RAN-01-10
February 12, 2001

TO: **All PCX Members and Member Organizations**

FROM: **Department of Regulatory Policy**

SUBJECT: **Requirements for Audit Committees of Listed Companies (File No. SR-PCX-00-40)**

On February 7, 2001, the Securities and Exchange Commission approved the PCX Equities, Inc. rule change to improve the requirements of audit committees of listed companies. The rule change requires listed companies to adopt formal written charters and establishes composition requirements for audit committees including expertise and independence criteria for committee members.

The rule provides issuers with time to comply with the proposed rule change as follows: (1) all public company audit committee members qualified under the previous PCX rules are "grandfathered" until they are re-elected or replaced; and (2) companies have eighteen months from the date of Commission approval (February 7, 2001) to recruit the requisite members for their audit committees. Issuers listed on the Exchange as of February 7, 2001 have six months to adopt a formal written audit committee charter.

Following is the text of the rule change. Questions regarding this bulletin may be directed to Cindy Sink at (415) 393-7926.

Text of the Rule Change:[1]

RULES OF THE BOARD OF DIRECTORS OF PCX EQUITIES, INC.

Section 3. Corporate Governance and Disclosure Policies

Rule 5.3 – No change.

[1] New text is underscored.

Corporate Governance

Rule 5.3 (a) **Conflicts of Interest –** No change.

Rule 5.3 (b) **Independent Directors/Audit Committee**

The Corporation shall require that each listed domestic issuer have at least two independent directors on its board of directors. Such issuer must maintain an audit committee. [a majority of which] All audit committee members must be independent directors that satisfy the audit committee requirement set forth below.

(1) *Audit Committee Charter*. The board of directors must adopt and approve a formal written charter for the audit committee. The audit committee must review and reassess the adequacy of the formal written charter on an annual basis. The charter must specify the following:

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

(ii) That the outside auditor is ultimately accountable to the board of directors and the audit committee of the company, that the audit committee and board of directors have the ultimate authority and responsibility to select, evaluate, and, where appropriate, replace the outside auditor (or to nominate the outside auditor to be proposed for shareholder approval in any proxy statement); and

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

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

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

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

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

(3) *Independence Requirement of Audit Committee Members*. In addition to the definition of Independent provided in 5.36(2)(i), the following restrictions shall apply to every audit committee member:

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

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

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

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

(iv)Immediate Family. A director who is an Immediate Family member of an individual who is an executive officer of the company or any of its affiliates cannot serve on the audit committee until three years following the termination of such employment relationship. "Immediate Family" includes a person's spouse, parents, children, siblings, mothers-in-law and fathers-in-law, sons and daughters-in-law, and anyone (other than employees) who shares such person's home.

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

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

(i) any determination that the company's board of directors has made regarding the independence of directors pursuant to any of the subparagraphs above;

(ii) the financial literacy of the audit committee member;

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

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

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

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