of this AD, within 2,500 landings on the NLG since accomplishment of the inspection performed in accordance with paragraph (c)(2)(iii) of this AD, replace the upper lock link with a new upper lock link, P/N 3914464–507; a reidentified upper lock link, P/N 3914464; or a new upper lock link assembly, P/N 5965065–507; all made from aluminum forging material; in accordance with McDonnell Douglas Service Bulletin DC9–32–315 [for Model DC–9, DC–9–80, and C–9 (military) series airplanes; and Model MD–88 airplanes], or McDonnell Douglas Service Bulletin MD90–32–033 (for Model MD–90 airplanes), both dated March 11, 1999; as applicable. Accomplishment of the replacement action constitutes terminating action for the requirements of this AD.

(B) If any crack is detected during the inspections required by paragraph (c)(2)(iii) of this AD, prior to further flight, replace the discrepant NLG upper lock link with a new upper lock link, P/N 3914464–507; a reidentified upper lock link, P/N 3914464; or a new upper lock link assembly, P/N 5965065–507; all made from aluminum forging material; in accordance with the applicable service bulletin. Accomplishment of the replacement action constitutes terminating action for the requirements of this AD.

Alternative Methods of Compliance

(d)(1) An alternative method of compliance or adjustment of the compliance time that provides an acceptable level of safety may be used if approved by the Manager, Los Angeles Aircraft Certification Office (ACO), FAA, Transport Airplane Directorate. Operators shall submit their requests through an appropriate FAA Principal Maintenance Inspector, who may add comments and then send it to the Manager, Los Angeles ACO.

(d)(2) Alternative methods of compliance, approved previously in accordance with AD 97–02–10, amendment 39–9895, are approved as alternative methods of compliance with paragraph (d)(1) of this AD.

Note 4: Information concerning the existence of approved alternative methods of compliance with this AD, if any, may be obtained from the Los Angeles ACO.

Special Flight Permits

(e) Special flight permits may be issued in accordance with sections 21.197 and 21.199 of the Federal Aviation Regulations (14 CFR 21.197 and 21.199) to operate the airplane to a location where the requirements of this AD can be accomplished.

Issued in Renton, Washington, on October 7, 1999.

D. L. Riggin,

Acting Manager, Transport Airplane Directorate, Aircraft Certification Service.

[FR Doc. 99–26872 Filed 10–13–99; 8:45 am]

BILLING CODE 4910–13–U

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 210, 228, 229, and 240

[Release No. 34–41987; File No. S7–22–99]

RIN 3235–AH83

Audit Committee Disclosure

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission is proposing new rules and amendments to its current rules to improve disclosure related to the functioning of corporate audit committees and to enhance the reliability and credibility of financial statements of public companies.

DATES: Public comments are due on or before November 29, 1999.

ADDRESSES: Please send three copies of your comment letter to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609. Comment letters can be sent electronically to the following e-mail address: rule-comments@sec.gov. Your comment letter should refer to File No. S7–22–99; if e-mail is used, please include the file number in the subject line. Anyone can inspect and copy the comment letters in the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549. Electronically submitted comment letters will be posted on the Commission's internet web site (http://www.sec.gov).

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

SUPPLEMENTARY INFORMATION: The Commission is proposing amendments to Rule 10–01 of Regulation S–X,[1] Rule 310 of Regulation S–B,[2] and Item 7 of Schedule 14A[3] under the Securities Exchange Act of 1934 (the ''Exchange Act'').[4] Additionally, the Commission is proposing new Item 306 of Regulation S–K[5] and Item 306 of Regulation S–B.[6]

[1] 17 CFR 210.10–01.

[2] 17 CFR 228.310.

[3] 17 CFR 240.14a–101.

[4] 15 U.S.C. 78a *et seq.*

[5] 17 CFR 229.306.

[6] 17 CFR 228.306.

I. Executive Summary

We are proposing new rules and amendments to current rules to improve disclosure relating to the functioning of corporate audit committees and to enhance the reliability and credibility of financial statements of public companies. The proposals are based in large measure on recommendations recently made by the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (the ''Blue Ribbon Committee'').[7]

The Blue Ribbon Committee's work was designed to promote quality financial reporting. Underpinning the Blue Ribbon Committee's work ''is the recognition that quality financial accounting and reporting can only result from effective interrelationships among'' corporate boards, audit committees, senior and financial management, the internal auditor and the outside auditors.[8] Among these corporate participants, the Blue Ribbon Committee's focus was on improving the effectiveness of corporate audit committees. As the Blue Ribbon Committee said, the audit committee is ''first among equals'' in the financial reporting process[9] because it is an extension of the full board, which is the ultimate monitor of the process.

Audit committees play a critical role in the financial reporting system by overseeing and monitoring management's and the independent auditors' participation in the financial reporting process. An audit committee can facilitate communications between a company's board of directors, its management, and its internal and independent auditors. A properly functioning audit committee helps to enhance the reliability and credibility of financial disclosures.

We have seen a number of significant changes in our markets, such as technological developments and increasing pressure on companies to meet earnings expectations,[10] that make it ever more important for the financial reporting process to remain disciplined

[7] *See* Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (1999) (the ''Blue Ribbon Report''). The Blue Ribbon Report is available on the internet at http://www.nasd.com and http://www.nyse.com.

[8] Letter from the Chairmen of the Blue Ribbon Committee to Messrs. Grasso and Zarb, Blue Ribbon Report, at 3.

[9] Blue Ribbon Report, *supra* note 7, at 7.

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

and credible.[11] We believe that additional disclosures about a company's audit committee and its interaction with the company's auditors and management will promote investor confidence in the integrity of the financial reporting process. In addition, increasing the level of scrutiny by independent auditors of companies' quarterly financial statements should lead to fewer year-end adjustments, and, therefore, more reliable financial information about companies throughout the reporting year.

Accordingly, today's proposals would:

- require that companies' independent auditors review the financial information included in the companies' Quarterly Reports on Form 10–Q or 10–QSB prior to the companies filing such forms with the Commission (see Section III.A below);
- require that companies include reports of their audit committees in their proxy statements; in the report, the audit committee must state whether the audit committee has: (i) Reviewed and discussed the audited financial statements with management; (ii) discussed with the independent auditors the matters required to be discussed by Statement on Auditing Standards No. 61,[12] as may be modified or supplemented; [13] and (iii) received certain disclosures from the auditors regarding the auditors' independence as required by the Independence Standards Board Standard No. 1, as may be modified or supplemented,[14] and discussed with the auditors the auditors' independence (see Section III.B below);
- require that the report of the audit committee also include a statement by the audit committee whether, based on such review and discussions, anything has come to the attention of the members of the audit committee that caused the audit committee to believe that the audited financial statements included in the company's Annual Report on Form 10–K or 10–KSB, as applicable, for the year then ended contain an untrue statement of material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading (see Section III.B below);
- require that companies disclose in their proxy statements whether their audit committee has adopted a written charter and, if the audit committee has adopted a charter, to include a copy of the charter as an appendix to the company's proxy or information statement at least once every three years (see Section III.C below);
- require that companies whose securities are quoted on Nasdaq or listed on the American Stock Exchange (''AMEX'') or New York Stock Exchange (''NYSE'') disclose in their proxy statements certain information regarding any director on the audit committee who is not ''independent,'' as defined in the applicable listing standard; small business issuers would not be required to comply with this requirement (see Section III.D below); [15]
- require that all other companies, including small business issuers, disclose in their proxy statements whether, if they have an audit committee, the members are ''independent'' within the definition of the National Association of Securities Dealer's (''NASD''), AMEX's or NYSE's proposed amendments to their listing standards [16] and which definition of independence was used (see Section III.D below); and
- create ''safe harbors'' for the information required to be disclosed under the proposals to protect companies and their directors from certain liabilities under the federal securities laws (see Section III.E below).

II. Background

Accurate and reliable financial reporting lies at the heart of our disclosure-based system for securities regulation, and is critical to the integrity of the U.S. securities markets. Investors need accurate and reliable financial information to make informed investment decisions. As an increasing number of investors enter our markets, it is important for us to continue our efforts to promote the highest quality financial reporting. Investor confidence in the reliability of corporate financial information is fundamental to maintaining the liquidity and vibrancy of our markets.

Over the past few years, we have seen dramatic changes in the way investors receive information and the speed with which information can be and is disseminated to the market. Market demand for information appears to be at an all time high as technology makes information available to more people more quickly. These developments have presented companies with an increasingly complex set of challenges. One such challenge is that companies are under increasing pressure to meet earnings expectations.[17]

Unfortunately, we have begun to see cases in which companies have engaged in inappropriate ''earnings management,'' [18] the practice of distorting the true financial performance of the company. Distortions may result from inappropriate earnings management and may undermine the integrity of financial reporting. As Chairman Levitt has stated, when inappropriate earnings management occurs, ''[i]ntegrity may be losing out to illusion.'' [19]

As a result of the changes in our markets and the increasing demands on companies, our continuing efforts to maintain the integrity of financial reporting have gained a sense of urgency. Market changes have highlighted the importance of strong and effective audit committees. Effective oversight of the financial reporting process is fundamental to preserving the integrity of our markets. Audit committees can, and should, be the corporate participant best able to perform that oversight function.

Audit committees oversee and monitor management and the independent auditors in the financial reporting process, and thereby play a critical role in assuring the credibility of financial reporting. Audit committees can facilitate communications between a company's board of directors, its management, and its internal and independent auditors on significant accounting issues and policies. They can provide a forum separate from management in which auditors can candidly discuss any concerns. By effectively carrying out their many functions and responsibilities, audit committees help to enhance the reliability and credibility of financial reports.

Since the early 1940s,[20] the Commission, along with the auditing

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

[12] *See* Codification of Statements on Auditing Standards, AU § 380 (''SAS 61'').

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

[14] Independence Standards Board Standard No. 1, *Independence Discussions with Audit Committees* (''ISB Standard No. 1''). A copy of ISB Standard No. 1 can be obtained at www.cpaindependence.org.

[15] ''Small business issuer'' is defined in Item 10(a)(1) of Regulation S–B, 17 CFR 228.10(a)(1), as a company with less than $25 million in revenues and market capitalization.

[16] The listing standards of the NASD, AMEX and NYSE are available on their websites at: http://www.nasd.com, http://www.amex.com, and http://www.nyse.com, respectively. *See infra* note 27 regarding proposed changes to their listing standards.

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

[18] *See, e.g., In the Matter of Livent, Inc.,* Exchange Act Release No. 40937 (Jan. 13, 1999) [68 SEC Docket 2881]; *see also SEC* v. *W.R. Grace & Co.,* Litigation Release No. 16008 (Dec. 22, 1998) [68 SEC Docket 2580].

[19] Arthur Levitt, Chairman, SEC, Address to the NYU Center for Law and Business (Sept. 28, 1998).

[20] In 1940, the Commission investigated the auditing practices of McKesson & Robbins, Inc., and the Commission's ensuing report prompted action on auditing procedures by the auditing community. *In the Matter of McKesson & Robbins,* Accounting

Continued

and corporate communities, has had a continuing interest in promoting effective and independent audit committees. It was, in large measure, with the Commission's encouragement, for instance, that the self-regulatory organizations first adopted audit committee requirements in the 1970s. In 1974 and 1978, the Commission adopted rules requiring certain disclosures about audit committees.[21] In 1980, the Commission issued a staff report on corporate accountability that addresses some of the issues underlying today's proposals.[22] Former SEC Commissioner James Treadway led the National Commission on Fraudulent Financial Reporting that issued recommendations on corporate audit committees in 1987.[23]

Most recently, the NYSE and NASD sponsored the Blue Ribbon Committee in response to ''an increasing sense of urgency surrounding the need for responsible financial reporting given the market's increasing focus on corporate earnings and a long and powerful bull market.'' [24] Representatives from corporations, the accounting profession, and the self-regulatory organizations, among others, were members of the Blue Ribbon Committee. In February 1999, the Blue Ribbon Committee issued ten recommendations. Several of the recommendations call for action by the Commission, and the proposals in this release are based in large measure on those recommendations.

The proposals in this release affirm what have long been considered sound practice and good policy within the accounting and corporate communities.[25] While recognizing that the audit committee's role is ''clearly one of oversight and monitoring,'' the Blue Ribbon Committee explains its recommendations as helping to ensure that:

> [a] proper and well-functioning system exists * * * [whereby] the three main groups responsible for financial reporting—the full board including the audit committee, financial management including the internal auditors, and the outside auditors—form a ''three-legged stool'' that supports responsible financial disclosure and active and participatory oversight.[26]

We recognize that how audit committees function may vary from company to company, and companies need flexibility to determine all of the specific duties and functions of their audit committees. In that regard, our proposals do not tell audit committees what specific duties they must carry out or how to function. In addition, we are not regulating the substance of the discussions between the audit committee and management or the independent auditors, and, in fact, we are not requiring disclosure of the substance of the discussions.

We recognize that many in the corporate community are concerned that increased disclosure about audit committees may expose audit committee members to additional liability, may make it more difficult for companies to find good people willing to serve on audit committees, and may impose added costs on companies. To address those concerns, some of our proposals differ from the Blue Ribbon Committee's recommendations. The differences are noted below in the specific discussions of each proposal. In addition, proposed safe harbors that address the liability concerns are discussed below in Section III.E.

The Blue Ribbon Committee also made recommendations that call for action by the NASD, the NYSE, or the AICPA. In response, the NASD and NYSE filed with the Commission proposed rule changes to their listing standards.[27] The significant amendments proposed by the NASD, NYSE, and AMEX are:

- a more demanding definition of ''independence'' for audit committee members;
- a requirement that audit committees include at least three members, comprised solely of ''independent'' directors who are financially literate,[28] with limited exceptions (under the NASD's and AMEX's proposed amendments to their listing standards, small business issuers must establish and maintain an audit committee composed of at least two members; a majority of the members must be independent directors);
- a requirement that at least one member of the audit committee has accounting or related financial management expertise; and
- a requirement that companies adopt a written audit committee charter that outlines certain specified responsibilities of the audit committee.

Other recommendations are directed at the AICPA. The Blue Ribbon Committee recommends that generally accepted auditing standards be amended to require that a company's independent auditors discuss with the audit committee the auditors' judgments about the quality, and not just the acceptability under generally accepted accounting principles (''GAAP''), of the company's accounting principles as applied in the company's financial statements. Similarly, the Blue Ribbon Committee recommends that Statement on Auditing Standards (''SAS'') No. 71[29] be modified to require that the independent auditors discuss with the audit committee, or at least its chairman, and a representative of financial management, the matters

Series Release (''ASR'') No. 19, Exchange Act Release No. 2707 (Dec. 5, 1940).

[21] ASR No. 165 (Dec. 20, 1974) [40 FR 1010] (requiring disclosure of the existence and composition of the audit committee); Exchange Act Release No. 15384 (Dec. 6, 1978) [43 FR 58522] (requiring disclosure of the functions performed and number of meetings held by the audit committee).

[22] *See* Staff of the SEC, Division of Corporation Finance, Report on Corporate Accountability, A Re-examination of Rules Relating to Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, 486–510 (Sept. 4, 1980).

[23] *See* Report of the National Commission on Fraudulent Financial Reporting (Oct. 1987) (the ''Treadway Report'').

[24] Blue Ribbon Report, *supra* note 7, at 17.

[25] *See* Advisory Panel on Auditor Independence (''Kirk Panel''), *Strengthening the Professionalism of the Independent Auditor,* Report by the Oversight Board of the SEC Practice Section, American Institute of Certified Public Accountants (''AICPA'') (Sept. 13, 1994) (the ''Kirk Panel Report''); *see also* the Treadway Report, *supra* note 23.

[26] Blue Ribbon Report, *supra* note 7, at 7. As noted, the Blue Ribbon Committee indicated that the audit committee, management, and the independent auditors form a ''three-legged stool'' that supports responsible financial disclosure and active and participatory oversight. If we adopt the proposed requirement for an audit committee report, shareholders annually will receive reports from two of the groups—the audit committee and the independent auditors—that describe their roles in the financial reporting process. Some have recommended that the SEC require a report signed by the chief executive officer or others that acknowledges management's responsibilities for the financial statements and internal controls. *See* Treadway Report, *supra* note 23, at 44. To date, the Commission has encouraged the use of management reports, but not required them. The Commission staff is considering whether requiring management reports, so that investors will have a report from each of the three main groups responsible for financial reporting, would be useful to investors and serve the public interest. If we decide to pursue mandatory management reports, a separate proposing release will be published for public comment.

[27] *See* Proposed Rule Change, NASD, File No. SR–NASD–99–48; Proposed Rule Change, NYSE, File No. SR–NYSE–99–39. While the Blue Ribbon Committee's recommendations were directed to the NYSE and the NASD, the AMEX has filed proposed rule changes to its listing standards in accordance with the recommendations. *See* Proposed Rule Change, AMEX, File No. SR–AMEX–99–38. The AMEX's proposed changes parallel the changes proposed by the NASD. It is possible that in the future other exchanges will propose to amend their listing standards in accordance with the Blue Ribbon Committee's recommendations. At such time, the Commission will evaluate whether the proposals in this release, if adopted, should be modified with respect to new listing standards.

[28] Under proposed amendments to Section 303.01(B)(2)(b) of the NYSE's listing standards, the board of directors would determine what ''financially literate'' means. Under proposed amendments to Rule 4310(c)(26)(B)(i) of the NASD's listing standards and Section 121B(b)(i) of the AMEX's listing standards, the audit committee members must be able to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement.

[29] *See* Codification of Statements on Auditing Standards, AU § 722 (''SAS 71''). SAS 71 provides guidance to independent accountants on performing reviews of interim financial information.

described in SAS 61[30] prior to the company filing its Quarterly Report on Form 10–Q or 10–QSB (and preferably prior to any public announcement of financial results), including significant adjustments and accounting estimates, significant new accounting policies and disagreements with management.

III. The Proposals

A. Pre-Filing Review of Quarterly Financial Statements

Under current Commission rules, a company's interim financial statements contained in its Quarterly Reports on Form 10–Q or 10–QSB need not be reviewed or audited by independent auditors prior to the company filing such forms with the Commission.[31] We propose to amend Rule 10–01(d) of Regulation S–X and Item 310(b) of Regulation S–B to require that a company's interim financial statements be reviewed by an independent public accountant prior to the company filing its Form 10–Q or 10–QSB with the Commission. The amendments would require that independent auditors follow ''professional standards and procedures for conducting such reviews, as established by generally accepted auditing standards, as may be modified or supplemented by the Commission.'' Under current auditing standards, this means that the auditors would be required to follow the procedures set forth in SAS 71, or such other auditing standards that may in time modify, supplement, or replace SAS 71. Consistent with current rules, we are not proposing to require that interim financial statements be audited.[32]

Under current Commission rules, if a company discloses in its filings with the Commission that an independent auditor has performed a review of interim financial statements, it must file a copy of the auditor's report.[33] We are not proposing to modify that requirement.[34] Investors and other users of financial statements rely on, and react quickly to, quarterly results. Quarterly financial reporting, however, has never been subject to the same discipline that is applied to annual financial reporting. Interim financial results are not required to be audited or reviewed by an independent auditor. It is commonplace, however, for financial analysts to set quarterly earnings expectations for companies that they follow.[35] The consequence of a company failing to meet or exceed these expectations may, in some cases, result in a precipitous decline in its stock price. As a result, companies may be experiencing increasing pressure to ''manage'' interim financial results. Accordingly, inappropriate earnings management could be deterred by imposing more discipline on the process of preparing interim financial information before filing such information with the Commission.[36]

The reviews required by our proposal should facilitate early identification and resolution of material accounting and reporting issues because the auditors will be involved earlier in the year. This is particularly important because interim financial information generally may include more estimates than annual financial statements.[37] Early involvement of the auditors should reduce the likelihood of restatements or other year-end adjustments.

We understand that the five largest U.S. accounting firms and others have each recently adopted policies to require that their clients have reviews of quarterly financial statements as a condition to acceptance of the audit.[38] Consequently, those firms already have implemented our proposed requirement for the companies that are audited by those firms.

We request comment on the need for independent auditors to review interim financial statements before they are filed with the Commission. Will interim reviews result in more reliable and credible interim financial statements? Will the involvement of independent auditors at quarterly intervals result in fewer restatements of Forms 10–Q and 10–QSB as a result of a year-end audit? What other benefits will be achieved? What will be the additional cost to registrants if the Commission requires interim reviews? Will having the auditors perform quarterly reviews shift some of the work away from the year-end audit, and therefore, result in lower year-end audit fees? What other ways can we enhance the quality and reliability of interim reporting?

We request comment on whether any modifications to SAS 71 are needed. For example, is there some formulation that would provide flexibility yet ensure that interim reviews meet objective minimum standards? In light of the proposed changes, are any modifications to Item 302(a) of Regulation S–K needed? For example, should we amend Item 302(a) to require all public companies to provide supplemental financial information?[39]

We also request your comments on the scope of the proposed requirement. Should the requirement apply to all public companies or only certain size public companies? If only certain size companies, what size and why? Should the requirement apply not only to

[30] SAS 61 requires independent auditors to communicate certain matters related to the conduct of an audit to those who have responsibility for oversight of the financial reporting process, specifically the audit committee. Among the matters to be communicated to the audit committee are: (1) methods used to account for significant unusual transactions; (2) the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus; (3) the process used by management in formulating particularly sensitive accounting estimates and the basis for the auditor's conclusions regarding the reasonableness of those estimates; and (4) disagreements with management over the application of accounting principles, the basis for management's accounting estimates, and the disclosures in the financial statements.

[31] Rule 10–01(d) of Regulation S–X and Item 310(b) of Regulation S–B, 17 CFR 210.10–01(d) and 17 CFR 228.310(b). Under Item 302(a) of Regulation S–K, however, larger, more widely-when necessary, reconciles amounts previously reported in a Form 10–Q or Form 10–QSB. *See* 27 CFR 229.302(a).

[32] A review of interim financial information under SAS 71 generally is limited to inquiries and analytical procedures concerning significant accounting matters, and does not include search and verification procedures. The objective of a review of interim financial information differs significantly from the objective of an audit of financial statements in accordance with generally accepted auditing standards. The objective of a review of interim financial information is to provide the accountant with a basis for reporting whether material modifications should be made for such information to conform with GAAP. The objective of an audit is to provide a reasonable basis for expressing an opinion regarding the financial statements taken as a whole. A review may bring to the accountant's attention significant matters affecting the interim financial information, but it does not provide assurance that the accountant will become aware of all significant matters would be disclosed in an audit. *See SAS 71, para. 9 (''Objective of a Review of Interim Financial Information'').*

[33] Rule 10–01(d) of Regulation S–X, 17 CFR 210.10–01(d).

[34] A conforming change to Item 310 of Regulation S–B, 17 CFR 228.310, is being proposed to require the filing of the report if the small business issuer discloses in its filings with the Commission that an independent accountant has performed a review of interim financial statements

[35] The importance of analysts to the proper functioning of our capital markets is well-recognized. *See, e.g., Dirks v. SEC,* 43 U.S. 646, 656 (1983). We do not intend to cast doubt on the importance of that role or the appropriateness of quarterly earnings estimates

[36] In 1989, the Commission issued a concept release on whether it should propose amendments to its rules to require more involvement of the independent accountant in the preparation of interim financial information. *See* Exchange Act Release No. 26949 (June 20, 1989) [54 FR 27023]. The Treadway Commission recommended that the SEC require independent public accountants to review quarterly financial data before a company releases it to the public. Treadway Report, *supra* note 23, at 53.

[37] *See* Accounting Principles Board Opinion No. 28.

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

[39] Subjecting additional companies to the requirements of Item 302(a) would result in auditor review of their quarterly financial information, but the review would not necessarily have to occur on a timely basis.

interim financial statements contained in quarterly reports, but those contained in registration statements under the Securities Act of 1933 (''Securities Act'') and Exchange Act as well? Should we require that interim reviews be completed prior to quarterly ''earnings releases,'' when a company releases to the public financial results before the Form 10–Q or 10–QSB is filed?

The Commission recently proposed a requirement providing for the filing of quarterly financial results on Form 8–K if released prior to the deadline for filing the Quarterly Report on Form 10–Q or 10–QSB.[40] We also solicited comment on whether to shorten the filing deadline for Form 10–Q and 10–QSB. If we adopt those changes, how would that affect your overall view of these proposals?

Should we require that a report on the independent auditors' review be filed?[41] If so, what liability should attach to the report?[42] Should the report clearly set forth the scope of the review procedures and degree of reliance that can be placed on the report? Would the inclusion of a report benefit investors?

We request your comments on whether we should require companies to disclose whether the quarterly financial statements have been reviewed by independent auditors. The Blue Ribbon Committee recommends that SAS 71 be amended to require that audit committees discuss with the auditors the matters covered in SAS 61, including significant adjustments, management judgments and accounting estimates, significant new accounting policies and disagreements with management, prior to the filing of the Form 10–Q.[43] If SAS 71 is not amended as recommended by the Blue Ribbon Committee, should the Commission consider any other changes to its rules, such as to require disclosure about particular discussions between the audit committee and the auditors prior the company filing its Form 10–Q or 10–QSB? Should we continue to permit companies to decide whether to disclose that the independent auditors have performed the review but eliminate the requirement to file the review report if such disclosure is made?

B. The Audit Committee Report

Proposed new Item 306 of Regulations S–K and S–B and Item 7(e)(3) of Schedule 14A would require that the audit committee provide a report in the company's proxy statement (or information statement) disclosing whether the audit committee has reviewed and discussed the audited financial statements with management and discussed certain matters with the independent auditors.[44] Specifically, under paragraphs (a)(1), (a)(2), and (a)(3) of proposed Item 306 (paragraph (a)(4) is discussed separately, below), audit committees would be required to state whether:

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

(2) The audit committee has discussed with the independent auditors the matters required to be discussed by SAS 61, as may be modified or supplemented;[45] and

(3) The audit committee has received the written disclosures and the letter from the independent auditors required by ISB Standard No. 1, as may be modified or supplemented, and has discussed with the auditors the auditors' independence.

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

Proposed paragraphs (a)(1), (2), and (3) of Item 306 would require audit committees to disclose whether the review and discussions took place and whether the letter and disclosures were received. The proposals would not require audit committees to perform the review and have the discussions. The proposed amendments would not require audit committees to take specific actions or adopt specific procedures. We are not proposing to require disclosure of the details of deliberations between or among the audit committee members, independent auditors, and management.[46]

The required disclosure will help inform shareholders of the audit committee's oversight with respect to financial reporting, and underscore the importance of the audit committee's participation in the financial reporting process. The proposed language of paragraphs (a)(1) and (a)(2) is similar to the language recommended by the Blue Ribbon Committee. Moreover, the language is consistent with the Blue Ribbon Committee's recommendation to the AICPA that it amend SAS 61.[47]

The disclosure required by paragraph (a)(3) relates to written disclosures, a letter from the independent auditors, and discussions between the audit committee and the independent auditors required by ISB Standard No. 1. The Commission has long recognized the importance of auditors being independent from their audit clients.[48] Public confidence in the reliability of a company's financial statements depends on investors perceiving the company's auditors as maintaining integrity and objectivity, being without conflicting interests with audit clients, and exercising independent judgment. Accordingly, we think that investors will benefit from the proposed disclosures.

Paragraph (a)(4) of the proposed rule would require the audit committee to state in the audit committee's report to be included in the company's proxy statement whether, based on the review and discussions described in paragraphs (a)(1) through (a)(3), anything came to the attention of the members of the audit committee that caused the audit committee to believe that the audited financial statements included in the company's Annual Report on Form 10–K or 10–KSB, as applicable, for the year then ended contain an untrue statement of material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading. We believe that this proposed amendment would reinforce the audit committee's awareness and acceptance of its responsibilities, and make visible for investors the audit committee's role in promoting reliable and transparent financial reporting.

The proposed language of paragraph (a)(4) differs from the Blue Ribbon Committee's recommendation.[49] Concerns have been expressed that the language in the Blue Ribbon Committee's recommendation is a

[40] *See* Exchange Act Release No. 40632A (Nov. 13, 1998) [63FR 67174] (the ''Securities Act Reform Release''), at Section XI.B, in which we solicited comment on whether to shorter the filing deadline for quarterly reports to within 30 days after the first three fiscal quarters.

[41] SAS 71 provides guidelines for the preparation of a report.

[42] *See, e.g.,* Rule 436 of Regulation C of the Securities Act, 17 CFR 230.436. Rule 436 provides that a report on unaudited interim financial information shall not be construed to be a part of a registration statement prepared or certified by an accountant within the meaning of Sections 7 and 11 of the Securities Act.

[43] Blue Ribbon Report, *supra* note 7, at 36.

[44] At least in some measure, these discussions are already prescribed by the auditing literature. *See* SAS 61.

[45] *See* ASB Exposure Draft, *supra* note 13.

[46] The proposals, of course, are not intended to either diminish or enhance a company's current disclosure obligations under the proxy rules.

[47] Blue Ribbon Report, *supra* note 7, at 33.

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

[49] The Blue Ribbon Committee's recommendation is for the audit committee to state that, in reliance on the review and discussions with management and the auditors, the audit committee ''believes that the company's financial statements are fairly presented in conformity with Generally Accepted Accounting Principles (GAAP) is all material respects.'' Blue Ribbon Report, *supra* note 19.

GAAP ''certification'' that implicitly would require that the audit committee know all of the nuances of GAAP. We have modified the Blue Ribbon Committee's language to address that concern. In performing its oversight function, the audit committee likely will be relying on advice and information that it receives in its discussions with management and the independent auditors. Accordingly, the proposed language acknowledges that the audit committee will be forming its belief based on the discussions with management and the auditors, but also focuses members of the audit committee on their role in the financial reporting process. The statement that ''nothing came to the attention of the audit committee members,'' when combined with the need for a sound internal reporting system, discussed below, is intended to encourage audit committees to ''ask tough questions of management and outside auditors'' [50] to serve the interests of investors.

This approach is consistent with state corporation law that permits board members to rely on the representations of management and the opinions of experts retained by the corporation.[51] The Blue Ribbon Committee noted the ''impracticability of having the audit committee do more than rely upon the information it receives, questions, and assesses in making this disclosure.'' [52]

Some have expressed concerns that requiring a report from the audit committee will result in increased exposure to liability for the audit committee members. We do not believe that improved disclosure about the audit committee and increased involvement by the audit committee should result in increased exposure to liability. Under state corporation law, the more informed the audit committee becomes through its discussions with management and the auditors, the more likely that the ''business judgment rule'' will apply and provide broad protection.[53]

Under both state corporation law and the federal securities laws, if the audit committee's discussions with management and the independent auditors become part of the financial reporting process and are used to form a belief about the financial statements, the likelihood increases substantially that the audit committee's decisions about the financial statements and other matters will be protected.[54] Those discussions should serve to strengthen the ''information and reporting system'' that should be in place.[55] Adherence to a sound process should result in less, not more, exposure to liability.[56]

Finally, we believe that the proposed requirement of paragraph (a)(4) is consistent with our view that by signing documents filed with the Commission, board members implicitly indicate that they believe that the filing is accurate and complete. In this regard, we believe that the proposed rule is consistent with current rules requiring board members to sign the company's Annual Report on Form 10–K or 10–KS [57] and our recent proposals to amend the signature sections of Exchange Act and Securities Act reports.[58] As the Commission recently stated: ''When the public sees a corporate official's signature on a document, it understands that the official is thereby stating that he believes that the statements in the document are true.'' [59]

Proposed paragraph (b) of Item 306 would require that the new disclosure appear over the printed names of each member of the audit committee.[60] The requirement should help to emphasize the importance of the audit committee's role to shareholders. We do not propose to require that audit committee members provide individual signatures.

We request your comments on whether the proposed disclosure would provide useful information to shareholders, and would reinforce the audit committee's awareness and acceptance of its responsibilities. While the amendments are not designed to elicit disclosure about the substance of the audit committee's deliberations, would they nonetheless result in meaningful disclosure? Should we instead require more complete disclosure about the activities, processes and/or discussions of the audit committee, such as by requiring the committee to identify the significant accounting issues it considered and/or discussed with management and the independent auditors and the conclusions reached about those issues? Should we require further disclosures about the basis for the audit committee's belief about the financial statements?

Would the proposed rule's purposes be served if we required less disclosure about the audit committee than proposed? Are all of the requirements necessary? For example, should we merely supplement Item 7(e) to require the company to disclose more generally whether the audit committee has met with management and the independent auditors to discuss significant accounting issues that developed in preparing the financial statements? Is the disclosure about discussions with management sufficient? For example, the Blue Ribbon Committee

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[50] *See supra* note 19.

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

[52] *See* Blue Ribbon Report, *supra* note 7, at 34; *see also id.* at 7 (''The [audit] committee's job is clearly one of oversight and monitoring, and in carrying out this job it acts in reliance on senior financial management and the outside auditors.'').

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

[54] We note that under Section 11 of the Securities Act, 15 U.S.C. § 77k, Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and other provisions of the federal securities laws, the members of an audit committee may have additional responsibilities, beyond the statement contemplated in subparagraph (a)(4), with respect to material misstatements and omissions. The Commission previously has stated that if ''an officer or director knows or should know that his or her company's statements concerning particular issues are inadequate or incomplete, he or she has an obligation to correct that failure.'' *Report of Investigation Pursuant to Section 21(a) of the Exchange Act Concerning the Conduct of Certain Former Officers and Directors of W.R. Grace & Co.*, Exchange Act Release No. 39157 (Sept. 30, 1997) [65 SEC Docket 1581].

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

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

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

[58] Securities Act Reform Release, *supra* note 40, at Section XI.C.

[59] Brief for Securities and Exchange Commission, Amicus Curiae, at 7, *Howard v. Everex Systems, Inc.* (9th Cir. 1999) (No. 98–17324) (citing cases).

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

recommends that the audit committee be required to state whether they discussed with management certain of the accounting matters that the audit committee must discuss with the auditors under SAS 61. Should we require that disclosure?

We request comment on alternative formulations of paragraph (a)(4) of proposed Item 306. We are considering an alternative formulation, for example, that would require the audit committee to state whether, based on the review and discussions with management and auditors, the audit committee is aware of any material modifications that should be made to the audited financial statements, and to state whether the audit committee recommended to the Board that the audited financial statements be included in the company's Annual Report on Form 10–K or 10–KSB (as applicable) filed with the Commission. Another possible formulation has been suggested by Ernst & Young.[61] Will those formulations achieve the intended objectives?

Should we require more disclosure about the auditors' independence? For example, should we require disclosure about the substance of the discussions between the audit committee and the auditors regarding the auditors' independence?

We request your comments on whether the requirement of proposed paragraph (b) of Item 306 would effectively encourage audit committee members to focus on the specific disclosure obligation. Would the purpose be served more effectively if we required individual signatures?

We request your comments on whether the proxy statement/ information statement is the appropriate place for the proposed new disclosure. We propose to include the disclosure in the proxy materials because we believe that the disclosure may have a direct bearing on shareholders' voting decisions, and because the proxy or information statement is actually delivered to shareholders and is accessible on the SEC's web site. In addition, we are proposing that the disclosure only be provided in a proxy or information statement relating to an annual meeting of shareholders at which directors are to be elected (or special meeting or written consents in lieu of such meeting). We are not proposing to include the new disclosure in the annual report to shareholders[62] because that document is not accessible electronically on our web site, though under our rules it must be sent to every shareholder.[63]

The Blue Ribbon Committee, however, recommends that the disclosure be included in the company's Annual Report on Form 10–K and annual report to shareholders. Should we instead, or additionally, include the information in one or both of those documents? Should the disclosure be required only when the proxy or information statement relates to an election of directors? Should the disclosure only be required to be provided one time during the year (e.g., in a proxy statement for an annual meeting at which directors are to be elected, but not in proxy solicitation material used in a subsequent election contest during that same year)? What are the implications, if any, if the proxy statement that includes the audit committee's report is of a later date than the date the Form 10–K is filed? Is it feasible for audit committees' reports to be included in proxy statements given the timing of the distribution of proxies and the completion of audit procedures and other events that must occur before the audit committee report may be finalized?

There may be companies, such as companies registered under section 15(d)[64] of the Exchange Act, that are not required to prepare proxy statements. Should we require those companies to provide the disclosures in another filing, such as in the Form 10–K or 10–KSB? Would we need to provide a safe harbor for the disclosures by those companies? If we do not make the requirement applicable to Section 15(d) companies, should we keep the text of the new requirement in Regulation S–K or, for example, move it into Item 7 of Schedule 14A?

C. Audit Committee Charters

We are proposing to require companies to disclose in their proxy statements or information statements whether their audit committee is governed by a charter. In addition, if the audit committee has a charter, a copy of the charter would have to be included as an appendix to the proxy or information statement at least once every three years. The new requirement would appear in new paragraph (e)(3) under Item 7 of Schedule 14A.

The new disclosure should help shareholders assess the role and responsibilities of the audit committee, and help focus committee members on their responsibilities as expressed in the charter. We believe that audit committees that have their responsibilities set forth in written charters are more likely to play an effective role in overseeing the company's financial reports.

The Blue Ribbon Committee recommends that the audit committee state whether it has satisfied its responsibilities during the prior year in compliance with its charter. We are concerned that requiring a statement about compliance with the charter may have the undesired effect of encouraging skimpy, broadly-worded and vague committee charters to minimize the audit committee members' exposure to liability. Accordingly, we are not proposing to require any statements about whether the audit committee has complied with the charter. The proposed amendments would not require companies to adopt audit committee charters, or dictate the content of the charter if one is adopted.[65]

Should we require companies to disclose whether they have adopted an audit committee charter, but not require that the charter be attached as an appendix to the proxy statement? In that case, we ask you to consider whether we should require a plain English summary of the charter's material terms, rather than a copy of the entire charter. Would such a disclosure requirement result in boilerplate disclosures? Is the charter itself useful information for investors?

Should we require the audit committee to disclose whether it has complied with its charter, as recommended by the Blue Ribbon Committee? We could require, for example, that the audit committee state whether it has complied in all material respects with the charter. Would a materiality threshold be appropriate, or some other threshold, such as compliance in all significant or substantive respects? We request your comments on whether we should instead require disclosure about any material deviations by the audit committee from their charter

[61] *See* Exhibit 1 to Letter from Ernst & Young to Harvey J. Goldschmid, General Counsel, and Lynn E. Turner, Chief Accountant, SEC (Aug. 20, 1999). A copy of the letter has been placed in the public file for this rulemaking.

[62] *See* Rule 14a–3 of the Exchange Act, 17 CFR 240.14a–3.

[63] Nothing, of course, would preclude a company from including such disclosures in its annual report to shareholders or in any other report.

[64] 15 U.S.C. § 78o(d).

[65] We note, however, that, in response to the Blue Ribbon Committee recommendations, the NYSE, NASD, and AMEX have proposed to require the audit committee to: (1) Adopt a formal written charter that is approved by the full board of directors and that specifies the scope of the committee's responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements; and (2) review and reassess the adequacy of the audit committee's charter on an annual basis.

obligations. We request your comments on whether a requirement to disclose compliance with an audit committee charter will have the undesired effect of encouraging skimpy, broadly-worded and vague committee charters. If any such disclosure is required, would we need to provide a safe harbor from liability for that disclosure? If so, what kind of safe harbor is needed?

Is requiring that the charter be attached as an appendix every three years the appropriate time frame? Should we require that it be attached as an appendix more frequently or less frequently?[66] Should we require that the charter also be attached as an appendix when there has been a material or substantive—or any—change in the charter?

Should we require reporting companies whose securities are not listed on the NYSE or AMEX or quoted on Nasdaq to disclose whether they have a charter? If these companies do not have a charter, should we require disclosure of the operative document of the audit committee (articles of incorporation, by-laws, etc.) or the material terms of the document? If so, should those documents be filed once every three years or some other interval? If a company does not have a charter or similar document, should we require disclosure of that fact?

Finally, we seek comments on whether the disclosure is properly included in the proxy or information statement, as proposed, or whether the disclosure should be included alternatively, or additionally, in another document, such as the annual report to shareholders, or the Annual Report on Form 10–K or 10–KSB.

D. Disclosure About ''Independence'' of Audit Committee Members

As early as 1940, the Commission encouraged the use of audit committees composed of independent directors.[67] As the Commission staff stated in a report to Congress in 1978, ''[i]f the [audit] committee has members with vested interests related to those of management, the audit committee probably cannot function effectively. In some instances this may be worse than having no audit committee at all by creating the appearance of an effective body while lacking the substance.''[68] Further, as the Blue Ribbon Committee noted, ''* * * common sense dictates that a director without any financial, family, or other material personal ties to management is more likely to be able to evaluate objectively the propriety of management's accounting, internal control and reporting practices.''[69]

In response to the Blue Ribbon Committee's recommendations, the NYSE, AMEX, and NASD have proposed amendments to their respective listing standards regarding, among other things, the ''independence'' of all audit committee members. The NYSE's, AMEX's, and NASD's proposed rule changes would provide a narrowly tailored exception to a requirement that all members of the audit committee be independent. Specifically, the NYSE, AMEX, and NASD have proposed that, under exceptional and limited circumstances, one director who is not independent may be appointed to the 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, and the Board discloses, in the next annual proxy statement subsequent to such determination, the nature of the relationship and the reasons for that determination.

Because of the importance of having an audit committee that is comprised of independent directors, we believe that shareholders should know when a director who is not independent is a member of an audit committee. We are proposing to require that companies whose securities are not listed on the NYSE or AMEX or quoted on Nasdaq, including small business issuers, disclose in their proxy statements whether, if they have an audit committee, the members are ''independent'' within the definition of the NYSE's, AMEX's, or NASD's proposed amendments to their listing standards. We are also proposing rules to require that for companies whose securities are listed on the NYSE or AMEX or quoted on Nasdaq, if the company's board determines in accordance with the proposed amendments to section 303.02(D) of the NYSE's listing standards, Section 121(B)(b)(ii) of the AMEX's listing standards, or sections 4310(c)(26)(B)(ii) or 4460(d)(2)(B) of the NASD's listing standards, as applicable and as may be modified or supplemented, to appoint one director to the audit committee who is not independent (as independence is defined in sections 303.01(B) (2)(a) and (3) of the NYSE's listing standards, Section 121(A) of AMEX's listing standards or Section 4200(a)(15) of the NASD's listing standards, as applicable and as may be modified or supplemented), the company must disclose the nature of the relationship that makes that individual not independent and the reasons for the board's determination. Small business issuers are not required to comply with this requirement.[70]

We request comment on whether the disclosures will help inform investors about the independence of the audit committee. If the proposed amendments to the NYSE's, AMEX's, and NASD's listing standards are not adopted, are there disclosures that we could require that would achieve the same purposes? Is the proposed requirement to disclose the nature of the relationship of the director who is not ''independent'' and the basis for the Board's determination specific enough, or will the requirement result in boilerplate disclosure?

Companies whose securities are not listed on the NYSE or AMEX or quoted on Nasdaq would be able to choose which definition of ''independence'' to apply to the audit committee members in making the disclosure. Whichever definition is chosen must be applied consistently to all members of the audit committee. Should we require small business issuers to comply with the requirement to disclose the nature of the relationship that makes the individual not independent? Will permitting companies to choose which definition to apply confuse investors in comparing companies? Should we instead mandate which definition should be used, and if so, which definition?

E. Proposed Safe Harbors

In making these proposals, we do not intend to subject companies or their directors to increased exposure to liability under the federal securities laws, or to create new standards for directors to fulfill their duties under state corporation law. We do not believe that the disclosure requirements will result in increased exposure to liability. To the extent the proposed disclosure requirements would result in more clearly defined procedures for, and disclosure of, the operation of the audit committee, liability claims alleging breach of fiduciary duties under state law actually may be reduced.

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[66] For example, only certain documents on file with the Commission may be incorporated by reference for more than five years. *See* General Instruction (a) to Regulation S–K, 17 CFR 229.10(a).

[67] *See supra* note 20.

[68] Staff of the SEC, 95th Cong., 2d Sess., Report to Congress on the Accounting Profession and the Commission's Oversight Role, Subcommittee on Governmental Efficiency and the District of Columbia of the Senate Committee on Governmental Affairs, at 97 (Comm. Print July 1978).

[69] Blue Ribbon Report, *supra* note 7, at 22.

[70] The NASD and AMEX excluded small business issuers from certain of the proposed amendments to their listing standards, including the requirement that all audit committee members be independent.

We recognize that, notwithstanding the audit committee's critical oversight role of the financial reporting process and financial statements, management ultimately has responsibility for the company's financial statements. As discussed above in Section III.B regarding the audit committee's report, the proposed disclosure requirements differ from the Blue Ribbon Committee's recommendations in response to liability concerns. In addition, we propose to follow the Blue Ribbon Committee's recommendation to adopt liability ''safe harbors'' to cover the new disclosures.[71] The ''safe harbors'' would track the treatment of compensation committee reports under Item 402 of Regulation S–K,[72] and would appear in proposed paragraph (c) in new Item 306 of Regulations S–K and S–B and in proposed paragraph (e)(v) of Schedule 14A. Under the ''safe harbors,'' the additional disclosure would not be considered ''soliciting material,'' ''filed'' with the Commission, subject to Regulation 14A or 14C or to the liabilities of Section 18 of the Exchange Act, except to the extent that the company specifically requests that it be treated as soliciting material, or specifically incorporates it by reference into a document filed under the Securities Act or the Exchange Act.[73]

We request your comments on whether we should adopt these proposed liability ''safe harbors'' to cover the information disclosed under the proposed amendments. Is a safe harbor necessary?

Should the safe harbors apply to all of the required disclosures or only certain of the disclosures? Is a safe harbor needed for factual statements? For example, is a safe harbor needed for the disclosure regarding whether the audit committee has discussed with the auditors the auditors' independence and received the written disclosures and letter from the auditors when these disclosures are factual in nature? Is the scope of the safe harbor appropriate?

IV. Request for Comments

We request your comments on the proposals, other matters that may have an impact on the proposals, and your suggestions for additional changes. In addition to the specific questions raised in Section III above, we request your comment on the matters discussed below.

First, the proposals generally do not distinguish between a Fortune 500 company and a small start-up company reporting on small business forms.[74] We request your comment on whether the scope of one or more of the proposed new requirements should be narrowed to exclude companies under a certain size. If so, should we exclude companies considered under the Commission's rules to be ''small business issuers'' (companies that have revenues and public float of less than $25 million)? The Commission has proposed to revise the definition of small business issuer to include companies with less than $50 million in annual revenues, and to delete the public float portion of the test.[75] If that proposal were adopted, would that affect your view on the applicability of today's proposals to small companies? Should there be a higher cutoff, such as $100 million or $200 million public float and/or revenues? If there should be a different standard, should it be based on additional or alternative criteria, such as total assets or reporting history?

The Blue Ribbon Committee's recommendations directed to the Commission are silent on whether to apply the requirements to all companies, regardless of size. In preparing your comments, you should consider whether the proportionate cost of complying with some of the proposals may be greater for smaller companies than for larger ones. You should also consider, however, that one recent study found that the incidence of financial fraud at smaller companies may be greater than at larger companies.[76]

We also request your comments on whether any or all of the proposals should apply to investment companies registered under the Investment Company Act of 1940. The proposals for requiring audit committee disclosure as currently formulated would only apply to closed-end funds. As we discussed above, our proposals are intended to work in conjunction with the listing standards of the NYSE, AMEX, and the NASD that would impose requirements on companies for their audit committees. Because mutual funds are not subject to the listing standards of an exchange or a national securities association that require companies to have audit committees, the Commission has not included those funds in the proposals at this time.[77] We also request your comments on whether interim financial statements of closed-end funds should be reviewed by independent auditors before being sent to shareholders.[78]

The proposals would not apply to ''foreign private issuers,'' which are exempt from the proxy rules, and which are not required to file Quarterly Reports on Form 10–Q or 10–QSB.[79] We request your comments on whether any one or more of our proposed amendments should apply to ''foreign private issuers.''

V. Paperwork Reduction Act

Certain provisions of the proposed amendments to Regulations 14A, 14C, S–X, S–B, and S–K contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 *et seq.*), and the Commission has submitted proposed revisions to those rules to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The titles for the collections of information are: (1) ''Proxy Statements—Regulation 14A (Commission Rules 14a–1 through 14a–15) and Schedule 14A;'' (2) Information Statements—Regulation 14C (Commission Rules 14c–1 through 14c–7 and Schedule 14C); (3) Regulation S–X; (4) Regulation S–B; and (5) Regulation S–K.[80] An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

Schedule 14A (OMB Control No. 3235–0059)[81] and Schedule 14C (OMB

[71] Blue Ribbon Report, *supra* note 7, at 35.

[72] *See* Instruction 9 to Item 402(a)(3) of Regulation S–K, 17 CFR 229.402(a)(3).

[73] Of course, the antifraud provisions of these Acts would continue to apply.

[74] The proposed disclosure requirements about the independence of audit committees does, however, distinguish between companies whose securities are listed on the NYSE or AMEX or quoted on Nasdaq and all other companies.

[75] *See* Securities Act Reform Release, *supra* note 40, at Section V.E.2.

[76] *See* Beasley, Carcello, and Hermanson, Fraudulent Financial Reporting: 1987–1997, An Analysis of U.S. Public Companies (Mar. 1999) (study commissioned by the Committee of Sponsoring Organizations of the Treadway Commission) (the ''COSO Report'').

[77] *See* proposed paragraph (e)(3)(vi) of Item 7, Schedule 14A. The proposed rules also exclude unit investment trusts (''UITs'') from the disclosure requirements because they do not have boards of directors and, therefore, do not have audit committees.

[78] Because closed-end and open-end funds and UITs generally are not required to file Form 10–Qs, these investment companies would not be subject to the proposal requiring the review of quarterly financial statements filed on Form 10–Q. Business development companies, however, are required to file Form 10–Qs and would be subject to the proposal.

[79] A ''foreign private issuer'' must file reports on Form 6–K promptly after the information required by the Form is made public in accordance with the laws of its home country or a foreign securities exchange. *See* 17 CFR 240.13a–16(b). The proposed amendments would, however, apply to a ''foreign private issuer'' that elected to file reports under the disclosure rules for U.S. companies.

[80] The Commission is not proposing any changes to Forms 10–Q or 10–QSB.

[81] 17 CFR 240.14a–101.

Control No. 3235–0057)[82] were adopted pursuant to Sections 14(a) and 14(c) of the Exchange Act. Schedule 14A prescribes information that a company must include in its proxy statement to ensure that shareholders are provided material information relating to voting decisions. Schedule 14C prescribes information that a company must include in its information statement under those circumstances.

The Commission currently estimates that Schedule 14A results in a total annual compliance burden of 173,906 hours. The burden was calculated by multiplying the estimated number of entities filing Schedule 14A annually (approximately 9,892) by the estimated average number of hours each entity spends completing the form (approximately 13 hours).[83] The Commission currently estimates that Schedule 14C results in a total annual compliance burden of 4,448 hours. The burden was calculated by multiplying the estimated number of entities filing Schedule 14C annually (approximately 253) by the estimated average number of hours each entity spends completing the form (approximately 13 hours). The Commission based the number of entities that would complete and file each of the forms on the actual number of filers during the 1998 fiscal year. The staff estimated the average number of hours each entity spends completing each of the forms by contacting a number of law firms and other persons regularly involved in completing the forms. Regulations S–X, S–K, and S–B do not impose reporting burdens directly on public companies. For administrative convenience, each of these regulations is currently assigned one burden hour. Although these regulations set forth disclosure requirements, the burden associated with the requirements is reflected in the forms and schedules that refer to those regulations.

We believe that the proposed amendments will bolster investor confidence in the securities markets by informing investors about the important role that audit committees play in the financial reporting process and enhance the reliability and credibility of financial statements of public companies. The proposed amendments would require companies to include additional disclosure in Schedules 14A and 14C, including certain information about the company's audit committee. The audit committee would be required to disclose whether the audit committee had certain discussions with management and the company's auditors. The substance of the discussions would not be required to be disclosed. The proposed amendments would also require companies that have adopted a written charter to include a copy of the charter as an appendix to Schedules 14A and 14C at least once every three years. The amendments do not require a company to prepare a charter. We estimate that, on average, the additional disclosure would require approximately one additional burden hour per filing, whether on Schedule 14A or 14C. Accordingly, the proposed amendments, if adopted, would result in an aggregate of 9,892 additional burden hours for Schedule 14A annually, and an aggregate 253 additional burden hours for Schedule 14C annually. We request your comments on the accuracy of our estimates.

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

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

Persons submitting comments on the collection of information requirements should direct the comments to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should send a copy to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609, with reference to File No. S7–22–99. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7–22–99, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication of this release. Consequently, a comment to OMB is assured of having its full effect if OMB receives it within 30 days of publication.

VI. Cost-Benefit Analysis

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

> Improving oversight of the financial reporting process necessarily involves the imposition of certain burdens and costs on public companies. Despite these costs, the Committee believes that a more transparent and reliable financial reporting process ultimately results in a more efficient allocation of and lower cost of capital. To the extent that instances of outright fraud, as well as other practices that result in lower quality financial reporting, are reduced with improved oversight, the benefits clearly justify these expenditures of resources.[84]

Reviews of Quarterly Financial Statements

We propose to require interim reviews of quarterly financial statements filed on Form 10–Q or 10–QSB.[85] Under the proposed amendments, the company's quarterly financial statements would have to be reviewed by independent auditors using ''professional standards and procedures for conducting such reviews, as established by generally accepted auditing standards, as may be modified or supplemented by the Commission.'' Currently, that means that the review would follow the procedures established by SAS 71. The proposed amendments apply only to the financial information contained in the company's quarterly report on Form 10–Q or 10–QSB. Accordingly, it would not impose any requirements on quarterly financial information that may be released to the public before the filing of the Form 10–Q or 10–QSB, such as the so-called quarterly ''earnings release.''

We believe that companies are under increasing pressure to meet financial

[82] 17 CFR 240.14c–101.

[83] Thirteen hours is 25% of the total company reporting time (75% is shown as cost).

[84] Blue Ribbon Report, *supra* note 7, at 19.

[85] *See* Section III.A above.

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

We do not currently have sufficient information to quantify these or other potential benefits. We, therefore, request your comments, including supporting data, on the degree to which the proposal is likely to improve the reliability of interim financial reporting.

The five largest U.S. accounting firms, the so-called ''Big 5,'' and some other firms, currently have in place policies that require that their clients have interim reviews as a condition to acceptance of an audit. The firms' adoption of these policies, and the acceptance of them by their clients, indicates that the value of these reviews justifies the associated costs.

Based on the staff's review of the Compustat database containing auditor information for about 8,600 companies for calendar year 1997, we estimate that approximately 75% of public companies (about 6,450) are clients of the Big 5 accounting firms, and that approximately 25% (or 2,150) are audited by other accounting firms. We request your comments on the accuracy of those estimates, including supporting data. Some of those 2,150 companies are audited by firms that have quarterly review policies similar to those of the Big 5 firms.

Based on the data provided to staff by the SEC Practice Section of the AICPA (''SECPS''), we estimate the incremental cost to conduct a SAS 71 review will be nominal for those companies currently audited by the Big 5 firms and for the remaining companies would range from approximately $1,000 to about $4,000 per quarter. The total cost of upgrading for all companies audited by non-Big 5 accounting firms would be approximately $16 million per year. We request your comments and supporting empirical data on the accuracy of these estimates and conclusions.

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

The firms providing information to the SECPS identified several benefits that they believe would result from the reviews, including better interim reporting, earlier identification and resolution of accounting issues, improvement in the quality of accounting estimates, and improved communications between clients and auditors. Medium and smaller sized accounting firms, however, indicated to the SECPS that SAS 71 reviews of small companies' interim financial statements may cause delays in filing Forms 10–Q or 10–QSB, be relatively more costly for small companies, be hampered by inadequate financial reporting processes, and would result in small companies shifting work from the company to the CPA firm.

The firms generally indicated, however, that the costs of reviews of quarterly financial statements vary depending on several factors, including: (i) The sophistication of the client's accounting and reporting system; (ii) the quality of the client's accounting personnel; (iii) the identification of ''fraud risk factors;'' (iv) the client's industry; (v) the number and location of the client's subsidiaries; (vi) the seasonality of the client's business; (vii) the existence of contentious accounting issues; and (viii) whether there will be a staffing ''crunch'' at the firm to handle the reviews each quarter.

Approximately half of the firms consulted believed that the cost of the reviews would be offset, in part, by a reduction in the annual audit fee, although the amount of the reduction in audit fees may vary based on, among other things, the performance of substantive audit procedures during the review, whether the review results in the client having better internal accounting and reporting controls, and how the results of the review impact planning for the annual audit. Because the cost of reviews would be only partially offset by a reduction of year-end audit fees, overall audit and review fees paid by the company to the auditors would increase.

Disclosure Related to the Functioning of the Audit Committee

The principal benefits of the proposals are improved disclosure relating to the functioning of corporate audit committee and enhanced reliability and credibility of financial statements. The benefits of improved disclosure regarding the audit committee's communications are not readily quantifiable. We believe, however, that they would include increased market efficiency due to improved information and investor confidence in the reliability of companies' financial disclosures. We request your comments and empirical data on whether the improved disclosure will have that result.

We believe the costs associated with this proposal would derive principally from the corresponding disclosure obligations; this is because we are not placing any substantive requirements on audit committees or their members. Based on the staff's experience with proxy and information statements, and analogous cost estimates, we believe that the additional disclosure contemplated by the proposed amendments would, on average, require approximately three-fourths of a page in a company's proxy or information statement. A financial printing company informed the staff that adding up to three-fourths of a page in the proxy statement would not likely increase the printing cost to the company. That is because up to an extra three-fourths of a page can normally be incorporated without increasing the page length by reformatting the document. The printer reported that adding more than three-fourths of a page could increase costs by about $1,500 for an average sized company. Accordingly, based on our preliminary estimates, there should be little, if any, additional printing costs from these additional disclosures. We seek your comments on the accuracy of these cost estimates, and we ask you to submit cost data to support your analysis.

We believe, however, that disclosure required by the proposed amendments could result in other costs. First, some companies may be required to set up procedures to monitor the activities of the audit committee in order to collect and record the information required by the proposed amendments. In our view, such monitoring costs are most likely to result from the proposed disclosure of the audit committee's discussions with management and the independent auditors and receipt of disclosures and a letter from the independent auditors.

Second, some companies may seek the help of outside experts, particularly outside legal counsel, in formulating responses to the new requirements. In some circumstances, for instance, the audit committee may seek the advice of legal counsel before making the required disclosure about the audited financial statements. We request your comments, including supporting data, on the magnitude of these costs and any other costs that we may not have mentioned.

For purposes of the Paperwork Reduction Act, we estimate that our proposed disclosures would, on average, impose one additional burden hour on each filer of Schedule 14A or 14C, or an aggregate annual total of 15,445 additional burden hours. That estimate is based on current burden hour estimates and the staff's experience with such filings. We further estimate that approximately 75% of the extra burden hours, or 11,584 hours, will be expended by companies' internal staff, and the remaining 25%, or 3,861 hours, by outside professional help.[86] These percentage estimates, which are based on current burden hour estimates and the staff's experience with such filings, reflect the time companies would spend preparing the additional disclosures in the proxy statement or information statement.[87] Assuming that the internal staff costs the company an average of about $85 per hour, the aggregate annual cost for internal staff assistance would amount to approximately $980,000. If we assume that the outside professional assistance would have an average cost of approximately $125 per hour, the aggregate annual paperwork cost would be approximately $500,000. The total annual costs would accordingly be about $1,500,000. We request your comments on the reasonableness of these estimates and their underlying assumptions.

These proposals are not intended to increase companies' or directors' exposure to liability under federal or state law. Indeed, we believe that the proposal will likely result in better and more reliable financial reporting. As an extra safeguard, the proposed amendments include liability ''safe harbors'' similar to that which applies to compensation committee reports under current rules.[88] We nonetheless request your comments on whether the proposals could have the unintended effect of increasing companies' and/or directors' exposure to liability. Your comments should specifically address the bases for liability concerns, including the underlying case law if applicable, and your estimates of any additional costs that may result from increased liability.

Are there any other costs or benefits that we have not identified? Please identify them and provide data.

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

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,[89] the Commission is requesting information regarding the potential impact of the proposals on the economy on an annual basis. Commentators should provide empirical data to support their views.

Section 23(a) of the Exchange Act requires the Commission, when adopting rules under the Exchange Act, to consider the anti-competitive effects of any rule it adopts. We do not believe that the proposals would have any anti-competitive effects since the proposals should improve the transparency, reliability, and credibility of companies' financial statements. We request comment on any anti-competitive effects of the proposals. In addition, Section 3(f) of the Exchange Act requires the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition, and capital formation. We believe that the proposals would bolster investor confidence in the securities markets by improving the transparency of the role of corporate audit committees and enhancing the reliability and credibility of financial statements of public companies. Accordingly, the proposals should promote capital formation and market efficiency. We request comment on these matters.

VIII. Initial Regulatory Flexibility Analysis

This Initial Regulatory Flexibility Analysis has been prepared in accordance with 5 U.S.C. § 603. It relates to proposed amendments to rule 10–01 of Regulation S–X, Item 310 of Regulation S–B, and Item 7 of Schedule 14A, under the Exchange Act, and proposed new Item 306 of Regulations S–B and S–K.

A. Reasons for the Proposed Action

The new rules and amendments to current rules are being proposed to improve disclosure relating to the functioning of corporate audit committees and to enhance the reliability and credibility of financial statements of public companies. The proposals are based in large measure on recommendations recently made by the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees. The required disclosure will help inform shareholders of the audit committee's role in overseeing the preparation of the financial statements and underscore the importance of the audit committee's participation in the financial reporting process.

B. Objectives

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

C. Legal Basis

The Commission is proposing the amendments and new rules pursuant to its authority under Sections 2, 13, 14, and 23 of the Securities Exchange Act.

D. Small Entities Subject to the Rule

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

Most reporting companies file either a proxy statement on Schedule 14A or an information statement on Schedule 14C, and all reporting companies must file quarterly reports on Form 10–Q or 10–QSB. Some companies are not subject to

[86] These assumptions are based on the staff's experience with these filings. We believe that a company's internal staff will typically carry most of the burden of preparing the proposed additional disclosures, and will consult with outside professionals only on specific issues that the company may periodically encounter in preparing the proxy statement or information statement.

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

[88] *See supra* note 72.

[89] Pub. L. No. 104–121, tit. II, 110 Stat. 857 (1996).

the 14A or 14C requirements because their securities are not registered under Section 12(b) or 12(g) under the Exchange Act. These companies may, however, be subject to the Form 10–Q or Form 10–QSB requirements. Because these requirements turn in part on the number of shareholders and amount of assets—which are subject to change—we have no reliable way to determine exactly how many reporting small businesses may be affected by the rule proposals.

E. Reporting, Recordkeeping, and Other Compliance Requirements

Under the proposed rules, public companies, both large and small, would be required to provide certain additional disclosure in their proxy statements regarding the company's audit committee. Companies would be required to include reports of their audit committees that include disclosure about whether certain conversations between the audit committee and management and the auditors took place. No disclosure of the substance of the discussions is required.

1. Reviews of Quarterly Financial Statements

We propose to require companies to engage their independent auditors to conduct interim reviews of their quarterly financial statements prior to the company filing its Form 10–Q or 10–QSB. Based on information provided to the Commission by the SECPS, it appears that most companies engage their independent auditors to undertake some level of review of their quarterly financial statements.

Medium and smaller sized accounting firms indicated to the SECPS that SAS 71 reviews of small companies' interim financial statements may cause delays in filing Forms 10–Q or 10–QSB, be relatively more costly for all companies, be hampered by inadequate financial reporting processes, and would result in small companies shifting financial responsibilities from the company to the CPA firm. Firms providing information to the SECPS also commented that the costs of compliance would be partially offset by a reduction in year-end audit fees and would lead to earlier identification of accounting and auditing issues and an improvement in the quality of the process used for preparing interim financial reports.

2. Disclosure Related to the Functioning of the Audit Committee

Some of the proposed amendments would increase disclosure of the audit committee's role. The increased disclosure will require all entities, large and small, to spend additional time and incur additional costs in preparing disclosures. Smaller companies may incur additional costs to set up procedures to monitor the activities of the audit committee in order to collect and record the information required by the proposed amendments. Smaller companies may also incur additional costs in seeking the help of outside experts, particularly outside legal counsel, in formulating responses to the new requirements.

F. Duplicative, Overlapping or Conflicting Federal Rules

The Commission believes that there are no rules that duplicate, overlap, or conflict with the proposed rules.

G. Significant Alternatives

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objectives, while minimizing any significant adverse impact on small entities. In connection with the proposed amendments, the Commission considered the following alternatives: (a) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (b) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities; (c) the use of performance rather than design standards; and (d) an exemption from coverage of the rule, or any part thereof, for small entities.

We considered not applying the proposals to small business issuers. We believe investors in smaller companies would want and benefit from the disclosures about the audit committee and the advantages of interim reviews just as much as investors in larger companies. In addition, the COSO Report found that the incidence of financial fraud was greater at small companies.[90] The report specifically noted that the ''concentration of fraud among companies with under $50 million in revenues and with generally weak audit committees highlights the importance of rigorous audit committee practices, even for smaller organizations.'' [91] In light of the COSO Report, it may be inconsistent with the purposes of the rule to exempt small business issuers from the proposed requirement for interim reviews.

[90] *See generally,* COSO Report, *supra* note 76. In fact, the COSO Report specifically found that a ''regulatory focus on companies with market capitalization in excess of $200 million may fail to target companies with greater risk for financial statement fraud activities.'' *Id.* at 4.

[91] *Id.* at 5.

We also considered the alternative of only requiring companies whose securities are listed on the NYSE or AMEX or quoted on Nasdaq to include disclosures regarding the independence of their audit committee members. We believe that the proposed amendments that require disclosure regarding the independence of the members of their audit committee impose only minimal additional costs but would provide useful information to investors.

The proposed rule amendments and new rules are designed to improve disclosure relating to the functioning of corporate audit committees and to enhance the reliability and credibility of financial statements for all public companies, and currently we do not believe it is feasible to further clarify, consolidate or simplify the rule for small entities.

H. Solicitation of Comments

The Commission encourages the submission of comments with respect to any aspect of this Initial Regulatory Flexibility Analysis. In particular, the Commission seeks comment on: (i) The number of small entities that would be affected by the proposed rules; (ii) the nature of the impact; and (iii) how to quantify the number of small entities that would be affected by and/or how to quantify the impact of the proposed rules. Comment is specifically requested regarding the number of small entities that are not registered under Section 12 of the Exchange Act that might be affected by the proposed amendments and what effect, if any, they would have on small entities. Should there be different requirements for those companies? Should those companies be required to include the audit committee disclosures in their Forms 10–K or 10–KSB, or in any other disclosure documents? Please describe the nature of any impact and provide empirical data supporting the extent of the impact. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed amendments and new rules are adopted, and will be placed in the same public file as comments on the proposed amendments and new rules themselves.

IX. Statutory Bases and Text of Amendments

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

List of Subjects

17 CFR Part 210

Accountant, Accounting, Reporting and recordkeeping requirements, Securities.

17 CFR Part 228

Reporting and recordkeeping requirements, Securities, Small businesses.

17 CFR Parts 229 and 240

Reporting and recordkeeping requirements, Securities.

Text of Amendments

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

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

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

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

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

§ 210.10–01 Interim financial statements.

* * * * *

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

* * * * *

PART 228—INTEGRATED DISCLOSURE SYSTEM FOR SMALL BUSINESS ISSUERS

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

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

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

§ 228.305 [Reserved]

§ 228.306 (Item 306) Audit committee report .

(a) The audit committee must state whether:

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

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

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

(4) Based on the review and discussions referred to in paragraphs (a)(1) through (a)(3) of this Item, anything has come to the attention of the members of the audit committee that caused the audit committee to believe that the audited financial statements included in the company's Annual Report on Form 10–KSB (17 CFR 249.310b) for the year then ended contain an untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading.

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

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

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

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

§ 228.310 (Item 310) Financial Statements.

* * * * *

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

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

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

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

* * * * *

7. By adding § 229.306 to read as follows:

§ 229.306 (Item 306) Audit committee report.

(a) The audit committee must state whether:

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

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

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

(4) Based on the review and discussions referred to in paragraphs (a)(1) through (a)(3) of this Item, anything that has come to the attention of the members of the audit committee that caused the audit committee to believe that the audited financial statements included in the company's Annual Report on Form 10–K (17 CFR 249.310) for the year then ended contain an untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading.

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

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

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

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

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

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

* * * * *

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

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

* * * * *

Item 7. *Directors and executive officers.* * * *

(e) * * *

(3) If the registrant has an audit committee:

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

(ii) State whether the company's audit committee has adopted a written charter.

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

(iv)(A) For companies whose securities are listed on the New York Stock Exchange (''NYSE'') or American Stock Exchange (''AMEX'') or quoted on Nasdaq, if the company's Board determines in accordance with the requirements of section 303.02(D) of the NYSE's listing standards, section 121(B)(b)(ii) of the AMEX's listing standards, or section 4310(c)(26)(B)(ii) or 4460(d)(2)(B) of the National Association of Securities Dealers' (''NASD'') listing standards, as applicable and as may be modified or supplemented, to appoint one director to the audit committee who is not independent (as independence is defined in Sections 303.01(B)(2)(a) and (3) of the NYSE's listing standards, section 121(A) of the AMEX's listing standards, or Rule 4200(a)(15) of the NASD's listing standards, as applicable and as may be modified or supplemented), disclose the nature of the relationship that makes that individual not independent and the reasons for the Board's determination. Small business issuers are not required to comply with this paragraph (e)(3)(iv)(A).

(B) For companies, including small business issuers, whose securities are not listed on the NYSE or AMEX or quoted on Nasdaq, disclose whether, if the company has an audit committee, the members are independent. In determining whether a member is independent, the company must use the definition of independence in section 303.01(B)(2)(a) and (3) of the NYSE's listing standards, section 121(A) of the AMEX's listing standards or Rule 4200(a)(15) of the NASD's listing standards, as such sections may be modified or supplemented, and state which of these definitions was used. Whichever definition is chosen must be applied consistently to all members of the audit committee.

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

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

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By the Commission.

Dated: October 7, 1999.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 99–26791 Filed 10–13–99; 8:45 am]

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ENVIRONMENTAL PROTECTION AGENCY

40 CFR Part 52

[Region II Docket No. NJ36–1–196, FRL–6457–2]

Approval and Promulgation of Implementation Plans; New Jersey; Nitrogen Oxides Budget and Allowance Trading Program

AGENCY: Environmental Protection Agency (EPA).

ACTION: Proposed rule.

SUMMARY: The Environmental Protection Agency proposes to conditionally approve New Jersey's State Implementation Plan (SIP) revision for ozone. This SIP revision relates to New Jersey's portion of the Ozone Transport Commission's September 27, 1994 Memorandum of Understanding, which includes a regional nitrogen oxides budget and allowance (NO_X Budget)