions, apart from compensation which is not relevant in this hypothetical, are now applied to board members and to audit committee members, it does not seem as if the requirements protect this situation for an audit committee member any differently than for an independent board member. In fact, the audit committee member in the hypothetical may have more incentive to approve non-audit services as he used to provide them.

The above hypothetical in part circles back to the problem of rules of form versus substance. The rule is met, but if the idea or substance behind the rule was to preserve independence between parties, then it will not always do so. This is an example of the realistic fact that no system of rules and regulations can account for all contingencies. In the end the quality of the financial reporting system will continue to depend on the integrity and ethical standards of individuals.

B. Composition

1. Membership and Focus

In 1978, when the audit committee-listing requirement was first implemented, the rules did not specifically require audit committee members to have a financial background. Rather, a general management background combined with reasonable skill in interpreting financial statements was considered most desirable. Although, it was also generally understood that there should be at least one com-

114. Note this hypothetical also implicates the gap in the independence rules notes in Section VI.A. regarding audit committee service by former employees.
115. However, if a situation such as the hypothetical arose it would be interesting to see if that individual was disqualified from the selection process in the same manner former CPAs have sometimes been.
117. APOSTOLOU & JEFFORDS, supra note 4, at 27; Treadway Commission, supra note 116; BRAIOITTA, supra note 10, at 6; BACON, supra note 3, at 7 (noting that for this reason retired CEOs, and former high-level executives comprise a large percentage of audit committee membership).
committee member with a strong financial background to facilitate communication with the auditors and the committee’s understanding of the auditing process, the desired qualities focused on for audit committee members were: *communication skills, curiosity, and a healthy skepticism*; qualities considered necessary to ask probing questions and get answers that go to the heart of an organization’s activities without alienating organization members.\(^{118}\) Now, the listing requirements and the S.O. § 407 rule for “audit committee financial experts” focus membership inquiry more on the quantitative financial qualifications of potential members rather than their qualitative communication and curiosity attributes.

The 1999 revision to the listing requirements included more specific financial literacy requirements, and the general composition literacy requirements will not change following the implementation of the proposed 2002 listing standards. An audit committee will still be required to have at least three independent directors, unaffiliated with management or ownership of the corporation, who are all able to analyze and interpret financial statements and reports; at least one member of whom has specific financial or accounting expertise.\(^{119}\)

However, although the listing requirement for financial experts remains the same, S.O. § 407 imposes much more specific requirements that audit committee members of listed companies will also have to meet.\(^{120}\) The commentary to SEC Release No. 33-8177 notes that the term “audit committee financial expert” was used in the rule in response to concerns that there are many types of financial experts—such as capital raisers, risk analysts, and valuation experts that would not necessarily have any characteristics relevant to the audit committee’s function of oversight over accounting matters and an understanding of financial statements.\(^{121}\) Although only one “audit committee financial expert is required” this at least ensures one person with heightened expertise; additionally, the rules permit but do not require company disclosure when it has more than one audit committee financial expert on its committee.\(^{122}\) The application of this

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118. BRIOTT, supra note 10, at 6; APOSTOLOU & JEFFORDS, supra note 4, at 28; Hon. Arthur Levitt Jr., Lecture: Inaugural Address: Costs Paid with Other People’s Money, 6 FORDHAM J. CORP. & FIN. L. 259, 263 (2001) (noting that there is no substitute for asking hard questions).

119. NYSE 2002 Standards, supra note 37, § 303A6 & cmts., at 9. The Exchange originally considered requiring the director to be a financial expert but put such a requirement on hold pending implementation of the Sarbanes-Oxley Act.

120. See supra Section V.F for a detailed discussion of the requirements.

121. NYSE 2002 Standards, supra note 37, § 303A6 & cmts., at 9 (originally used the term “financial expert”).

122. Id. Note that in addition to the specified background requirements, audit committee members must also meet the more general independence requirements discussed above; inde-
requirement on the listed companies’ audit committees seems positive in that “expert” audit committee members should be more able to spot unusual accounting instances; yet, the concern that the specified requirements displace the initial desired communication, skepticism and curiosity attributes was also visible in the commentary regarding this Release. In response to commentary that the proposed definition was too restrictive, the final rules allow leeway by qualifications due to “other similar experiences”; a company that believes that an audit committee member qualifies through such experience should be able to explain why.\textsuperscript{123} Furthermore, it is possible that through requiring one member with heightened background financial experience, the nominating committees will in turn shift their focus more to the non-numerical desired qualities in the selection of other members.

Apart from the new expertise requirements imposed under the Sarbanes-Oxley Act, as analyzed above in Section V., what has changed regarding the audit committee membership composition is the applicable definition of independence. Thus, the relationships each member has with the company may be limited in different ways than in the past.

Despite the fact that audit committee members are subject to more stringent independence requirements, it is not clear that modern committees continue to meet original desired qualities of curiosity, skepticism, and communication.\textsuperscript{124} The number of people who have served as audit committee members, and the number of committees that an individual member has or does serve on has grown with the number of listed companies. Although prior audit committee experience is good in the sense that it lowers the learning curve for each new position and helps members have points of comparison for how things are or should be done to conform with listing and regulatory requirements, there is the countervailing concern that as audit committee service becomes more commonplace, members lose their focus, curiosity, skepticism, and diligence.\textsuperscript{125}

Another related concern is that when individuals serve on more than one audit committee they will have less time and energy to get to the hard questions, and will become more complacent when some-

\textsuperscript{123} NYSE 2002 Standards, supra note 37, § 303A6 & cmts., at 9. Note that the final rules make some exceptions and provide some further guidance for foreign issuers; but detailed examination of this is beyond the scope of this paper.

\textsuperscript{124} Levitt, supra note 120, at 266.

\textsuperscript{125} Levitt, supra note 120, at 266. For example, when you think you have seen something done before (and ok’d it); it is easier to skim over the details without asking as many questions.
thing "looks right"; thereby accepting the surface form of a transaction rather than delving into the substance.  

Ironically, one of the benefits to come out of Enron type scandals may be that due to increased liability concerns, people will serve on fewer audit committees which may in turn increase their level of service for those on which they remain.

2. Relevant Topics that the Composition Requirements Fail to Address

With respect to audit committee composition there are several issues that the listing requirements do not reach that have the potential to affect the communication skills, curiosity, and degree of skepticism of audit committee members.

a. Length of Service

First, there is no required minimum or maximum length of service. As mentioned above, experience for audit committee members can be a double-edged sword. Experience is good in that an individual will have the skills necessary to read and interpret financial statements, and to interact with management, the internal auditors, and the external auditors; thus, terms should be long enough to develop seasoned judgment. However, experience can also lead to complacency. Experts have suggested that rotation of audit committee members would: (1) spread the burden of time involved in serving; (2) foster new ideas; and (3) maintain the independence of members since they would not have a chance to grow to identify with management. Comments to the proposed listing requirements have suggested limiting the length of service on a board under the theory that as the length

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That being said, I find it unbelievable that Enron's audit committee had no idea what was going on behind the "front" of allowable business transaction; there are some situations where the wool can be pulled over the audit committee members eyes, but there are others where he or she must choose to "look away".

127. See supra Section VII.B. of this paper for an analysis of the liability of audit committee members.

128. Mautz & Neumann, supra note 8, at 24-25 (noting that typical lengths of service started off as one year appointments and grew over time); Steinberg & Bromilow, supra note 17, at 39.

129. Apostolou & Jeffords, supra note 4, at 27.

130. Bacon, supra note 3, at 9.
of service grows, it becomes difficult to maintain disattachment and intellectual independence.\textsuperscript{131}

It could be beneficial if the Exchange and the SEC perform studies (perhaps through the new oversight board) to determine a maximum length of service that would best take advantage of members' experience, yet avoid complacency. Several commentators have suggested 2-3 years as appropriate.\textsuperscript{132} Furthermore, perhaps as part of their annual performance evaluation requirement by § 3037(b)(iii), audit committees along with input from the entire board of directors, should evaluate the quality of service and contributions by each member and composition and be required to disclose such evaluation to investors. (Which, as noted above, is not currently required in their annual performance evaluation).

\textbf{b. Limit to the Number of Boards and Audit Committees an Individual can Simultaneously Serve On}

Second, neither the 1999 or proposed listing requirements require a listed company to limit the number of boards that an audit committee member can serve on. The Exchange only provides that:

if an audit committee member simultaneously serves on the audit committee of more than three public companies . . . then in each case, the board must determine that such simultaneous service would not impair the ability of such member to effectively serve on the listed companies audit committee and disclose such determination in the annual proxy statement.\textsuperscript{133}

This statement is discretionary and does not provide guidance for how such a determination should be made. A company that really wants to have a specific audit committee member need only disclose why, in the board's opinion, that member has time to serve.\textsuperscript{134} This will potentially lead to a wide range of standards and cut-offs used by companies implementing this requirement that could cause investor confusion. Furthermore, apart from required disclosure of service on more than three audit committees, there is no mention of any limitation on the number of boards an individual can serve on.

The author agrees with industry commentary that there should be a limit on the number of directorships an individual holds in order to

\textsuperscript{131} Report from the New York Stock Exchange Corporate Accountability and Listing Standards Committee, \textit{supra} note 99, at A-19. \textit{See also} \textit{Steinberg} \& \textit{Bromilow}, \textit{supra} note 17, at 39 (noting that the appropriate term must be decided by a balancing of experience and staleness or complacency).

\textsuperscript{132} \textit{CICA}, \textit{supra} note 4, at 70-75.

\textsuperscript{133} \textit{NYSE} 2002 Standards, \textit{supra} note 37, § 303A6 and cmts., at 10.

\textsuperscript{134} \textit{Id.}
ensure audit committee members can meet the demands of their responsibilities. For example, perhaps the NYSE should limit simultaneous service to three audit committees and one additional board position. The requirement should attempt to strike a balance between building experience and expertise and overloading any one individual. Audit committee members have to have the time and energy to perform their jobs such that the hard questions will be asked; individuals who are rushed often take the shortest corners to avoid the difficult and potentially time-consuming questions. Yet, those who do serve need the experience required to identify and analyze what the hard questions are.

Warren Buffet once suggested that the audit committee's core purpose of accurate financial reporting and oversight could be summed up in the following three questions:

'If you were solely responsible for the preparation of the company's financial statements, how would they be different?' Or ‘If you were an investor, would you be able to learn from the financial statements information essential to understanding the company's financial performance?' Or, ‘Is the company following the same internal audit procedures as it would if you were the CEO?'

These questions seem like a good place for an audit committee to start in order to analyze if it has ownership over oversight of the financial processes, but as industries and technologies advance many more questions need to be asked for full oversight. One place to start in ensuring that the questions are asked is formulating rules to ensure the committee members have sufficient time to ask them.

c. Number of Meetings an Audit Committee Must Hold Each Year

Third, neither the current nor the proposed listing standards specify how many times a year the audit committee should meet. However, the consensus among companies is that four meetings are sufficient. As a listing of required duties and responsibilities that must be accom-

135. STEINBERG \& BROMILOW, supra note 17, at 34 ("perhaps audit committee members should limit the number of directorships they hold so they can meet the demands of their audit committee responsibilities.").

136. BACON, supra note 3, at 24 (noting that in 1987, 64% of surveyed CEO and CFOs believe that service on the audit committee take more time now than ten-years ago and will take even more time in the future).

137. Levitt, supra note 120, at 266-67. See also, Conference Audit Proceedings, supra note 4, at 91 (an important job of the audit committee is to ask challenging questions).


139. STEINBERG \& BROMILOW, supra note 17, at 34.

140. BACON, supra note 3, at 23; STEINBERG \& BROMILOW, supra note 17, at 39.
plished annually is set forth in § 303A7, it may be somewhat duplicative to also require a certain number of meetings. However, some guidance could be helpful. It seems like an audit committee that rushed through and met all the facial requirements of § 303A7 during the course of one meeting, while perhaps maintaining the status quo, would be much less effective than a committee that divided up the tasks and met several times a year to monitor progress and completion. Specially, a 1987-1997 survey found that most audit committees of “fraud companies” met only once a year. Thus, a minimum number of required meetings should be proposed; best practices guidelines suggest committees meet at minimum four times a year.

d. Other Miscellaneous Composition Topics

In future revisions the Exchange may want to address: requiring an odd number of audit committee members for resolving voting issues and requiring staggered terms. Good practice guidelines have recommended the audit committee be composed of three or more individuals with an odd number to preempt voting disputes.

3. Alternative Composition Suggestions to Enhance the Performance of Audit Committees

The key to a good committee seems to be in the composition or mix. Despite the fact that many listed companies have established nominating committees, something that seems to be lacking in today’s audit committees is the asking of tough questions. Nominating committees often come up with the following types of candidates for audit committee membership: academics, CPAs, internal auditing directors of unrelated organizations, lawyers, retired CEOs, and senior executives from unrelated organizations. These types of candidates continue to be thought of as ideal. However, these are also the people who are most likely to have served on numerous other audit committees. Perhaps, something different is needed.

141. STEINBERG & BROMILOW, supra note 17, at 53.
142. Id.
143. APOSTOLOU & JEFFORDS, supra note 4, at 81; BRAINTA, supra note 10, at vii.
144. APOSTOLOU & JEFFORDS, supra note 4, at 28.
145. Levitt, supra note 120.
146. NYSE Standards, supra note 39, § 303A4, The NYSE proposed listing requirements also propose the required establishment of a nominating committee for listed firms.
a. Require One Audit Committee Member with a Financial Stake in the Company

One suggestion for reform is requiring one audit committee member who has a financial stake (either directly or indirectly) in the company to mix up the norm.\textsuperscript{147} Since a role of the audit committee is to oversee the independent and internal audits, such that investors are presently with fair and accurate information, it seems that allowing or requiring an investor to be represented on the committee would be a step towards this goal. However, to really implement such a rule would require a complete analysis of moral hazard and freeloading, as well as incentives and representativeness. It could be difficult to convince a small investor to take the time and potential liability to serve, and too big an investor could potentially have interests adverse to the minority interest. So, this suggestion might not be feasible. In addition, current rules forbid audit committee members from having any financial stake in the company, regardless of if they are otherwise independent, and it would be very messy and risky to turn those rules on their heads; not to mention perhaps politically impossible.\textsuperscript{148}

b. Require the Audit Committee to Address Investor Proposed Questions During Discussions with Management, Internal, and External Auditors

An overarching concern of the Exchange in updating its listing standards is to “allow shareholders to more easily and efficiently monitor the performance of companies and directors in order to reduce instances of lax and unethical behavior.”\textsuperscript{149} An alternative and likely novel suggestion that would not actually change the composition of the audit committee, but could potentially enhance monitoring of the audit committee’s performance, would be to allow investors to propose “audit committee questions” in the same manner that they can sometimes make proxy proposals. Currently, audit committees are required to report to and meet with external auditors, internal auditors,

\textsuperscript{147} NYSE Standards, \textit{supra} note 39, §303A2(a) and cmts., at 5. Stock ownership alone will not render a director non-independent for board membership but may cause problems for audit committee membership as audit committee members are not supposed to have a financial stake in the company.

\textsuperscript{148} NYSE Standards, \textit{supra} note 39, § 303A6. It is not well analyzed or clear if in allowing, much less requiring, a stock owner to serve on the audit committee would be a good idea of if it would present that investor with an unfair advantage over other stock holders; this is a topic that perhaps should be investigated by the new Public Oversight Board. Note that S.O. § 407 allows one audit committee member with less than 10% stock ownership.

\textsuperscript{149} NYSE Standards, \textit{supra} note 39, § 303A and cmts., at 2.
and the board of directors, but there is no requirement that they meet separately with or answer directly to interested investors.\footnote{150}{NYSE Standards, \textit{supra} note 39, § 303A7.}

If investors were allowed to propose tough questions they wanted answered and the audit committee had to ask management and/or the auditors those questions, perhaps, the harder questions would more likely to be asked. One risk with this suggestion is that the investors who may not be financially literate will not know which questions to ask; however, there are enough institutional and large investors holding stock that this risk seems nominal compared to the potential upside. Furthermore, just as it has implemented a proposed list of things the audit committee’s charter must include in § 303A7, perhaps the Exchange in conjunction with the SEC or oversight board can brainstorm a suggested list of questions for investors’ reference under § 303A.\footnote{151}{Note this list should be a starting point not an end point limit on which questions investors may raise.} While this type of requirement may make the audit committee members’ jobs more difficult, it could also help to focus them in the right direction regarding what issues the investing public wants to know, and what issues to be concerned about. Also, with respect to the critique that a normal investor will not know what to look for to uncover fraud or deception, the investors’ questions would not replace the current questions and duties of the audit committee, but could supplement them.

4. Non-Complacency and Time as Key Characteristics

In the end, audit committees should ideally consist of: people with a general understanding of company’s industry and social, political, economic, and legal forces which affect the industry; knowledge of company history, organization and operational policies; an understanding of fundamental problems of planning and control as well as the fundamentals of the functional aspect of the company; and both financial and non-financial people.\footnote{152}{See \textit{supra} notes 117, 118, 131-33.} Audit committees should also consist of members with the time and energy required to devote to the position. The author agrees with practice guidelines that suggest if an audit committee is larger than three it should still be small enough for all members to be active and required participants.\footnote{153}{Brajiotta, \textit{supra} note 10, at vii (recommending that the committee be large enough to involve a reasonable range of viewpoints, but small enough to work efficiently).}

Further, although the above suggestions and criticisms are interesting ones that could
help reach the ideal type of composition; they are by no means exhaus
tive, and have not been tested in practice.

C. Written Charter

With the establishment of stricter guidelines for audit committees, it is increasingly important that each committee have a comprehensive written charter.

1. Development of this Requirement and Debate over the Purpose and Scope Specification

From the initial establishment of audit committees, it was thought that an audit committee should be guided by a written charter to establish its roles and responsibilities within the organization; since the 1999 listing requirements it has been required and each issuers' proxy must disclose if its board has adopted a written charter.\(^{154}\)

a. Purpose of the Written Charter

The purpose of a formal charter is to help guide the audit committee in fulfilling its responsibilities effectively and in a timely manner.\(^{155}\) Under corporate law such a charter can be established through a board resolution or may be incorporated into bylaws of a corporation.\(^{156}\) In the past, it was thought that charters should be flexible enough to meet the changing needs of the business environment.\(^{157}\) Originally, each board of directors was responsible for assigning its audit committee functions that meshed with its own structure and philosophy; yet it was recognized early on that the audit committee should also be free to exercise independent and objective judgment including the authority to investigate any organizational activity as it deems necessary and appropriate.\(^{158}\)

b. Scope of the Written Charter

The topic of exactly what functions should in fact be assigned to the audit committee has always been highly debated.\(^{159}\) Some people think that the only function required by law should be "to review the

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\(^{154}\) NYSE 2002 Standards, *supra* note 37, § 303.01B; Steinberg & Bromilow, *supra* note 17, at 16 (noting that the duties agreed upon by the board of directors and the audit committee should be specified clearly in a charter so all parties understands their duties); Bacon, *supra* note 3, at 25; SEC Release No. 33-8220, *supra* note 44.

\(^{155}\) NYSE 2002 Standards, *supra* note 37 § 303.01B.


\(^{158}\) Apostolou & Jeffords, *supra* note 4, at 35.

\(^{159}\) Braiotta, *supra* note 10, at 4.
annual audited financial statements before board approval.”

Others believe that all “closely related” functions should also be delegated to the audit committee, including review of: (1) external reporting; (2) the audited annual financials; (3) review of changes in accounting principles and practice; (4) all financial reports which require approval by the board; (5) the financial content of all sections of the annual report to ensure consistency with the audited financials; and the authority to make recommendations to the full board regarding (6) the appointment of external auditor; reviews of audit fees; (7) the scope and timing of audit work; (8) any problems encountered during the audit; (9) any conflicts between management and the auditors.

These are the types of duties that have been delegated to the audit committee through S.O. § 301 and SEC Release No. 33-8220. Further, under both the old and new NYSE listing requirements, most of the “closely related” functions have in fact been delegated to the audit committee, and the scope of their responsibility for each particular task has been more specifically delineated over time. However, despite the increasingly tightened specifications for the written charter, as recently as February 13, 2002, legal counsel has continued to recommend that audit committees maintain flexibility in their chartered duties as part of industry best practices.

The debate over the specificity of the charter goes to the idea that, with increasingly specific charter requirements it becomes arguably more difficult for companies to maintain necessary flexibility and tailoring of roles. However, two purposes of tightening the requirements are: improved corporate governance and oversight, and to raise corporate governance and disclosure standards. One goal in the modifications of listing requirements is to strike a more proper balance between these conflicting ideals; both purposes and goals are widely held by industry experts.

160. CICA, supra note 4, at 4.  
161. STEINBERG & BROMILLOW, supra note 17, at 3, 49; BRAIOTTA, supra note 10, at 9-14; Barr, supra note 7, at 19 (noting customary roles include reviewing financial statements, testing controls, investigating reserves and supervising the external and internal auditors).  
162. See supra Section V.B.1.  
163. NYSE 2002 Standards, supra note 37, § 303A(B).  
164. Keller, supra note 108. Note that this recommendation was made prior to the unveiling of the 2002 NYSE proposed listing requirements which incorporate much more specific charter requirements for the audit committee.  
165. Gibson, Dunn & Crutcher LLP, After Enron: Issues for Boards and Audit Committees to Consider, in CORPORATE LAW AND PRACTICE COURSE HANDBOOK SERIES 361 (Practicing Law Institute 2002) (noting that perhaps this increased specificity is not good as they recommend audit committees maintain flexibility in their charters in order to maintain the ability to focus on policies and issues which may change over time).  
166. NYSE 2002 Standards, supra note 37, § 303A and cmts., at 2.
The 1999 listing requirements specify that the audit committee charter list certain roles, accountabilities, and the scope of the committees' responsibility and relationship with the outside auditors and the board of directors.\(^{167}\) Now, the Exchange has gone one step further and in addition to delineating general roles; § 303A7 proposes specific purposes and ten specific duties and responsibilities that the audit committee must, at minimum, include in its written charter. Time will show the impact of the increased specificity in charter requirements.

2. Will the Increased Specificity in Written Charter Requirements Positively Change What is Done in Practice?

a. Increased Authority and Responsibility over the Independent Auditors

Perhaps the most significant change incorporated in both § 303A7(a) of the proposed listing requirements and S.O. § 301 through SEC Release No. 33-8220, is the granting to the audit committee of "sole authority to hire and fire the independent auditors, and to approve any significant non-audit relationship with the independent auditors."\(^{168}\) Previously the audit committee had limited autonomy in this area since the board made the final decision concerning any of the committees' recommendations.\(^ {169}\) For example, the 1999 listing standards granted the audit committee and the board of directors ultimate authority and responsibility over selection, evaluation, replacement, and nomination of the outside auditors.\(^ {170}\)

The modifications in the audit committees' scope of authority should enhance the independence between the audit committee, the board, and management as a whole. The new definitions of independence for audit committee directors and the new definitions of independence for outside auditors in the proposed requirements mitigate the likelihood that they will have ties to each other. This is the same type of reasoning behind the theory that while it has always been thought that non-practicing CPAs are valuable for audit committee membership they do not participate in the selection of the auditors.\(^ {171}\)

To maintain the integrity and oversight of the financial reporting pro-

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167. *Id.* § 303.01(B)(1). Three specific requirements and responsibilities must be specified. *Id.*

168. *Id.* § 303A7(a).

169. BRAIOTTA, supra note 10, at 24.

170. NYSE 2002 Standards, supra note 37, § 303A7(a). When referring to the external auditors, there was a terminology change from "outside" auditors in § 303.01 to "independent" auditors in § 303A. Alone the change is linguistic; its significance comes from the updated definitions of auditor independence developed by the FASB, AICPA and SEC.

171. APOSTOLOU & JEFFORDS, supra note 4, at 27.
cess it is better if those whom are responsible for overseeing the external auditors have no prior ties to or affiliation with them. Additionally, administratively and numerically, it will be easier to monitor the presence of relationships between the independent auditors and those who select and evaluate them if fewer parties are involved.

Along with the authority to hire and fire, under both the S.O. and NYSE rules, the audit committee will have authority to approve all audit engagement fees, terms, and any significant non-audit engagements with the independent auditors. Despite the fact that the new listing standards also require a majority independent board, proponents of the updated requirements felt that the best way to preempt any connection or allegiances was to leave the oversight and authority in the hands of the audit committee alone.

Whether delegating the selection of the independent auditor solely to the audit committee will have any effect on the financial reporting process remains to be seen. Although it appears as if this is the best way to preempt allegiances, only time will tell how the system will respond to actual pre-existing relationships (or glitches).

b. Purposes Required to be Included with Specificity

In contrast to the general language of § 303, § 303A7(b) of the proposed listing standards require an audit committee to include specific purposes in its written charter. Previously, it was thought that the audit committee responsibilities should include review and evaluation of the annual financial statements before they were submitted to the board. While S.O. § 303 continues to incorporate the general broad-brush approach to delineating the purposes of the audit committee and simply notes that the committee is responsible for all accounting matters, the proposed listing requirements specify which purposes the audit committee must include in its written charter. These are: (1) to assist board oversight and prepare a separate report for the SEC; (2) to oversee the integrity of the financial statements and the company's compliance with legal and regulatory requirements; and (3) to oversee the independent auditor's qualifications and

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172. See also independence requirements in NYSE 2002 Standards, supra note 37, § 303A2(b) and supra Section VI.A.
173. NYSE 2002 Standards, supra note 37, § 303A7(a). See supra Section VII.A. for a discussion regarding non-audit services.
174. See supra Section IV.C.1. for a detailed description of the specific purposes required.
175. BRAIOTTA, supra note 10, at vii; Barr, supra note 7, at 19.
176. BRAIOTTA, supra note 10, at vii; Barr, supra note 7, at 19.
independence, and the performance of the internal audit and the internal auditors.\textsuperscript{177} It remains to be seen if adding these formal purposes will change the way the audit committees' function. First and foremost, the effectiveness of the written charter will depend on if the audit committee complies with and enforces the charter. Note, that there is nothing in the listing requirements or S.O. § 301 that enhances enforcement of the charter, rather the rules focus on having the charter. Thus, enforcement is an issue that should be addressed.\textsuperscript{178}

In addition, the listed oversight purposes of the audit committee are arguably not new requirements, § 303.01(B)(1)(a)-(c) previously specified that the audit committee was responsible for "engaging in dialog with the outside auditor with respect to any disclosed relationship or services that may impact the objectivity or independence of the outside auditor . . . and take appropriate action . . . to satisfy itself of the outside auditors' independence"; and it is not clear how else the committee would oversee the independent auditors independence apart from engaging in this type of dialog.\textsuperscript{179}

Finally, historically, the audit committee has always been thought of as the bridge between the internal auditors, external auditors, management, and the financial reporting process anyway.\textsuperscript{180} Thus, requiring the audit committee to oversee the process is not really adding anything new to the duties it has typically performed; it seems as if the formal report to the SEC is the only substantively new requirement for the audit committee's purpose. Yet, perhaps having to officially report to the SEC will push audit committees to perform more diligently.

\textsuperscript{177} NYSE 2002 Standards, supra note 37, § 303A7(b)(i)(A). \textsuperscript{178} NYSE 2002 Standards, supra note 37, § 303A7(b)(i)(A).

\textsuperscript{178} NYSE 2002 Standards, supra note 37, § 303A7(b)(i)(A).

\textsuperscript{179} NYSE 2002 Standards, supra note 37, § 303A7(b)(i)(A).

\textsuperscript{180} NYSE 2002 Standards, supra note 37, § 303A7(b)(i)(A).
c. Duties and Responsibilities

In addition to specifying which purposes the audit committee must include in its charter, § 303A7(b)(ii)(A-J) lists ten duties and responsibilities that the written charter must include. However as noted at several points below, it is debatable to what extent the requirements actually modify that which audit committees have historically been responsible for overseeing. As the analysis for each duty/responsibility shows, the audit committee has performed most of the newly listed requirements in the past despite the fact that they were not formally required.\(^{181}\)

i. Hire and Fire the Independent Auditor

This first duty requires the authority given in § 3037(a) – to hire and fire the company’s independent auditors - to be addressed in the written charter. As discussed above, this seems a reasonable empowerment of the audit committee.

ii. Obtain and Review a Required Report by the Independent Auditor

Next, the charter must specify that one duty of the audit committee is to, at least annually, obtain and review a report by the independent auditor, which describes specifically listed elements.\(^{182}\) This requirement puts the audit committee in a position where it can evaluate the independent auditors' qualifications, performance, and independence. There is nothing in the language of the requirement that prohibits the audit committee from taking into account the opinions of management and internal auditors when making such evaluation.\(^{183}\) Thus, while seemingly new, this responsibility encompasses those required in the previous listing requirements: § 303.01(B)(1)(c) delegated to the audit committee responsibility for ensuring that the outside auditor submitted on a periodic basis a formal written statement including all relationships between the company and the auditor and discussing with the outside auditor any relationship or services that could impact objectivity and independence and § 303.01(B)(1)(b) required that the

\(^{181}\) Apostolou & Jeffords, supra note 4, at 73.

\(^{182}\) NYSE 2002 Standards, supra note 37, § 303A7(b)(ii)(B) ("describing: the firm's internal quality-control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and steps taken to deal with any such issues; and (to assess the auditor independence) all relationships between the independent auditor and the company.").

\(^{183}\) NYSE 2002 Standards, supra note 37, § 303A7(b)(ii)(B).
audit committee evaluate the qualifications of the outside auditor.\textsuperscript{184} It also is similar to SEC Release No. 33-42266, which requires that issuers include reports in their proxies noting if their audit committees have discussed required matters with the independent auditors, including their independence. The novelty of the proposed requirement is its specificity. In fact, it may be that the charter requirements are too specific; for example, could limiting the minimum evaluation to the issues raised in the \textit{most recent internal quality-review} cause audit committees to ignore past reviews; and if so, were past reviews something they normally have looked at anyway?

A jurisdictional issue raised by requiring the review of this report to be included in the audit committee’s written charter is that the charter is required to specify what the report \textit{from the external} auditors must include. Whether it is a proper role for the NYSE to specify what must be included in an independent auditor report is questionable. The analysis here would in part depend on if the Financial Accounting Standards Board (FASB) or the American Institute of Certified Public Accountants (AICPA) issues an accounting pronouncement or report asking the independent auditor to prepare such a report. Perhaps changing the wording to require the audit committee “to discuss” and investigate these issues with the independent auditor, and to report on them would place the NYSE regulatory reach back in the hands of the listed company, which seems like the proper scope for a self-regulatory organization such as the Exchange.

One way to tell if this requirement will change anything is to compare it to present best practices for firms that have performed well. However, as the collapse of Enron and WorldCom displayed, best practices do not always equate to sufficient regulation. Thus, once the new listing requirements are implemented, time will tell if they affect the way that an audit committee acts.

The commentary to this duty and responsibility listed in § 303A7(b)(ii)(B) further suggests that the audit committee should regularly evaluate the lead partner of the independent auditor and ensure regular rotation as required by law.\textsuperscript{185} Yet, the proposed listing requirement does not implement rotation requirements for either independent auditors or audit committee members. However, under SEC Release 33-8183, at minimum, the lead and concurring partners of the independent audit team must be rotated at least every five years.

\textsuperscript{184} However, the new proposal takes away joint responsibility for such an evaluation from the board as a whole.

\textsuperscript{185} NYSE 2002 Standards, supra note 37, § 303A7(b)(ii)(B) and cmts., at 11.
iii. Discuss Annual and Quarterly Financial Statements with Management and the Independent Auditor

Third, the audit committee charter must specify that the audit committee is responsible for regularly discussing the annual audited financial statements and quarterly statements with management and the independent auditor, including MD&A disclosures. Solely looking at the plain language of § 303.01, this requirement seems to be new, as far as listing requirements go. However, since 1999, the SEC has required audit committees to discuss and review the audited financial statements with management. Further, such discussion of the annual audited financial statements has always been considered part of the intrinsic duties of the audit committee, and since the 1999 listing requirements revisions, the committee has also been expected to look at interim, or quarterly, statements and reports. Examples of the types of information the audit committee has previously been expected to discuss is: management judgments and accounting estimates, significant audit adjustments, related matters, reportable conditions, and all interim financial statements.

In addition to the audit committee meeting with the above mentioned groups, for this requirement to have more bite there should also be a way to ensure that the right questions and analyses are performed during discussions with the audit committee. Perhaps the new oversight board or the SEC should develop a guide for how an audit committee may approach such a discussion. Despite the risks of causing a minimum efforts type phenomenon inherent with providing a guide or list, in this case a guide seems better than no guidance. Finally, perhaps the audit committee should be required to meet individually with each of these groups prior to the completion of the reports when the interesting discussion and compromises are still taking place.

iv. Discuss Earnings Press Releases and Guidance Provided to Analysts and Rating Agencies

Another charter responsibility of the audit committee is to “discuss earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies.” Apart from

186. Id. § 303A7(b)(ii)(C).
188. BRAIOTTA, supra note 10, at 8; MAUTZ & NEUMANN, supra note 8, at 89.
189. APOSTOLOU & JEFFORDS, supra note 4, at 73.
190. Levitt, supra note 120.
191. NYSE 2002 Standards, supra note 37, § 303A7(b)(ii)(D).
mentioning that such a discussion can be done generally and that each earning release need not be discussed in advance, no specific guidance is provided for this discussion. 192 Part of this issue may be taken care of with the implementation of new analyst and broker disclosure and separation rules for public companies, but this is an area where the Exchange should consider providing some additional guidance.

v. Obtain Advice from Outside Expert Advisors as Necessary

Next, the proposed rules implement as a charter duty that the audit committee hold discussions with and obtain advice as appropriate from outside legal, accounting, or other advisors without seeking board approval. 193 Similarly, S.O. § 301 requires each issuer give its audit committee the funding and autonomy to engage independent advisors. This is not a new idea. Since 1978, experts have recommended that it is “advisable for the committee to retain the necessary professional expertise”; without clearly mentioning whether advance approval by the board was required. 194 Specifically granting this authority gives the audit committee more leeway in acting without the entire board. Whether they will use this leeway to consult experts more, time will show. The S.O. requirement that the issuer provide funding for audit committee advisors seems like a beneficial addition to the listing requirements.

vi. Periodically Discuss in a General Manner Risk Assessment Policies and Procedures with Management

Another duty that must be included in the written charter is to hold regular discussions regarding the risk assessment and management policies and procedures of the company. 195 This type of discussion is of the type that fits under the audit committees’ prior oversight function; but was not specifically delineated. The comments to this section suggest that since it is the CEO and senior management’s job to manage risk exposure, the audit committee while, required to discuss major risk exposure and steps management has taken to monitor and control such exposure, it is not required to replace the mechanisms the company has in place. 196 Thus, the concern over whether the directive “to discuss” has any bite applies here. Perhaps requiring the

192. Id. § 303A7(b)(ii)(D) and cmts., at 11-12.
193. Id. § 303A7(b)(ii)(E).
194. BRAGIOTTI, supra note 10, at 10.
195. NYSE 2002 Standards, supra note 37, § 303A7(b)(ii)(F).
196. Id. § 303A7(b)(ii)(F) and cmts., at 11.
audit committee to disclose or make public the content of their discussion and analysis would add more substance to this requirement.

vii. Periodically Meet Separately with Management, Internal Auditors, and External Auditors

The audit committee must meet periodically and separately with management, internal auditors, and independent auditors. In conjunction with this requirement, §303A7(c) requires that all listed companies have an internal audit function. While not specifically required under §303, these meetings are the type of recommended "best practice" that have always been widely followed, and are thought of as extremely beneficial and important.

vii. Review with the Independent Auditor any Audit Problems

The audit committee also has a charter duty to review with the independent auditor any audit problems or difficulties and management's responses, and to include this duty in its charter. Previously, despite not formally being required in the charter, issues the audit committee has been expected to discuss with the independent auditor include: any difficulties encountered in performing the audit, any resistance from management, and a general discussion about the external auditors' relations with management.

The commentary accompanying this requirement suggests that the audit committee regularly review: the work of the independent auditor; any difficulties or restrictions encountered in the course of that work; any significant disagreements with management or restricted access to requested information; any accounting adjustments noted but passed on; any communications with the independence auditor's national office over issues presented during the audit; any management or internal control letters issued or proposed by the audit firm; and the responsibilities, budget, and staffing for the audit engagement. These are similar to the types of issues audit committees have historically been responsible for overseeing. This open type of suggested topics is good in that it gives a starting point to the committee, is flexi-

197. Id. §303A7(b)(ii)(G).
198. BACON, supra note 3, at 11 (1987 survey showed that many charters required the audit committee to meet with outside auditors and 90% of respondents did so at least 2 times a year); MAUTZ & NEUMANN, supra note 8, at 89-91.
199. NYSE 2002 Standards, supra note 37, §303A7(b)(ii)(H).
200. APOSTOLOU & JEFFORDS, supra note 4, at 73-75; see also, SEC Release No. 33-8183, supra note 36 (regarding proxy disclosures).
201. NYSE 2002 Standards, supra note 37, §303A7(b)(ii)(H).
202. Id. §303A7(b)(ii)(H).
ble in allowing room for other duties, and sufficiently incorporates what was done in the past. However, to ensure that an audit committee does not simply limit its oversight to the suggested topics as a checklist to go through, and thus neglect to also track other individualized problem areas as needed, perhaps the exchange should require each committee to submit a summary of items discussed so it can track how committees may actually move outside the suggested scope.

viii. Establish and Review Hiring Policies for Current and Former Employees of the Independent Auditor

Another charter item is the audit committees' responsibility to set "clear hiring policies for employees or former employees of the independent auditors." Such a policy while a step in the right direction, should conform to the new independent requirements and will only be as good as those requirements. See the discussion in Section III.A. for commentary regarding the proposed independence requirements.

ix. Regularly Report to the Board of Directors Regarding any Integrity, Legal, Regulatory, or Performance Issues Involving the Financial Statements or the Performance of the Internal or External Audit

Finally, the audit committee is required as a charter duty to report regularly to the board of directors any issues that affect the integrity or quality of the company's financial statements, compliance with legal or regulatory requirements, the performance and independence of the independent auditor, or the performance of the internal audit function. This requirement seems to properly encompass the ultimate goal of enhancing the reliability and integrity of financial reporting. Yet, it is not clear that troubled companies have not already been doing this type of reporting, and thus it is not clear that adding this responsibility will affect change.

For example, as early as 1978 it was recommended that the audit committee focus its attention on reports of legal counsel including reports regarding governmental, legal, and regulatory compliance. Examples of the types of matters the audit committee has been expected to discuss include: any resistance from management during the audit, internal control structure communications, any noted illegal acts by the client, related matters noted in the audit, reportable condi-

203. Id. § 303A7(b)(ii)(H), (I).
204. Id. § 303A7(b)(ii)(H), (J).
205. BRAIOTTA, supra note 10, at 10.
tions, and any errors and irregularities. A 1987 survey showed that 98% of respondents' audit committees regularly report to the full board at least once a year, with an average reporting of three times a year.

Further examples of the type of performance based communications that the external auditors have previously held with the audit committee are: the selection of and any changes in significant accounting policies or their application; management judgments and accounting estimates; significant audit adjustments; discussion about the external auditors' relations with management; discussion with the audit committee regarding any difficulties encountered in performing the audit. Thus as mentioned, the extent to which this report will affect change may be minimal.

x. Annual Performance Evaluation

In addition to purposes, duties, and responsibilities, the audit committee's written charter must require an annual performance evaluation of the committee. The commentary accompanying the proposed requirement suggests that the annual performance evaluation of the audit committee should include an evaluation of major issues regarding accounting principles and financial statement presentations, specifying any significant changes in the company's selection or application of accounting principles and methods, and should include an evaluation of major issues regarding the adequacy of internal controls and any audit steps adopted to make up for any control deficiencies. The audit committee should review reports by the independent auditors and management delineating any significant financial reporting issues or judgment calls made in preparing the financial statements; as well as look at any earnings press releases or information provided to analysts and rating agencies, particularly looking at pro forma or non GAAP information. Many of those topics are similar to those reviewed by independent auditors and reported to the board as noted in § 303A7b(ii) and (I); the New York Stock Exchange provides more guidance in this area than in any other regarding audit committees.

206. Id.; Apostolou & Jeffords, supra note 4, at 73.
207. Bacon, supra note 3, at 17.
208. Id.
209. NYSE 2002 Standards, supra note 37, § 303A7(b)(iii).
210. Id. § 303A7(b)(iii) and cmts., at 12. These responsibilities are also encompassed in NYSE 2002 Standards § 303A7(b)(ii)(B),(F),(H),(J). Id.
211. Id. § 303A7(b)(iii). This responsibility is also incorporated in § 303A7(b)(ii)(B), (C), and (D).
As mentioned in Section IV.C., this annual report could be enhanced by adding a requirement that the audit committee also perform a detailed evaluation regarding the service and performance of each member. However, this may not be a plausible suggestion, given the current concerns over increased potential liability due to service on the audit committee.

xi. Summary of Impact of Written Charter Requirements

Although many of the specifics delineated in § 303A7 may not have been explicitly required in the past, the audit committee has historically been responsible for a formal annual report to the board. Previously there was not a standard format required for this report, but it was thought appropriate to include: the title, date, statement of the audit committee's mandate, as given in the board's authorizing resolution or corporate bylaws; scope of review; activities; names of members; and signature of the chair. The proposed listing requirements regarding the written charter will force the audit committee to take specific steps before it can provide a complete report. Yet, as analyzed in detail above, many of the duties and responsibilities the audit committee is required to perform are already widely practiced. Thus, the extent to which the new requirements will change practice is debatable.

Rather, the main benefit of adding these duties and responsibilities to the listing requirements may be the notice and disclosure that it provides to the investing public. As a result, (1) the investing public will have easy access to and awareness of the proper role of audit committees and their oversight over the independent auditing process; (2) there will be enhanced consistency in that all listed companies must now do all the listed required charter steps rather than should; (3) and with respect to liability concerns, potential audit committee members will know in writing in advance what their required rather than expected duties are.

D. Fees

While the 1999 NYSE listing requirements do not mention fees for the audit committee, the 2002 proposed requirements specify that au-
dit committee members' only form of compensation from the company can be normal director's fees. The S.O. § 301 prohibition on acceptance of fees other than for committee membership service is similar. However, both the proposed listing requirements and S.O. § 301 fail to specifically mention the related topic of non-audit fees paid to the independent auditors.

E. Rotation

Apart from the mandatory rotation of the lead audit partner that is independently required by state corporate law, the NYSE does not mandate periodic rotation because of a belief that it may undercut the effectiveness of the independent auditor and the quality of the audit. In contrast, Sarbanes-Oxley § 203 established mandatory five-year rotation periods for the lead and concurring partners on audit engagements.

1. Arguments For and Against Mandatory Rotation

The Exchange itself and commentators have regularly expressed concern that a mandatory transition could disrupt the financial reporting process, deprive auditors of institutional memory and make new auditors more dependent on management for information. Apart from what is otherwise required by law, the proposed listing requirements leave the determinations as to whether a company is obtaining high-quality audits; or if either rotation of the lead audit partner, or retention of a new independent audit company would be helpful for the particular company to the judgment of the audit committee. Yet, as a practical matter all listed companies that are listed on any SEC Regulated Exchange will have to comply with the SEC limited mandatory rotations requirements for the lead and concurring audit partners anyway.

Although autonomy over the rotation of the auditor increases the independence of the audit committee in one sense, some commentators feel it also makes it easier for a dishonest audit committee or

216. See Section VII. of this paper for a discussion regarding non-audit services and fees.
217. NYSE Statement, supra note 11, at 14; Wachtell, et al., Enron/Anderson: Directors Q & A, in CORPORATE LAW AND PRACTICE COURSE HANDBOOK SERIES 355 (Practicing Law Institute 2002) (noting that there is no requirement to switch auditors so the question is solely in the discretion of management and the board).
219. Id. (noting that while rotation has been a component of quality control process for auditors for at least 25 years, there is a concern that too much will threaten the integrity and quality of audits).
single member to collude with the independent auditor for an indeterminate period of time. As a result of this risk of collusions and complacency, it is the view of Co-Chairman of the NYSE review committee H. Carl McCall, Comptroller of the State of New York and Sole Trustee, Common Retirement Fund of the State of New York, that mandatory rotation may improve auditor independence and therefore should be mandated. Yet, other parties staunchly feel that mandatory rotation should not be implemented. For example, the commission has so far been against mandatory rotations because of the potential disruption of the oversight process.

The author agrees that mandatory rotation of the independent auditor could result in a better system of oversight. However, on the other hand, mandatory rotation of audit firms may not accomplish a better or different result than mandatory rotation of the lead audit partner; unless other changes are simultaneously made to current practices. First, to respond to the concern that required rotation of the firm would disrupt the process and institutional memory, the author does not think that it is bad. Each audit firm should be able to competently perform an audit from the ground up. Yes, it may cost more to rotate firms since institutional memory will not last as long and will have to be "rebuilt" with each rotation, but this would force the firms, and the audit committees to step back and look at the process and take initiative over consistently updating and reviewing their methods and investigation.

For example, many auditors begin a year-end audit by using the audit program from the year before and update it for any new FASB or SAS pronouncements or requirements. Then they essentially perform the same audit steps they did the year before. Yes, they are able to use institutional memory to make the process faster, less costly, and more time efficient. Yet, they do not always analyze if there were alternative steps or procedures that would work better, or if there were additional questions they should ask that had not been relevant in a previous year. If they find an oddity in their results they then can go to management and further investigate the cause, but they do not always talk to management or the internal auditors as much as they could before setting their audit program. In contrast, if a new inde-

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220. NYSE Statement, supra note 11, at 14. Note that several of the recently proposed accounting reform bills' proposals brought in Congress suggest rotation of the independent audit form and the lead partner and suggest the SEC perform a study on this topic). See also Mautz & Neumann, supra note 8, at 70.

221. Harms & Rosen, supra note 126, at 16.

222. Note: the name of the firm the author worked for and the client the author worked on have been excluded for privacy purposes. Although the author only worked at one of the "Big
ependent auditor had been hired to complete the audit for this company, they would have had to start with management discussion and observations of the operating methods of the company before composing an audit program. Furthermore, if a new independent auditor finds anything unusual or unethical about the processes used by the former, they are supposed to report this information. This observation is not meant to suggest that a new program should be made from scratch each year; there are certain benefits to institutional memory - e.g. the auditors know which contacts at the clients will be straightforward with them and which will try to send them in circles. However, the best combination could be a limit on the number of years the same firm can perform a reoccurring audit; five might be a good number, in light of other five-year time stipulations chosen by the Exchange, but this would have to be fully investigated.

VII. ADDITIONAL ISSUES THAT IMPLICATE THE AUDIT COMMITTEE NOT FULLY ADDRESSED IN THE PROPOSED LISTING REQUIREMENTS

A. NON-AUDIT SERVICES PERFORMED BY INDEPENDENT AUDITORS

1. Addressing Non-Audit Services in Conjunction with Rotation

As mentioned above, there is not convincing evidence that mandatory rotation of audit firms would accomplish a better or different result than mandatory rotation of the lead audit partner. In part this is because most independent auditing firms also offer numerous non-audit services ("NAS") to both audit and non-audit clients; there is evidence that this provides incentives that are in opposition to the potential benefits of mandatory rotation.

Five firms, she is aware from conversations with auditors at each that it was the normal industry practice to use this type of approach in setting the audit program for a recurring client.

223. Note that although the incoming firm is often given copies of the outgoing firms audit program for the past several years, a new firm is still more likely to come up with a new and different program in order to attempt to provide the client with superior services utilizing its own process. Additionally, even if the new firm uses some of the old program, it still has to go through the steps and questions that will allow it to develop an understanding and familiarization with the company.

224. This duty falls under the ethical oath that a C.P.A. takes when admitted to practice as such.

225. Andrew D. Bailey Jr., The Multidisciplinary Practice of Certified Public Accountants and Lawyers, 52 CASE W. RES. 895, 897-98 (2002) (noting that independent auditing firms have become the largest client services businesses in the world and for some client non-audit fees exceed audit fees by multiples of 3-30 times). For example, in 2001 Arthur Anderson earned $25M from Enron for audit services and $27M for NAS. BACON, supra note 3, at 19 (noting that "independent audit firms might find it difficult to oppose management over controversial accounting practices if doing so jeopardizes lucrative management consulting contracts"). See also Deborah
For example, assume independent audit firm A is providing audit services for client X and consulting services for clients X and Y. Suppose at the end of five years A is replaced by independent audit firm B with respect to the audit services provided to client X. Assume A also performs tax services for client Y and then B provides consulting services to Y. Generally, if B reports that there were irregularities or problems with A’s audit methods with respect to X, then A may be investigated by the SEC. This could lead to all A’s clients – for any services – being investigated, including Y. It would be potentially bad for B if Y were investigated because that could lead to an investigation of the services Y is receiving from B as well. Even if B is doing nothing wrong, the taint of an investigation alone goes along way in the corporate field. Thus, because of the non-audit services B is supplying to Y, B has less incentive to fully investigate A’s prior year audits of X. Similar incentive issues exist if A provides audit services to X and consulting services to Y; and B provides consulting services to X and audit services to Y. Neither A nor B has an incentive to question the methods employed by the other due to the potential impact on its own business or methods. Furthermore, this type of situation makes it easier for one “bad apple” to perpetuate fraud. If there are separate firms performing the audit and tax engagements, then each will undertake every required step. Despite the additional cost duplication may cause, the corresponding benefit is the increased oversight resulting from the fact that the two teams will in a sense be “checking” each others work as their results should be the same.

Furthermore, if the additional incentives provided by the simultaneous provision of NAS are removed, perhaps we will see more firms developing different auditing and investigatory methods to complete

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Solomon, After Enron, a Push to Limit Accountants to... Accounting, WALL St. J., Jan. 25, 2002, at 226. Additional example: When a single firm provides independent auditing services and other services to a client there is a potential for negative incentives. For example, suppose Independent Auditor Firm A is providing both auditing and tax service to client X. Some of the procedures that must be undertaken for a complete audit program and a complete tax analysis are similar. Thus, firm A will have an incentive to perform each required analysis only one time to save costs. For example, suppose both engagements require that A interview the company’s controller. It would be cost-efficient for A to have one individual perform the interview and share the result with both the audit and tax engagement teams. However, the problem with this is that the follow-up questions that should be asked may be different for each type of engagement. Thus, the interviewer may not ask the same “difficult” questions that an auditor would and should. Furthermore, the engagement teams are likely to rely on each other’s work without asking the same question or performing the same checking that they would if they were independent firms.
the same required audit steps.227 At the same time, this will force the audit committees to be more aware and less complacent throughout the oversight process because they will have to ask more questions to gain an understanding of new or different methods.

2. Addressing Non-Audit Services in Conjunction with Fees

As mentioned, the proposed NYSE listing requirements restrict audit committee members' compensation from the company to normal directors' fees including the typical additional amount paid to chairs of committees and to members of committees, that meet more frequently or for longer periods of time.228 This limitation fails to account for the incentives provided from non-audit fees paid to the independent auditors. As discussed above, the fact that independent auditors provide and are paid for non-audit services can influence their audit programs and processes, which in turn may influence their interactions with and oversight by the audit committee.229 Independent auditors may be less inclined to challenge management accounting practices for fear of removal from a lucrative NAS contract as retaliation. Restricting independent auditors to auditing services only should diminish these incentives. Furthermore, it seems like the only way to fully address the problem of inter-relationships between independent audit firms is to prohibit them from providing non-audit services at all; simply restricting the additional services that an audit firm may provide to its own audit clients is not sufficient.

Thus, based on the above analysis, the author recommends mandatory independent auditor firm rotation and the elimination of non-audit services by auditing firms as a best practice. As then Chairman of the SEC, Arthur Levitt recognized in his original 2000 proposal for listing requirement changes he would support prohibiting auditors of public companies from providing NAS to audit clients in an effort to increase the quality of audit services provided.230 How-


228. See supra Section IV.D. of this paper for discussion of the proposed requirements for audit committee member fees.


230. See Revision of the Commission's Auditor Independence Requirements, Release No. 34-43602 (Oct. 12, 2001) for the watered down version of this proposal that actually passed.
ever, for the reasons discussed above, the author proposes an even more radical solution of not allowing independent audit firms to provide any NAS.

Realistically, the industry and Exchanges are likely not willing to go that far; so in the alternative, implementing mandatory partner rotation alone will be a step towards removing the biased incentives inherent in the current system.\textsuperscript{231} Furthermore, current proposals that auditing firms be prohibited from providing specified listed services is a step in the right direction.\textsuperscript{232}

B. Liability

The legal liability of the board of directors and the audit committee has been of increasing concern since the 1990s and is manifested in state corporation laws and certain federal statutes regarding directorate responsibilities.\textsuperscript{233} Most, state corporate law statutes currently limit the board’s power to delegate authority and responsibility to committees.\textsuperscript{234} However, with respect to the audit committee, that limitation has always been discretionary because audit directors can exercise their own judgment in the interest of the board. With the addition of written charter requirements, very specific and numerous responsibilities are specifically delegated to the audit committee. In fact, an argument behind limiting the number of committees an individual can serve on is the underlying concern over the ability of an

\begin{footnotes}
\item[231] Bailey Jr., supra note 225; see also SEC Release No. 33-8183, supra note 36 discussing auditor rotation.
\item[232] Harms & Rosen, supra note 126 (proposing that auditors be restricted from providing: bookkeeping; financial information and systems design implementation; appraisal or valuation; internal audit; management or human resources; broker, dealing, investment banker or investment advisor; legal; expert or any other services designated by the SEC rule).
\item[233] BACON, supra note 3, at 4 (noting that prior to the implementation of the 1999 listing requirements, one reason there was reluctance to hold audit committees responsible for oversight over a company’s quarterly financials in addition to its yearly was fear that it would increase members exposure to liability). Conference Audit Proceedings, supra note 4, at 81 (as early as 1976 experts recognized that at some point in the future the ambers of the audit committee might be legally held to a higher standard than the board of directors in general). For example, see NEW YORK BUSINESS CORPORATION LAW § 712 (McKinney 1963); see also THE FEDERAL SECURITIES EXCHANGE ACTS OF 1933 AND 1934; THE FOREIGN CORRUPT PRACTICES ACT; Kevin Iurato, Warning: A Position of the Audit Committee Could Mean Greater Exposure to Liability: The Problems with Applying a Heightened Standard of Care to the Corporate Audit Committee, 30 STETSON L. REV. 977 (2001).
\item[234] Dennis J. Lehr, The Emergence of the Corporate Audit Committee, in CORPORATE LAW AND PRACTICE COURSE HANDBOOK SERIES 273; Joseph Hinsey IV, The Impact of the Audit Committee on Director Liability, 31 (N.Y.C., P.L.I. 1978) (as early as 1978 a number of states had adopted an affirmative duty of care for corporate directors), BRAIOTT, supra note 10, at 44 (noting that state law statutes limits on board’s power to delegate responsibilities to committees); Iurato, supra note 233.
\end{footnotes}
audit committee to properly handle the list of responsibilities assigned to it in the recommendations. A possible alternative that could be used to spread the risk of liability is delegating the actual act of firing and hiring to the entire board while requiring the board to act on the recommendation of the audit committee. Whether this would have an effect on the level of liability of audit committee members is debatable, but seems likely.²³⁵

As the proposals stand, in addition to all board members statutory duties of care and loyalty, the audit committee members will have some increased responsibility over the delegated duties. Furthermore, ABA § 35 of its Model Business Corporations Act, increases a director’s ability to rely on standing committees such as the audit committee; this leaves questions open as to the potential difference in degrees of liability or exoneration of committee members.²³⁶ In states that have enacted § 35 of the Model Business Corporations Act, the audit committee has an additional legal responsibility because other board members can rely on information provided by a standing committee such as an audit committee.²³⁷ Thus, while a non-audit committee director may escape liability if he acts responsibly with due care, an audit committee member may be held to a higher legal standard.²³⁸ While this legal standard will not change with the proposed standards, since the list of audit committee responsibilities will be expanded in the written charter, it is arguable that the non-audit committee members will be able to claim reliance on the audit committee in a larger number of situations. If the scope of liability is narrowed for the board as a whole the audit committee will correspondingly shoulder more risk individually.

Legal liability at the federal level includes the Securities Exchange Acts of 1933 and 1934, and the Foreign Corrupt Practices Act. Consistent with § 35 of the Model Business Corporations Act, these acts allow non-experts to rely on information provided by experts. Although it is not clear whether an audit committee member would be considered an “expert” for purposes of this act, it is a possibility that

²³⁵. Note that unlike the 1999 SEC preliminary Release No. 33-8220 which specifically included a safe-harbor for new disclosures in order to protect companies from liability; and 2003 SEC Release No. 33-8177 which specifically provides that “audit committee financial experts” will not be subject to liability any greater than other audit committee members, the proposed listing requirements are silent on the potential of increased liability for audit committee members as a group.

²³⁶. MBCA § 35. BRAINTON, supra note 10, at 45 (noting that § 35 increases directors’ reliance on standing committees).

²³⁷. Id.

²³⁸. APOSTOLOU & JEFFORDS, supra note 4.
audit committee members for public companies issuing registration statements and other filings under those acts should be aware of. If an audit committee member will be considered an expert over all the duties and responsibilities required to be included in the written charter, then their official scope of liability will be expanded by the new listing requirements.

Further, in addition to liability concerns due to the proposed listing requirements, commentary to S.O. § 407 included the concern that heightened expertise requirements would lead to heightened liability. In response to concern that requiring the names of the "audit committee financial experts" to be listed on the proxy statement would subject them to higher potential liability, and thus discourage qualified people from service, the SEC added a safe harbor provision specially noting that such expert designation does not subject the individual to any different a degree of liability than regular audit committee members.\(^{239}\) Although this safe-harbor does not address the liability of audit committee members vis-a-vis other board members, it can arguably be seen as evidence that the SEC does not intend to impose additional liability on committee members for the same reason of discouragement from service.

Liability insurance has long been recommended for board and audit committee members. Yet, with an increased potential for liability such insurance will cost more. There is the circular risk that due to increased insurance costs companies will limit the number of members on the audit committee to the minimum required – three. This in turn could make the job harder and could increase the exposure of the remaining members, consequentially leading to more refusals of requests for audit committee service.\(^{240}\)

Despite the risk that the potential liability for audit committee members is increased by the proposed listing requirements, there are ways to minimize the potential for legal liability. For example: practice oversight responsibilities with the degree of care, diligence, and good faith required by law; document everything necessary to confirm the diligence with which the committee performs its responsibilities; and maintain regular communication with the board and with expert counsel. However, the potential for liability should not be underestimated. The nature of the auditing process and Generally Accepted Auditing Standards ("GAAS") will remain one in which the professional judgment of all involved parties is imperative. While the judg-

\(^{239}\) Id.

\(^{240}\) STEINBERG & BROMILOW, supra note 17, at 61.
ment of the audit committee may be entitled to the broader corporate board’s business judgment standard of liability review, there is always the potential for irreparable lapses in judgment.\textsuperscript{241} There continues to be a risk that as potential liability increases, it will be harder to find members to serve.\textsuperscript{242}

A hard question is where to draw the line between an audit committee that has properly performed its duties, and one, which has not met its basic oversight responsibilities. Within the business industry, Enron is often seen as an unusual or unique situation, yet one in which a more alert board may have caught signs of trouble. Does this mean that the board should be personally liable for not catching what was going on? John C. Whitehead, former non-management director and audit committee chairman, testified that Enron showed signs that a more alert or curious board should have noticed.\textsuperscript{243} Perhaps if the audit committee and board failed to exercise a "normal" level of oversight they should be personally liable. But, on the other hand we do not want to make it impossible to recruit qualified and willing board members by increasing the financial and liability risks too much. Furthermore, the reputational public stigma of having served on such a board combined with the new SEC ability to place the former board members on a list of people who can no longer serve on any public board may be punishment enough for those members who did not have actual or constructive knowledge of the fraud.

C. Disclosure

1. Economic Ties

As noted in the discussion regarding independence for board and audit committee members, disclosure and independence can be highly interrelated. The proposed tightened independence requirements require disclosure of all economic interrelationships, and board members with any economic ties to the company are not allowed to serve on the audit committee.\textsuperscript{244} As analyzed in Section VI.A.4. above, it

\textsuperscript{241} SEC Release No. 34-42266, supra note 28, included a release that audit committee requirements are not meant to increase the audit committee’s liability; the commentary implies that the SEC implicitly recognizes the argument that under state corporate law the more informed the audit committee becomes through its discussion with management and auditors, the more likely that the “business judgment rule” will apply and provide broad protection.” This goes along with the discussion in this paper that adherence to a sound business process should result in less, not more, exposure to liability.

\textsuperscript{242} Steinberg & Bromilow, supra note 17, at 61.

\textsuperscript{243} NYSE Statement, supra note 11, at A-133. See also Lubin, supra note 100, at C1.

\textsuperscript{244} NYSE 2002 Standards, supra note 37, § 303A1.
remains to be seen if the new disclosure requirements regarding eco-
nomic ties will be sufficient for ensuring true independence.

2. Ordinary Business and Non-Ordinary Transactions Classified

In addition to disclosure requirements regarding director indepen-
dence, neither the current nor proposed disclosure requirements pro-
vide guidance to help the audit committee distinguish between
ordinary business and non-ordinary business transactions that must be
disclosed in a company's financial statements. For example, Enron
was able to pull off its infamous Special Purpose Entity ("SPE") trans-
actions because it managed to classify the transactions, despite unusu-
alness, outside of the form of transaction that was required to be
disclosed.\(^{245}\) Thus, although the existence of SPEs was disclosed, the
disclosure was inadequate to sufficiently inform investors as to the im-
plications of the transactions.\(^{246}\)

Although the Sarbanes-Oxley Legislation now requires disclosure
of all off balance-sheet SPE transactions, what happens when the next
ingenious invention of a new transaction type comes along? Some-
how the audit committee's oversight in conjunction with disclosure
rules should catch these types of complex transactions. Although the
resulting disclosure might still be necessarily imperfect due to the
complicated nature of the transactions, at least investors would be on
notice that something unusual was occurring.\(^{247}\) Although the suffi-
ciency of transactional disclosure is an issue the FASB and the SEC
must address, it seems like the exchanges should be able to do some-
thing, in conjunction with those other groups, in the meantime. Per-
haps the situation can be addressed by the SEC and FASB first

\(^{245}\) Harms & Rosen, supra note 126, at 16. Briefly, Enron had developed and/or purchased
SPEs that were 97% owned by Enron and 3% by an independent party; this 3% minority inter-
est ensured that Enron did not have to consolidate the SPEs for balance sheet purposes. Enron
then sold some of their assets to the SPEs in order to get them off Enron's balance sheet. In
return, the SPE paid Enron for the assets' fair market value ("FMV"), and Enron claimed a gain
of the difference between the FMV and its basis in the assets sold. The SPE financed the
purchase price of the assets by selling bonds to the public and borrowing from bank loans. How-
ever, the SPEs could only get the banks and bondholders to finance the required money if Enron
guaranteed it. So, Enron did a total rate of return SWAP with the SPE, covering the same
assets, and transaction where it had performed the sale of assets. Enron signed an agreement to
pay and guarantee all the interest and principle due on the borrowed money and SPEs paid
Enron any profits from the subsequent sale of the assets to outside parties. (Author's summary
of Enron situation.).

\(^{246}\) Steven L. Schwarcz, Duke Law School Public Law Research Paper No. 28: Some
Thoughts on the Enron Bankruptcy, at http://www.chron.com/content/news/photos/02/02/03/en-
ron-powersreport.pdf.

\(^{247}\) Id. at 8 (suggesting that investors must rely on the board's business judgment to some
extent as they will not understand the full implications of exceedingly complex transactions).
putting together a list of all transaction types that are ordinary in the sense that they are straight-forward and transactions that the investing public has knowledge about; transactions such as loans, bonds, leasebacks. This list could be mobile in the sense that the SEC could add new transactions to it as soon as they determined acceptable accounting treatment for each new type of transaction. Next, the NYSE could implement a listing requirement that all transactions not appearing on that list must be discussed with the audit committee and disclosed in the company’s annual report. Although this proposal does not address a long-term solution for how to account for new transactions at least it will result in public awareness of the fact that something different or unique is going on. Furthermore, since such a disclosure could have a negative impact on the stock price of a company – investors are wary about things they do not understand – this type of listing requirement could also provide an incentive for companies to bring new types of transactions to the attention of the SEC so that they can be added to the list as quickly as possible and thus no longer require specific disclosure.

Various groups have proposed disclosure requirements that focus on board principles rather than new procedures. For example, the Business Roundtable cautions against regarding establishment of new processes or procedures as a panacea, and instead recommends that the focus be on setting forth broad principles of corporate governance that will facilitate the sufficiency of disclosure. Although perhaps not ideal long-term solutions, the process suggested above, or one of that type of board principles requiring disclosure of all new transaction types, would at least provide heightened disclosure to the investing public.

3. Disclosure Verse Oversight

Critics of the current disclosure system claim that it does not need more financial disclosure rules, but stronger oversight of the rules. Others, including the author, disagree with this statement and think that a major cause of situations like Enron is the lack of investor awareness of what was really going on; it seems that a mixture of heightened disclosure requirements and stronger oversight is needed.

248. Note that the author is not suggesting that such a system will rid the process of fraud. As discussed supra Section VII.D., if someone is determined enough to commit fraud they will almost always succeed for a time at least. The author is not suggesting that this type of system would catch those non-fraudulent transactions that are not currently disclosed because they fall outside the disclosure requirements, but that investors should be made aware of.


250. Id. at A-93.
Although some of the problems at Enron were due to fraud and illegal actions, the SPE transactions that took place were not necessarily fraudulent or illegal in their composition. While stronger oversight may have allowed the audit committee to catch the fraudulent and illegal acts that were being perpetuated, stronger oversight alone would not have stopped the entire situation. The SPE transactions at issue were arguably, technically in compliance with accounting and disclosure rules even if the purpose was fraudulent. Heightened disclosure would have at least provided public awareness of these transactions while greater oversight may not have stopped them.

D. Detection of Fraud

Since the beginning of time people have found ways of getting around "the rules." Regardless of what rules, regulations or standards are in place, if an individual really wants to effect a fraudulent transaction it is difficult, if not impossible to stop them. Although the audit committee can increase heightened disclosure and oversight as a means of addressing detection of fraud, there are situations where even the most stringent rules will not stop the perpetuation of fraud. The events of 2001 have shown that massive fraud is likely to be detected, eventually. However, eventually is not the same as immediately.

1. Enron and Disclosure

Enron's board of directors was what most experts would call ideal. However, they either participated in, or did not discover, massive fraud perpetuated by management. First, the board waived its own code of ethics to allow Enron to participate in deals with part-


252. William C. Powers, et al., Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron (THE POWERS REPORT) (Feb. 1, 2002); Powers Report, CORPORATE LAW AND PRACTICE COURSE HANDBOOK SERIES, at 307 (Practicing Law Institute 2002) (noting that the transactions were designed to accomplish favorable financial statement results not to achieve any bona fide economic objective or transfer risk; and the SPE transactions consisted of creative efforts to circumvent accounting principles through complex structuring).


254. Lubin, supra note 100, at Cl.

255. The following discussion regarding the level and types of fraud in the Enron case was in part developed from a lecture during an advanced reorganization class at Harvard Law School, Spring 2003.
partnerships that were controlled by its own CFO. Although this waiver was disclosed, experts felt it was not sufficiently questioned. The "theft" that eventually occurred through the partnerships was later estimated at almost $40 million. Here, board oversight and disclosure of the deals failed to catch the fraud. The 2002 NYSE proposed listing requirements and the Sarbanes-Oxley Act will prohibit all business transactions between related parties, require that the SPE off-balance sheet transaction be disclosed, and will not allow corporate loans to executives and directors.

Yet, there is never a 100% assurance that fraud could not take place in a slightly different form. For example, Enron's CFO could have had a friend, with whom he had no public relations or prior business transactions with, run these partnerships so the CFO was not involved, then paid the CFO on the side. Yes, such actions would be illegal, involve an additional participant, and most likely eventually be discovered. However, whether such a transaction would be approved in the first place would depend in large part on the board's determination of the third parties "non-relatedness" in its oversight role. The proposed requirements would make this type of fraud more difficult to perpetuate, but it would still not necessarily be impossible.

The issue of financial fraud brings us back to the simple inquiry if audit committees are asking the right questions to get to the heart of what is going on in a company; it has been suggested that three questions every audit committee should ask in the wake of Enron are: (1) what off balance sheet financing does the company do; (2) what related party transactions has the company engaged in; and (3) what relationships exist between the independent audit firm and the company. These questions seem reasonable; they also seem rather basic. Thus, a better question to ask may be why audit committees were not already asking these questions.

A second type of transaction that led to the bankruptcy of Enron was through transactions with SPEs. Essentially Enron used two perfectly legal transactions in combination to transact a sale of assets in a way through which it could recognize the gain inherent in the fair market value of appreciated assets, but also retained the risk of default inherent in bonds sold to finance the sale of those assets.

256. Powers, supra note 252, at 24; NYSE Statement, supra note 11, at A-33; See generally The Powers Report, supra note 252.
258. Keller, supra note 108.
259. Id. at 255.
question remains, was this combination transaction fraudulent or illegal? There seems to be no reason why they would have combined these transactions except for fraudulent purposes.\textsuperscript{260} Thus, in the cases going forward the courts will have to decide if the purpose renders the combined transactions illegal. Assuming the transaction itself is not illegal, the fact that it was not disclosed seems fraudulent. Yet, although it seems like this transaction must have been done to fool the market and some actor must have known, an inherent risk in this type of situation is that most of the people involved probably never realized they were doing something wrong and thus were not looking out to stop any wrongdoing.

Part of the reason the SPE transactions were not flagged as high risk, was that Enron’s independent auditors signed off on the non-disclosure of these transactions. This shows at minimum poor judgment and at maximum, collusion. The auditors may have been influenced to go along with Enron’s transactions because of their lucrative consulting contracts with Enron; if independent auditors are required to spin off all other services, this part of the problem may be avoided.\textsuperscript{261} Yet, until this is required, of ongoing concern is ensuring that the next generation of this type of transaction is also disclosed. The responsible agencies and the new oversight board will have to develop a stronger long term solution to combat the methods people come up with to distort current disclosure rules.\textsuperscript{262}

2.Detection of Fraud through Accountability

In addition, to the proposed NYSE listing requirements, the Sarbanes-Oxley and Oversight board will implement new disclosure procedures in an attempt to avoid the finger-pointing that goes on between the board and the independent auditors whenever a problem is uncovered.\textsuperscript{263} The SEC, Congress, and the self-regulatory agencies have announced intentions to make significant changes in laws regul-

\textsuperscript{260} Harms & Rosen, \textit{supra} note 126, at 43. See \textit{U.S. v. Simon}, 425 F. 2d 296 (2d Cir. 1969) (holding that” financial statements that fully comply with GAAP may nevertheless be fraudulent under federal securities laws”).

\textsuperscript{261} Harms & Rosen, \textit{supra} note 126, at 43.

\textsuperscript{262} \textit{Id.} at 42. Note that the 2002 NYSE proposed listing requirements contain the recommended general disclosure requirement for expanded MD&A and critical accounting policies disclosure in addition to the discussed audit committee requirement; however these are outside the scope of this paper.

\textsuperscript{263} Under the Financial Accounting Standards Board and SEC pronouncements, management, not the audit committee, is ultimately responsible for the financial statements while the independent auditor is responsible for oversight. In the past this has led to much inter pointing of the variety of the audits claiming “I did not know X was occurring because I was not told by management”; and management responding “I did not know X was fraudulent because the audi-
lating public companies' auditor oversight and company responsibility. The new rules attempt to get those parties who typically claim, "I did not know." Chief Executive Officers (and perhaps CFOS) must certify that they have put in place and reviewed the effectiveness of required "disclosure controls and procedures" within 90 days before an audit report is filed and that they presented the result of the review to their auditors. In turn, the auditor must certify that management has installed internal control procedures and must independently assess them. Thus, in a sense the independent auditor is certifying that managements' certification is correct; this should dissipate the "he said she said" phenomenon and looking over each-others' shoulders. Although the audit committee is not specially mentioned in this process, it is indirectly implicated through its responsibility over selecting and overseeing the independent auditor.

E. Initial Audit Committee Training and Continuing Professional Education

From the beginning, people have recognized the importance of orienting new members - it has been estimated that it takes at least a year for new members to gain a working knowledge of organization's financial reporting system and internal controls. Yet, the topics of standardization of audit committee members training, or ongoing professional educations are not addressed in the proposed listing requirements and industry experts feel that many committee members are not receiving enough training at this time. Since it has been recognized that ongoing training is one of the imperative factors for a successful audit committee; this is a topic the Exchange should address going forward. Suggestions for topics that should be covered in orientation and training include: the charter responsibilities, business and industry insight, key risk for the company, key financial reporting, operations and compliance controls, standard financial reports, key accounting policies, statutory and regulatory requirements, reporting and audit processes, earnings trends, support and resources, external auditors, and committee self assessment and review.

264. Harms & Rosen, supra note 126, at 43.
265. Apostolou & Jeffords, supra note 4, at 31.
266. Steinberg & Bromilow, supra note 17, at 63.
267. Apostolou & Jeffords, supra note 4, at 34.
268. Id. at 43.
The Institute of Internal Auditors has proposed that the NYSE, AMEX and Nasdaq should jointly issue a uniform set of corporate governance principles.\textsuperscript{269} If uniform standards are developed they may ease concerns about potential shortcomings of the audit committees for companies listed on various exchanges due to the perception that expectations for audit committees may be unrealistic and that there is a lack of available suitable committee members.\textsuperscript{270} These problems could be eased if each exchange's requirements are the same since there will be no competition between them regarding expectations, and suitable candidates will have no reason to prefer serving on a committee whose company is listed on a certain exchange verse a different exchange. However, other general concerns will not be helped by uniformity, such as managements concern about lack of representation on the committee.

Uniformity may not be required or beneficial for two reasons. First, the fear that uniform rules will lead to a race to the bottom in the sense that coordination will ensure there is no competition with "better" standards that protect the investing public more so each one will be less motivated to update and better its own standards. Second, a brief comparison of the NYSE and NAS proposed listing requirement shows that they are in fact relatively similar in most respects such that requiring a transition to a uniform system could be a whole lot of work for limited results.

\textbf{VIII. Conclusion}

As a representative of investors with simultaneous fiduciary duties of loyalty and care to the company, the board as a whole must concurrently be independent from and answer to management. Thus, there is an inherent conflict which can never be put to rest, but that might be best taken care of with heightened disclosure and independence requirements. The audit committee has a critical role within the framework of corporate accountability since the jurisdiction of the committee is to oversee and monitor the activities of the corporation's financial reporting system, and the internal and external auditing processes. As discussed above, it seems like the key to an effective audit committee is the right mix of knowledge, judgment, indepen-

\textsuperscript{269} NYSE Statement, \textit{supra} note 11, at A-82.
\textsuperscript{270} \textit{CICA}, \textit{supra} note 4, at 63; Olson, \textit{supra} note 178, at 1102 (noting that good directors may decline to take on audit committee service and those who do serve may face increased risk of personal liability).
The above analysis details a critical look at the 2002 proposed NYSE listing requirements and sets forth additional alternative issues that could be investigated. In general, the above analysis shows that although the proposed audit committee listing requirements present a step in the right direction; eventually more will be needed. A summary of the author’s conclusions regarding specific provisions and implications of the proposed listing requirements follows.

A. INDEPENDENCE

First, the expanded cooling-off period from three to five years is likely to catch more non-independent relationships; yet, the SEC and Exchanges should investigate if an even longer time period would be more beneficial. Second, the requirement that each listed company have a majority of independent directors is significant in that it should help investors’ confidence in the oversight process; but, since studies show that most listed companies already meet or are close to meeting this requirement, whether this requirement will actually affect change in many boards’ composition remains to be seen. Third, the author thinks the Exchange’s focus on defining types of relationships that render directors non-independent rather than listing specific relationships is a good method that provides adequate guidelines for companies and their expectations but also leaves room to incorporate new types of relationships as necessary. Fourth, the Exchange should consider examining each director’s past relationships with other directors as another possible area that may affect the autonomy and independence of board and audit committee decisions. Finally, the Exchange should further investigate the practicality and potential impact of commentaries’ suggestions that an alternative focus on changing disclosure requirements rather than independence rules could have a stronger and more lasting impact on investor confidence.

B. Composition

Despite the decision by the Exchange not to update its financial expert requirement, the “audit committee financial expert” requirement implemented under the Sarbanes-Oxley Act will affect some change in the composition of audit committees for listed companies. This change seems positive and perhaps will make it easier for the committees to recognize instances of financial fraud and misstatements. Yet, the SEC and Exchange should make certain that the

271. Steinberg & Bromilow, supra note 17.
movement to focus membership qualifications on quantitative backgrounds and financial expertise does not eclipse the equally important need for members who possess the more qualitative virtues of curiosity, skepticism, and diligence. Furthermore, the Exchange should consider addressing additional composition topics such as: (1) the length of audit committee service; (2) limiting the number of committees and boards an individual can simultaneously serve on; (3) dictating a minimum number of meetings the committee must hold each year; (4) imposing staggered terms for committee members; and (5) requiring an odd number of members. Finally, the exchange should consider investigating the practicality of the offered alternatives and more unique suggestions for enhancing the performance of the committee in a way that could bring back the emphasis on communication skills, curiosity, and diligence as desired qualities.

C. Written Charter

Maintaining the requirement to have a written charter may seem like the right decision. The debates surrounding this charter requirement center around how specific the scope and duties laid out in the charter should be. The proposed listing requirements move towards a much more specific delineation of required duties, responsibilities, and purposes for the audit committee; it is possible that as the new requirements are implemented we will see that they may in fact be too specific. Yet in response to the commentary that the requirements are too specific is the counter-claim that many of the new requirements are in fact things that audit committees have unofficially been responsible for, for years. Thus, another potential critique of the proposed requirements is that they will not truly affect change in practice. The applicable section of this paper presents a comparative discussion of these views but time and implementation will tell which pans out.

With respect to some of the specific purposes, duties, and responsibilities added: (1) granting the audit committee sole authority over the hiring, firing, and other services performed by the independent auditors should have a positive impact on the integrity of financial reporting; (2) with respect to the oversight purposes mentioned in the charter, it seems as if the requirement is lacking in that there is no enforcement mechanism included; (3) granting explicit authority for the audit committee to obtain advice from outside experts as needed, could positively increase their use of this previously available outlet; (5) with respect to the audit committee’s annual performance evaluation, perhaps the Exchange should go further and specifically require
the committee to present a formal evaluation of its own activities and members' level of involvement to the board.

D. Fees

The proposed limitation on fees for audit committee members is good. Yet, perhaps the Exchange should also consider further limiting the independent auditors' fees received for the provisions of non-audit services.

E. Rotation

Although the Exchange does not formally require rotation, listed companies will have to adhere to state corporate law and SEC rules in this area. Further, the Exchange should consider requiring mandatory rotation of independent audit firms as an alternative to the SEC required rotation of lead and concurring audit partners. The Exchange should also consider addressing the issue of the rotation of audit committee members, which has thus far been overlooked.

F. Other Issues the NYSE Should Investigate

Despite the many beneficial changes included in the proposed listing requirements, there remain areas of concern, which the exchange has failed to reach. To properly attain its goal of fostering investor confidence in financial markets and providing clean and accurate financial reports, the Exchange will need to consider: (1) the impact and incentives from non-audit services on auditor and audit committee independence, and in conjunction with auditor rotation and fees; (2) the potential chilling effect of both stricter membership requirements and more specific responsibilities, due to potential audit committee members' fear of increased personal liability; (3) heightened disclosure requirements for economic ties (i.e. including between members of an audit committee), and for the classification of non-ordinary business transactions the audit committee should be investigating; (4) rules for heightened awareness of the importance of early detection of fraud; (5) training and continuing education for audit committee members; and (5) whether there should be more uniformity in the rules of the various SROs.