

**SEC ISSUES FINAL RULES ON DISCLOSURE OF AUDIT COMMITTEE
FINANCIAL EXPERTS AND CODES OF ETHICS**

Last week, the Securities and Exchange Commission (“SEC”) issued final rules¹ to implement Sections 406 and 407 of the Sarbanes-Oxley Act of 2002 (the “Act”) that require public companies to disclose in their annual reports filed with the SEC under the Securities Exchange Act of 1934 (the “Exchange Act”)²:

- that the board of directors of the company has determined whether or not (and if not, why not) it has at least one “audit committee financial expert” and if so, the name of the expert and whether he is independent of management; and
- whether or not (and if not, why not) the company has adopted a code of ethics for its chief executive officer and senior financial officers.³

These disclosures **will not be required in companies’ upcoming annual reports**, but will be required beginning with annual reports filed for fiscal years ending **on or after July 15, 2003**.

Foreign companies will generally be subject to the new disclosure requirements. Asset-backed issuers will be exempt. Registered investment companies will be subject to the new requirements, as further described in a separate SEC release.

Audit Committee Financial Experts*Disclosure Requirement*

The final rules implementing Section 407 of the Act require a company to disclose in its annual reports that its board of directors has determined that the company either

¹ SEC Release Nos. 33-8177; 34-47235 (January 23, 2003).

² The rules apply to annual reports on Form 10-K, Form 10-KSB (small business issuers), Form 20-F (foreign private issuers) and Form 40-F (Canadian issuers). The required disclosure should be included in Part III of the annual reports on Form 10-K and 10-KSB and may be incorporated by reference to a company’s proxy statement that involves election of directors that is filed no later than 120 days after the end of the fiscal year covered by the annual report.

³ The SEC release announcing the proposed rules (No. 33-8138, etc. (October 22, 2002)) also contained proposals to implement Section 404 of the Act regarding an annual management report on a company’s internal financial controls. No implementation date for Section 404 is specified in the Act, and the SEC will issue a separate adopting release at a later date. In its previous release, the SEC proposed to defer this requirement until fiscal years ending on or after September 15, 2003.

- has at least one audit committee financial expert⁴ serving on its audit committee and if so, such expert's name and whether the person is independent of management;⁵ or
- does not have an audit committee financial expert serving on its audit committee and if not, provide an explanation.⁶

The final rules incorporate the definition of "independence" contained in the proxy statement rules, which, in turn, refer to the listing standards employed by the New York Stock Exchange ("NYSE"), the NASDAQ Stock Market ("NASDAQ") and the American Stock Exchange ("AMEX") (collectively, "SROs"). The definition of "independence" will be substantially amended later this year pursuant to proposals by the SROs currently pending before the SEC and the listing rules for audit committees of companies whose securities trade on SROs, which are mandated under Section 301 of the Act.⁷

Commentary:

- While the SEC rule is a disclosure requirement, the SROs' proposed amendments to their listing standards require that at least one member of a listed company's audit committee *actually be* a "financial expert" as that term is defined by the SEC rule. The SROs are expected to revise their proposals in light of the final SEC rule.⁸

⁴ The final rules use the term "audit committee financial expert" instead of simply "financial expert" as used in the Act to emphasize that the designated person has the attributes that are "particularly relevant to the functions of the audit committee." The terms "audit committee financial expert" and "financial expert" are used interchangeably in this memorandum and refer to the same concept.

⁵ The final rules permit, but do not require, a company to disclose that it has more than one audit committee financial expert on its audit committee.

⁶ The SEC noted it would still be appropriate for a company disclosing that it does not have an audit committee financial expert to explain the aspects of the definition that various members of the committee do satisfy.

⁷ Under the SEC's proposed rules implementing Section 301 of the Act, all members of a listed company's audit committee must be independent. To qualify as "independent," an audit committee member may only receive compensation for his or her service as a director/committee member and may not be an affiliated person of the company or any of its subsidiaries. Under the SROs' proposed listing standards, director "independence" would also be determined based on certain potentially compromising relationships with the company, with certain relationships deemed to be automatically disqualifying. For more information, see our previous client memorandum, dated January 15, 2003.

⁸ See footnote 6 to proposed subsection 6 of Section 303A to the NYSE's Listed Company Manual and proposed NASD Rule 4350(d)(2). AMEX has issued a press release (the "AMEX Press Release"), dated November 25, 2002 (available on the AMEX website), briefly summarizing their corporate governance proposals, but has not yet released a detailed rule proposal.

Definition of “Financial Expert”

After receiving numerous comments criticizing its proposed definition of “financial expert” as too narrow, the SEC substantially revised the definition. Under the final definition, an “audit committee financial expert” is a person who has the following attributes:

- (i) an understanding of generally accepted accounting principles and financial statements;
- (ii) the ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;
- (iii) experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant’s financial statements, or experience actively supervising one or more persons engaged in such activities;
- (iv) an understanding of internal controls and procedures for financial reporting; and
- (v) an understanding of audit committee functions.

A person must have acquired such attributes through one or more of the following:

- (i) education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions;
- (ii) experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;
- (iii) experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or
- (iv) other relevant experience.

Comparison of Final Definition to Proposed Definition

- The SEC originally proposed that a “financial expert” have education and experience as an accountant or auditor or financial or accounting officer of a public reporting company. In response to comments that many private companies and foreign companies prepare

audited financial statements in accordance with generally accepted accounting principles (whether U.S. or international), this requirement was eliminated.

- The first attribute relating to an understanding of generally accepted accounting principles has been adopted as substantially proposed. For foreign private issuers, the audit committee financial expert must understand generally accepted accounting principles used by the foreign private issuer in preparing its primary financial statements filed with the SEC.
- The proposed second attribute would have required a financial expert to have experience applying accounting principles in connection with accounting for estimates, accruals and reserves that are common in a reporting company's particular industry. In response to concerns that only a small pool of individuals could meet such narrow, industry-specific standards, the SEC instead adopted a standard where a financial expert must be able to assess the general application of generally accepted accounting principles in connection with accounting estimates, accruals and reserves. The SEC has stated that such an audit committee member would have the necessary background to address industry-specific standards.
- The proposed third attribute would have required a financial expert to have direct experience preparing or auditing financial statements that are generally comparable to a reporting company's financial statements. Recognizing that analysts in industries such as investment banking and venture capital possess experience with financial statements that would be beneficial to an audit committee, this standard was significantly broadened to allow individuals with experience "preparing, auditing, analyzing or evaluating" financial statements to qualify as financial experts if their experience is with financial statements of "breadth and complexity" generally comparable to the reporting company's financial statements.
 - In determining if an individual has such generally comparable experience, the board should consider a variety of factors, such as the size of the company with which the person has experience, the scope of that company's operations and the complexity of its financial statements and accounting. The SEC has indicated that familiarity with particular financial reporting or accounting issues, or any other narrow area of experience, is not required.
 - The SEC release states that previous experience in the same industry or even with public companies, while certainly factors that the board may consider, are not requirements.
 - Active supervision of a person who prepares, audits, analyzes or evaluates financial statements would also satisfy this attribute. However, the individual must not have mere supervisory responsibility, but should

participate in, and contribute to, the process of addressing, albeit at a supervisory level, the same general types of issues regarding preparation, auditing, analysis or evaluation of financial statements as those addressed by the person or persons being supervised. The supervisor should also have experience that has contributed to the general expertise necessary to prepare, audit, analyze or evaluate financial statements that is at least comparable to the general expertise of those being supervised.

- Thus, a principle executive officer who has little active involvement in financial and accounting matters would not qualify under this standard.
- With respect to the fourth required attribute, the SEC replaced “experience” with internal financial reporting controls with an “understanding” of the purpose of internal financial reporting controls and the ability to evaluate their effectiveness. The audit committee financial expert must also understand why the internal controls exist, how they were developed and how they operate. Experience establishing or evaluating such controls would provide such “understanding,” but is not required to satisfy the standard.
- The final requirement, that a financial expert have an understanding of audit committee functions, has been adopted as proposed.

Means of Obtaining Expertise

The SEC originally proposed that the board of directors consider a list of factors regarding the individual’s experience and education to determine if the person possessed all the attributes of a “financial expert.” While the SEC emphasized that the list was meant to be suggestive and not followed mechanically, comments that boards would do so anyway prompted the SEC to eliminate this list and instead require a financial expert to have obtained expertise by one of the several methods discussed above.

- In the adopting release, the SEC emphasized that in making its determination of an audit committee member’s financial expertise, the board should consider all the available facts and circumstances, including the previously proposed qualitative factors which are listed for reference on Exhibit A.
 - Current audit committee members should not be automatically “grandfathered” as “financial experts,” and experience as a public accountant or auditor, or a principal financial officer, controller or principal accounting officer does not, by itself, justify the board of directors in deeming the person to be an audit committee financial expert.
 - An audit committee financial expert must embody the highest standards of personal and professional integrity. A board should consider any disciplinary actions to which a potential expert is, or has been, subject in

determining whether that person would be a suitable audit committee financial expert.

- In response to comments, the final rules provide that experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements can provide a person with the requisite expertise. Accordingly, persons with such experience serving in governmental, self-regulatory and private-sector bodies overseeing the banking, insurance and securities industries may qualify as a financial expert.
- In general, the board is not required to disclose the basis for its determination of a person as a financial expert. However, if it determines that an audit committee member acquired the required expertise through “other relevant experience,” the company must briefly list that experience in its disclosure.

Safe Harbor From Liability for Audit Committee Financial Experts

Responding to concerns that designation as a financial expert could expose the director to additional liability, the final rule includes the following safe harbor:

- (i) A person who is determined to be an audit committee financial expert will not be deemed an expert for any purpose, including for purposes of Section 11 of the Securities Act of 1933.
- (ii) The designation of a person as an audit committee financial expert does not expand the duties, obligations and liability otherwise imposed on such person as a member of the audit committee and board of directors in the absence of such designation.
- (iii) The designation of a person as an audit committee financial expert does not affect the duties, obligations or liability of any other member of the audit committee or board of directors.

Code of Ethics

Disclosure Requirement

The final rules implementing Section 406 of the Act require companies to disclose in their annual reports whether they have adopted a written code of ethics that applies to their principal executive officer, principal financial officer, and principal accounting officer or controller, or persons performing similar functions. If a company has not adopted such a code of ethics, it must disclose the reasons why not.

- As previously proposed, the SEC has extended the requirement that would have applied under the Act only to senior financial officers to a company's CEO as well. Codes that comply with the specific requirements may be separate or part of a broader code that addresses additional issues and applies to additional persons, such as all executive officers, employees and/or directors.
- In addition to providing the required disclosure, a company would have to either
 - file a copy of its code of ethics as an exhibit to its annual report;
 - post the text of such code of ethics on its internet website and disclose, in its annual report, its internet address and the fact that it has posted such code of ethics on its internet website;⁹ or
 - undertake in its annual report filed with the SEC to provide to any person without charge, upon request, a copy of such code of ethics and explain the manner in which such request may be made.

Commentary:

- Although the SEC's rules do not require companies to adopt codes of ethics, or to amend their existing codes, they would only be able to disclose having a qualified code if it complies with the SEC's standards. Companies with pre-existing codes of ethics should therefore review their codes to ensure that they comply with the proposed standards.
- The SROs have proposed requirements that listed companies formally adopt codes of business conduct and ethics that would be applicable to all **directors, officers and employees.**¹⁰ Additionally, it is likely that this requirement will also be applied by the SROs to foreign private issuers.

⁹ Inclusion of such website does not, by itself, include or incorporate by reference information on the company's website into the annual report. If a company has multiple websites, it should post the code of ethics to the website used for investor relations.

¹⁰ Waivers granted to directors and executive officers would require prompt disclosure. The NYSE proposal contains a list of areas to be addressed by codes of conduct that, on its face, is more extensive than the SEC rule (e.g., confidentiality and fair dealing). See proposed subsection 10 of Section 303A of the NYSE's Listed Company Manual. The NYSE is likely to revise its proposal in light of the final SEC rules. NASDAQ recently revised its proposal in light of the SEC proposed rules implementing Section 406 of the Act. NASDAQ's proposed rules require that any waivers for directors or executive officers be approved by the Board. See proposed NASD Rule 4350(m) (as filed with the SEC on January 15, 2003 and available on the NASDAQ website). See the AMEX Press Release for the AMEX proposed requirement.

Code of Ethics Standards

The final rule defines “code of ethics” as written standards that are reasonably designed to deter wrongdoing and to promote:

- (i) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
 - (ii) full, fair, accurate, timely, and understandable disclosure in reports and documents that a registrant files with, or submits to, the SEC and in other public communications made by the registrant;
 - (iii) compliance with applicable governmental laws, rules and regulations;
 - (iv) the prompt internal reporting of violations of the code to an appropriate person or persons identified in the code;¹¹ and
 - (v) accountability for adherence to the code.
- While a company’s code of ethics must address each of these standards, the SEC has not mandated any specific language or procedures or the types of sanctions that companies should impose for ethics code violations, noting that ethics codes will and should vary from company to company.
 - o The SEC further encourages companies to adopt codes that are broader and even more comprehensive than that mandated by these new rules.
 - The final definition eliminated a separate component requiring a code to promote the avoidance of conflicts of interest, including disclosure to an appropriate person or persons of any material transaction or relationship that reasonably could be expected to give rise to such a conflict, since such conduct is already addressed by the first prong of the proposed definition, requiring the ethical handling of actual and apparent conflicts of interest.

¹¹ The SEC recommends that the person appointed to handle conflicts of interest should have “sufficient status within the company to engender respect for the code and the authority to adequately deal with the persons subject to the code regardless of their stature in the company.” These considerations would also apply to the person appointed to receive reports of code violations.

Immediate Disclosure of Amendments and Waivers

The final rule has added the following items to the list of Form 8-K triggering events that require disclosure:

- The nature of any amendment to the code of ethics that applies to the officers required to be subject to the code of ethics; and
- The nature of any waiver, including an implicit waiver, from a provision of the code of ethics for one of these officers or persons, with a description of the nature of the waiver, the name of the person to whom the waiver was granted, and the date of the waiver.
 - “*Waiver*” means the approval of a material departure from a provision of the code of ethics, and “*implicit waiver*” means the failure to take action within a reasonable period of time regarding a material departure from a provision of the code of ethics that has been made known to an executive officer.
 - Only amendments or waivers relating to required elements of the code and specified officers must be disclosed. A waiver of a provision applicable only to directors, for example, would not be required to be disclosed.
 - Only substantive amendments need to be disclosed, not technical or administrative amendments.
- The company must file a Form 8-K with this disclosure within five business days after the amendment is made or waiver is granted. Alternatively, the company may disclose the required information on its internet website within five business days following the date of the amendment or waiver, but only if it has disclosed in its most recently filed annual report its internet address and intention to provide disclosure in this manner.
- If the registrant elects to disclose the information required by this item through its website, such information must remain available on the website for at least a 12-month period. Following such 12-month period, the registrant must retain the information for a period of not less than five years and furnish it to the SEC upon request.

Commentary:

- Last June, the SEC proposed a significant reorganization of Form 8-K along with the addition of a number of items that would require immediate disclosure on Form 8-K and an accelerated filing deadline of two business days.¹² To be consistent with this still pending proposal, the SEC originally proposed that amendments to, and waivers

¹² See SEC Release No. 33-8106 (June 17, 2002).

from, codes of ethics be disclosed within two business days. In these rules, the SEC has provided for a longer filing deadline, but has indicated that the period may be shortened when it considers the other Form 8-K proposals.

Foreign Companies

Audit Committee Financial Expert

Similar to domestic companies, foreign private issuers will be required in their annual reports to disclose if a member of their audit committee was a financial expert as determined by the board of directors. However, foreign private issuers will not be required to determine whether or not such a member is “independent” until the audit committee listing requirements mandated by Section 301 of the Act are adopted.

- Under the Act, these rules must be adopted by April 26, 2003. Since the definition of “independence” under Section 301 will then be finalized, we expect that foreign private issuers will be required to make and disclose this independence determination the first time that the overall audit committee financial expert disclosure is made, in the first annual report covering the fiscal year ending on or after July 15, 2003.
- As part of the proposed rules implementing Section 301, special accommodations were made for foreign private issuers that have statutory auditors or a board of auditors. The SEC is soliciting comment on if and how the independence disclosure requirement should apply to such foreign private issuers.

Code of Ethics

Foreign private issuers will be subject to the same disclosure rules as domestic issuers regarding adoption of codes of ethics for senior officers. However, disclosure of amendments to, or waivers from, a code of ethics are only required to be disclosed in the foreign company’s annual report.

- Though not required, the SEC strongly encourages foreign private issuers to promptly disclose such events on a Form 6-K or their internet website.

Transition Provisions

- The audit committee financial expert and code of ethics disclosure requirements will apply beginning with annual reports for fiscal years ending on or after July 15, 2003.
- Disclosure of amendments to, and waivers from, ethics codes are required on or after the filing date of the first annual report that includes disclosure about a company’s code of ethics.

- Recognizing that smaller businesses may have the greatest difficulty attracting qualified audit committee financial experts, small business issuers must comply with the audit committee financial expert disclosure requirements in their annual reports for fiscal years ending on or after December 15, 2003.

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If you wish to obtain additional information regarding these new rules or other initiatives, assistance in developing a detailed program to help ensure compliance or copies of any of our previous client memoranda, please contact John S. D'Alimonte (212-728-8212, jd'alimonte@willkie.com), Yaacov M. Gross (212-728-8225, ygross@willkie.com), Jeffrey S. Hochman (212-728-8592, jhochman@willkie.com), or the partner who regularly works with you.

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EXHIBIT A

The SEC has noted that the board of directors of a reporting company should consider the following “factors,” in addition to all available facts and circumstances, in making the determination of whether a member of the audit committee qualifies as an “audit committee financial expert”:

- a. Accounting and financial education of a person, including any advanced degrees in these fields;
- b. Whether the person is a certified public accountant, or the equivalent, in good standing, and the length of time that the person actively has practiced as a certified public accountant, or the equivalent;
- c. Whether the person is certified or otherwise identified as having accounting or financial experience by a recognized private accounting standards body, whether that person is in good standing with the recognized private body, and the length of time that the person has been actively certified or identified as having this expertise;
- d. Whether the person has served as a principal financial officer, controller or principal accounting officer of a company that files periodic reports under the Exchange Act, and if so, for how long;
- e. The person’s specific duties while serving as a financial officer;
- f. The person’s level of familiarity and experience with all applicable laws and regulations regarding the preparation of financial statements that must be included in periodic reports filed under the Exchange Act;
- g. The level and amount of the person’s direct experience reviewing, preparing, auditing or analyzing financial statements that must be included in periodic reports filed under the Exchange Act;
- h. The person’s past or current membership on one or more audit committees of companies that, at the time the person held such membership, were required to file periodic reports filed under the Exchange Act;
- i. The person’s level of familiarity and experience with the use and analysis of financial statements of public companies;
- j. Whether the person has any other relevant qualifications or experience that would assist him or her in understanding and evaluating the company’s financial statements and other financial information and to make knowledgeable and thorough inquiries whether:

- o The financial statements fairly present the financial condition, results of operations and cash flows of the company in accordance with generally accepted accounting principles; and
 - o The financial statements and other financial information, taken together, fairly present the financial condition, results of operations and cash flows of the company; and
- k. In the case of a foreign private issuer, the person's level of experience in respect of public companies in the foreign private issuer's home country, generally accepted accounting principles used by the issuer, and the reconciliation of financial statements with U.S. generally accepted accounting principles.