

## VI. Conclusion

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

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

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>43</sup>

**Jonathan G. Katz,**  
Secretary.

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-42233; File No. SR-NYSE-99-39]

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

December 14, 1999.

## I. Introduction

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

The **Federal Register** published the proposed rule change for comment on October 13, 1999.<sup>3</sup> In response, the Commission received 25 comment letters.<sup>4</sup> On October 15, 1999 and December 8, 1999, the Exchange submitted Amendments No. 1<sup>5</sup> and No.

2,<sup>6</sup> respectively, to the proposed rule change. This order approves the proposed rule change and grants accelerated approval to Amendments No. 1 and No. 2. The Commission is also soliciting comment on Amendments No. 1. and No. 2 to the proposed rule change.

## II. Description of the Proposed Rule Change

### A. Background

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

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

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

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

<sup>7</sup> *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (1999)*. A copy of this Report can be found on-line at [www.nasdaqnews.com](http://www.nasdaqnews.com).

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

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

NYSE Listed Company Manual

\* \* \* \* \*

### Section 3

#### Corporate Responsibility

#### 303.00 Corporate Governance Standards

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

#### 303.01 Audit Committee

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

(B) *Requirements for a Qualified Audit Committee*.

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

(a) The scope of the audit committee's responsibilities and how it carries out those responsibilities, including structure, processes and membership requirements;

(b) That the outside auditor for the company is ultimately accountable to the Board of Directors and audit committee of the company, that the

<sup>42</sup> 15. U.S.C. 78s(b)(2).

<sup>43</sup> 17. CFR 200.30-3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

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

<sup>4</sup> The comment letters are discussed in Section III of this order.

<sup>5</sup> Letter from James E. Buck, Senior Vice President and Secretary, NYSE, to Richard Strasser, Assistant

audit committee and Board of Directors have the ultimate authority and responsibility to select, evaluate and, where appropriate, replace the outside auditor (or to nominate the outside auditor to be proposed for shareholder approval in any proxy statement); and

(c) That the audit committee is responsible for ensuring that the outside auditor submits on a periodic basis to the audit committee a formal written statement delineating all relationships between the auditor and the company and that the audit committee is responsible for actively engaging in a dialogue with the outside auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the outside auditor and for recommending that the Board of Directors take appropriate action [to ensure the independence of the outside auditor] *in response to the outside auditors' report to satisfy itself of the outside auditors' independence.*

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

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

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

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

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

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

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

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

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

(d) Immediate Family. A director who is an Immediate Family member of an individual who is an executive officer of the company or any of its affiliates cannot serve on the audit committee until three years following the termination of such employment relationship. See para. 303.02 for definition of "Immediate Family."

303.02 Application Standards

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

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

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

(1) Any determination that the company's Board of Directors has made regarding the independence of directors pursuant to any of the subparagraphs above;

(2) The financial literacy of the audit committee members;

(3) The determination that at least one of the audit committee members has accounting or related financial management expertise; and

(4) The annual review and reassessment of the adequacy of the audit committee charter.

(D) Independence Requirement of Audit Committee Members.

Notwithstanding the requirements of subparagraphs (3)(1) and (3)(d) of para. 303.01, one director who is no longer an employee or who is an Immediate Family member of a former executive officer of the company or its affiliates, but is not considered independent pursuant to these provisions due to the three-year restriction period, may be appointed, under exceptional and limited circumstances, to the audit committee if the company's board of directors determines in its business judgment that membership on the committee by the individual is required by the best interests of the corporation and its shareholders, and the company discloses, in the next annual proxy statement subsequent to such determination, the nature of the relationship and the reasons for that determination.

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

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

B. Charter

The Exchange proposes to require audit committees to adopt a formal written charter that is approved by the company's board and to review and reassess annually the adequacy of the charter. The charter must specify: (i)

The scope of the audit committee's responsibilities and how they are being carried out; (ii) the ultimate accountability of the outside auditor to the board and audit committee; (iii) the responsibility of the audit committee and board for selection, evaluation and replacement of the outside auditor; and (iv) The responsibility of the audit committee for ensuring the independence of the outside auditor by reviewing, and discussing with the board if necessary, any relationships between the auditor and the company or any other relationships that may adversely affect the independence of the auditor.

### C. Structure and Membership of the Audit Committee

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

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

### D. Independence

The proposed rule change places four restrictions on audit committee members for purposes of determining each member's independence. First,

Employees (including non-employee executive officers) of the company or its affiliates may not serve on the audit committee until three years following the termination of employment. However, if the relationship is with a former parent or predecessor of the company (see definition of "Affiliate" described in Subsection F below), the three-year bar applies to the time period following the severance of the relationship between the company and the former parent or predecessor.

Second, a director: (i) who is a partner, controlling shareholder, or executive officer of an organization that has a business relationship with the company, or (ii) who has a direct business relationship with the company (e.g., a consultant), may serve on the audit committee only if the company's board determines in its business judgment that the relationship does not interfere with the director's exercise of independent judgment. Business relationships can include commercial, industrial, banking, consulting, legal, accounting and other relationships. A director can have this relationship directly with the company, or the director can be a partner, officer or employee of an organization that has the business relationship.

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

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

### E. Written Affirmation

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

- (i) Any determination that the company's board has made regarding the independence of directors;
- (ii) The financial literacy of the audit committee members;
- (iii) The determination that at least one of the audit committee members has

accounting or related financial management expertise; and

- (iv) The annual review and reassessment of the adequacy of the audit committee charter.

### F. Definitions

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

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

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

### G. Implementation

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

### III. Comments

As of December 9, 1999, the Commission received 25 comment letters on the proposed rule change.<sup>9</sup> In

<sup>8</sup> See Amendment No. 1, *supra* n. 5.

<sup>9</sup> See letters from: Ernst & Young LLP ("E&Y") dated November 1, 1999; Deloitte & Touche LLP ("Deloitte") dated November 3, 1999; Council of Institutional Investors ("CII") dated November 8, 1999; Brian T. Borders (on behalf of the National Venture Capital Association ("NVCA")) dated November 12, 1999; Investment Company Institute ("ICI") dated November 3, 1999; PriceWaterhouseCoopers LLP ("PWC") dated November 1, 1999; Gary P. Kreider ("Kreider") dated November 5, 1999; Emerson Electric Co. ("Emerson") dated November 1, 1999; Exxon Corporation ("Exxon") dated November 3, 1999; McDonald's Corporation (McDonald's) dated November 1, 1999; Connectiv ("Connectiv") dated November 2, 1999; Texas Instruments ("TI") dated November 2, 1999; Dime Bancorp, Inc. ("Dime") dated November 3, 1999; Airlease Management Services, Inc. ("Airlease") dated November 3, 1999; The Dun & Bradstreet Corporation ("D&B") dated November 3, 1999; EMC Corporation ("EMC") dated November 1, 1999; Dorsey & Whitney LLP ("Dorsey") (on behalf of nine closed-end investment management companies whose stock is listed on the Exchange) dated October 28, 1999; Massachusetts

general, most commenters favored the proposed rule change but recommended certain modifications. Three commenters opposed the proposed rule change.<sup>10</sup>

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

Many of the commenters pointed to differences between the proposed rule change, on the one hand, and the Amex Proposal and Nasdaq Proposal, on the other. Specifically, several commenters stated that the Exchange should adopt the Amex's and Nasdaq's definitions of financial literacy and expertise.<sup>14</sup> These commenters noted that allowing individual companies to define these

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

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

APTC stated that the proposed rule change will be counter productive to the goal of better audit committees.<sup>23</sup> In addition, APTC stated that the proposed rule change will disadvantage smaller companies more than larger companies, but concluded that it is appropriate to apply the proposed rule change to all companies, regardless of size.<sup>24</sup> Moreover, APTC is opposed to the

proposal's financial literacy requirement.<sup>25</sup> APTC believes that the financial literacy requirement may deprive audit committees of the service of individuals with "exceptional character and/or operational experience."<sup>26</sup> The commenter suggested that the Exchange replace this requirement with a requirement that the committee as a whole possess a certain level of financial acumen.<sup>27</sup>

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

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

Deloitte and PWC each stated that requiring a company's board or audit committee to "ensure" the

Financial Services Company ("MFSC") (on behalf of six closed-end funds advised by MFSC) dated November 22, 1999; Meritor Automotive, Inc. ("Meritor") dated November 24, 1999; American Federation of Labor and Congress of Industrial Organizations ("AFL-CIO") dated November 29, 1999; Mayer, Brown & Platt on behalf of Morgan Stanley Dean Witter ("MSDW") dated November 29, 1999; Arthur Andersen LLP ("Arthur Andersen") dated December 3, 1999; Association of Publicly Traded Companies ("APTC") dated December 6, 1999; Robert A. Profusek ("Profusek") dated December 3, 1999; Stanley Keller and Richard Rowe ("Keller and Rowe") dated December 7, 1999; and The Committee on Securities Regulation of the Business Law Section of the New York State Bar Association ("NYSBA") dated December 1, 1999.

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

<sup>11</sup> CII Letter at 2; see also AFL-CIO Letter at 2.

<sup>12</sup> AFL-CIO Letter at 2.

<sup>13</sup> MFSC Letter at 1.

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

<sup>15</sup> Dime Letter at 2; NVCA Letter at 2; D&B Letter at 2; MFSC at 2.

<sup>16</sup> Keller and Rowe Letter at 2.

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

<sup>18</sup> Profusek Letter at 2.

<sup>19</sup> Keller and Rowe Letter at 2.

<sup>20</sup> *Id.* at 3.

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*; see also NYSBA Letter at 6.

<sup>23</sup> APTC Letter at 2.

<sup>24</sup> *Id.* at 3.

<sup>25</sup> *Id.* at 4-5.

<sup>26</sup> *Id.*

<sup>27</sup> *Id.* at 5.

<sup>28</sup> TI Letter at 1.

<sup>29</sup> Exxon Letter at 1; NYSBA Letter at 2.

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

<sup>31</sup> Exxon Letter at 1.

<sup>32</sup> *Id.*

<sup>33</sup> McDonald's Letter at 2.

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

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

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

<sup>34</sup> Deloitte Letter at 1; PWC Letter at 1; Meritor Letter at 2.

<sup>35</sup> *Id.* at 2.

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

<sup>37</sup> Airlease Letter at 1.

<sup>38</sup> NVCA Letter at 5.

<sup>39</sup> *Id.* at 4.

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

<sup>41</sup> ICI Letter at 3-4; MSDW Letter at 2.

<sup>42</sup> ICI Letter at 3; MSDW Letter at 1. ICI and MSDW also noted that the independent accountants

#### IV. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange,<sup>43</sup> and, in particular, the requirements of section 6(b)(5) of the Act.<sup>44</sup> The Commission believes that the proposed rule change will protect investors by improving the effectiveness of audit committees of companies listed on the Exchange. The Commission also believes that the new requirements will enhance the reliability and credibility of financial statement of companies listed on the Exchange by making it more difficult for companies to inappropriately distort their true financial performance.

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

of investment funds are selected by the independent directors of the fund.

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

<sup>44</sup> 15 U.S.C. 78f(b)(5).

<sup>45</sup> See Keller and Rowe Letter at 2.

<sup>46</sup> The Commission does not believe that the Exchange should require its listed companies to

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

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

The Commission believes that the proposed rule change's requirement that each issuer have an audit committee composed of three independent directors who are able to read and understand fundamental financial statements will enhance the effectiveness of the audit committee and help to ensure that audit committee members are able to adequately fulfill their responsibilities. The Commission believes that requiring each audit committee member to satisfy this standard will help to ensure that the committee as a whole is financially literate.<sup>47</sup> Moreover, the Commission believes that requiring one member of the audit committee to have past employment experience in financial or accounting, requisite professional certification in accounting, or any other comparable experience or background that indicates the individual's financial sophistication, will further enhance the effectiveness of the audit committee in carrying out its financial oversight responsibilities. The Commission does

adopt a separate provision on consultants. See Keller and Rowe Letter at 3.

<sup>47</sup> See APTC Letter at 5.

not believe that these requirements will discourage qualified candidates from serving on audit committees. Rather, the Commission believes that these requirements will better enable companies to identify and select qualified directors. In addition, the Commission does not believe that companies will experience undue difficulty recruiting an audit committee member that satisfies the financial expertise requirements.

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

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

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

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

The Commission finds good cause for approving Amendments No. 1 and No. 2 to the proposed rule change prior to the thirtieth day after publication in the **Federal Register**. The Commission notes that Amendment No. 1 revises the implementation time periods for the proposed rule change solely to provide greater clarity to issuers and to

investors. The Commission believes that Amendment No. 1 will enable issuers to determine when they must comply with the new requirements and will enable investors to determine when to reply on the protections afforded by the proposed rule change. The Commission notes that Amendment No. 2 simply codifies the Exchange's existing policy on the timing of audit committee requirements for IPO's; clarifies that the company's board must take appropriate action to satisfy itself of the outside auditor's independence, and is not intended to provide an absolute guarantee of independence; and requires the board to adopt the audit committee charter, rather than approving the charter adopted by the audit committee. The Commission believes that accelerated approval will allow the Exchange to simultaneously make all relevant modifications to its *Listed Company Manual* and will avoid potential confusion. Accordingly, the Commission finds good cause to accelerate approval of Amendments No. 1 and No. 2 to the proposed rule change, consistent with the Sections 6(b)(5)<sup>52</sup> and 19(b)<sup>53</sup> of the Act.

#### V. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the Exchange. All submissions should refer to the File No. SR-NYSE-99-39 and should be submitted by January 11, 2000.

#### VI. Conclusion

For the foregoing reasons, the Commission finds that the Exchange's proposal to amend its audit committee

requirements is consistent with the requirements of the Act and the rules and regulations thereunder.

*It Is Therefore Ordered*, pursuant to Section 19(b)(2) of the Act,<sup>54</sup> that the amended proposed rule change (SR-NYSE-99-39) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>55</sup>

**Margaret H. McFarland,**  
*Deputy Secretary.*

[FR Doc. 99-33052 Filed 12-20-99; 8:45 am]

**BILLING CODE 8010-01-M**

## DEPARTMENT OF STATE

### [Public Notice 3180]

#### Culturally Significant Objects Imported for Exhibition Determinations: "Walker Evans"

**DEPARTMENT:** United States Department of State.

**ACTION:** Notice.

**SUMMARY:** Notice is hereby given of the following determinations: Pursuant to the authority vested in me by the Act of October 19, 1965 (79 Stat. 985, 22 U.S.C. 2459), the Foreign Affairs Reform and Restructuring Act of 1998 (112 Stat. 2681, *et seq.*), Delegation of Authority No. 234 of October 1, 1999, and Delegation of Authority No. 236 of October 19, 1999, as amended, I hereby determine that the objects to be included in the exhibition "Walker Evans," imported from abroad for temporary exhibition without profit within the United States, are of cultural significance. These objects are imported pursuant to loan agreements with the foreign lender. I also determine that the exhibition or display of the exhibit objects at The Metropolitan Museum of Art, New York, New York, from on or about January 31, 2000, to on or about May 14, 2000; the San Francisco Museum of Modern Art, San Francisco, California, from on or about June 2, 2000, to on or about September 12, 2000, and at the Museum of Fine Arts, Houston, Texas, from on or about December 17, 2000, to on or about March 11, 2001, is in the national interest.

**FOR FURTHER INFORMATION CONTACT:** For further information, including a list of exhibit objects, contact Lorie J. Nierenberg, Attorney-Adviser, Office of the Legal Adviser, U.S. Department of State (telephone: 202/619-6084). The address is U.S. Department of State, SA-

<sup>48</sup> See NVCA and Airlease Letters.

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

<sup>50</sup> See Keller and Rowe Letter at 5; ICI Letter at 3; MSDW Letter at 1.

<sup>51</sup> Kreider Letter at 2.

<sup>52</sup> 15 U.S.C. 78f(b)(5).

<sup>53</sup> 15 U.S.C. 78s(b).

<sup>54</sup> 15 U.S.C. 78s(b)(2).

<sup>55</sup> 17 CFR 200.30-3(a)(12).