

Client Alert

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for clients
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of the firm **January 2003**

SEC Has Adopted Rules Requiring Codes Of Ethics For Chief Executive Officers and Senior Financial Officers; and Disclosure About Audit Committee Financial Experts¹

The Securities and Exchange Commission, in Rel. 33-8177 (January 23, 2003) (the "Adopting Release"), adopted rules to implement Sections 406 and 407 of the Sarbanes-Oxley Act.

These rules, which apply to both domestic and foreign companies subject to requirements for filing periodic reports with the SEC, will become effective 30 days after their publication in the *Federal Register*, but companies will only be required to provide this disclosure in annual reports for fiscal years ending on or after July 15, 2003 (December 15, 2003, for small business issuers).

The SEC also has asked for additional comment as to whether the disclosure requirements with respect to the audit committee financial expert should apply to foreign companies that would be exempt from SRO audit committee member independence standards under separate SEC proposals. (See Rel. 33-8173) This comment period expires 30 days after the Adopting Release is published in the *Federal Register*.

Codes of Ethics for CEOs and Senior Financial Officers

These rules, in part, are required by Sec. 406 of Sarbanes-Oxley.

Sarbanes-Oxley

Sec. 406(a) and (b) of Sarbanes-Oxley direct the SEC, by January 26, 2003, to adopt final rules requiring both domestic and foreign companies subject to periodic reporting under section 13(a) or 15(d) of the Exchange Act to disclose:

- Whether or not they have a code of ethics for their senior financial officers (CFOs) and "comptroller"² or principal accounting officers (CAOs) or persons performing similar functions.
- "Immediately," on Form 8-K, "any" change in or waiver of this code of ethics, including an implicit waiver by inaction.

Under Sec. 406(c) of Sarbanes-Oxley, the term "code of ethics" means such standards as are reasonably necessary to promote:

- Honest and ethical conduct, including ethical handling of actual or apparent conflicts of interest between "personal and professional relationships";
- Full, fair, accurate, timely and understandable disclosure in periodic reports; and
- Compliance with applicable governmental laws, rules and regulations (according to the SEC, including compliance with "up the ladder" reporting by lawyers under Sec. 307 of Sarbanes-Oxley and the SEC's rules).³

¹ Issuers of asset-backed securities are not subject to these rules. In addition, the SEC deferred consideration of proposals to require an annual report by management regarding internal controls for financial reporting and related CEO and CFO certification requirements proposed in Rel. 33-8173.

² In its rules, the SEC has defined the term "comptroller" as "controller".

³ See Rel. 33-8138, footnote 68.

SEC rules - Items 406 of Regulations S-B and S-K, Item 16B of Form 20-F and General Instruction B(9) of Form 40-F⁴

The SEC rules go beyond Sec. 406 of Sarbanes-Oxley, in that they also address codes of ethics for principal executive officers (CEOs) and they add the following two items (in addition to the three required by Sec. 406) that the standards of the code of ethics must be reasonably necessary to promote:

- Prompt internal reporting to an appropriate person or persons, identified in the code of ethics, of violations of the code;⁵ and
- Accountability for adherence to the code of ethics.⁶

Also, the SEC expanded the disclosure related provision to require full fair, accurate, timely and understandable disclosure in reports or documents that the company files with, or "submits to," the SEC and "other public communications" made by the company.

The code of ethics should apply to the Company's principal executive officer (CEO), principal financial officer (CFO), principal accounting officer (CAO) or "controller" ("comptroller" in Sec. 406) or persons performing similar functions ("Covered Persons").

The SEC's rules require disclosure as to whether the company has adopted a written code of ethics for the Covered Persons and, if not, the reasons why it has not done so. The code of ethics is required to be filed as an exhibit to the company's annual report or provided on its internet website or disclosed as otherwise provided in the rule. As an alternative to filing the code of ethics as an exhibit or posting it on its website, a company may undertake in its annual report to provide a copy of the code of ethics to any person on request and without charge.

Although the rules do not specify the form or content of the code of ethics, it must address the items discussed above. Some companies may have existing codes of ethics that satisfy these requirements.

Any change in the code of ethics or waiver (including an "implicit" waiver by inaction)⁷ of a provision of the code of ethics with respect to a Covered Person, who would have to be identified, despite any privacy concerns, would be required to be disclosed within five business days pursuant to Item 10 of Form 8-K or, in the alternative, within five business days of the event on the company's website. The alternative of website disclosure only can be used if the company has disclosed in its most recent annual report on Form 10-K, 10-KSB, 20-F or 40-F that it intends to disclose these events on its website and its website address. The website disclosure must remain available on the website for 12 months after it is posted. Thereafter, it must be retained and made available to the SEC on request for five years.

We expect that some companies may make the required information available on its website and also include the information in a Form 8-K pursuant to Item 10 of that Form, or any successor items.

It should be noted that requirement to report these waivers amendments is not subject to any materiality standard, but technical, administrative and other non-substantive amendments are not required to be disclosed.

Foreign Companies

The annual report, website or other disclosure requirements apply to foreign private issuers, including Canadian issuers filing reports on Form 40-F. However, foreign private issuers are not required to file current reports on Form 8-K. Therefore, the required disclosure of changes or waivers of their codes of ethics with respect to covered persons would be required only annually in Forms 20-F (Item 16B) or 40-F (General Instruction B(9)) or on the company's website. However, the SEC strongly encourages foreign private to disclose these waivers or changes on Forms 6-K.

Small business issuers

These rules apply to small business issuers, with the transition relief mentioned above.

⁴ This requirement and the requirement for disclosure about "financial experts" discussed below apply U.S. standards under the SEC's Multi-jurisdictional Disclosure System, which generally relies on Canadian requirements.

⁵ Sec. 301 of Sarbanes-Oxley (section 10A(m) of the Exchange Act) requires the SEC to direct the national securities exchange and Nasdaq to adopt listing standards that require the audit committee to establish procedures for the receipt, retention and treatment of complaints received by the company regarding accounting, internal accounting controls or auditing matters. Section 10A(m) also requires the audit committee to establish procedures for the confidential, anonymous submission by employees of the company of concerns about questionable accounting and auditing matters. On January 9, 2003, in Rel. 33-8173, the SEC proposed rules to implement these provisions. In addition, Sec. 806 of Sarbanes-Oxley provides protection under the criminal code for employees of public companies who provide evidence of fraud. Companies should develop policies to protect these "whistleblowers." All companies should integrate or coordinate these audit committee responsibilities and whistleblower protections with the required code of ethics.

⁶ This could include dismissal or other corporate actions.

⁷ A "waiver" is the approval by the company of a material departure from the Code. An "implicit waiver" is a company's failure to take action within a reasonable time regarding a material departure from the code that has been made known to one of its executive officers.

Disclosure About "Audit Committee Financial Experts"

These rules, in part, are required by Sarbanes-Oxley.

Sarbanes-Oxley

Sec. 407(a) of Sarbanes-Oxley required the SEC to adopt rules by January 26, 2003, requiring a company subject to reporting under sections 13(a) or 15(d) of the Exchange Act to disclose whether or not its audit committee includes at least one member who is a "financial expert," as such term is defined by the SEC.⁸

The SEC rules define an audit committee financial expert as a person who has the following attributes:

- An understanding of generally accepted accounting principles and financial statements⁹;
- The ability to assess the general application of those principles in connection with the accounting for estimates, accruals and reserves;
- Experience in the preparation, auditing of financial statements that present a breadth and level of complexity of accounting issues that generally are comparable to the breadth and complexity of issues that reasonably can be expected to be raised by the company's financial statements or experience "actively"¹⁰ supervising persons engaged in such activities.
- An understanding of internal accounting controls; and
- An understanding of audit committee functions.

A person must have acquired the attributes described above through:

- 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 performance of similar functions;

- Experience "actively" supervising one or more of the persons mentioned immediately above;
- Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or
- Other relevant experience (The company is not required to disclose the board of directors basis for its determination that a person has this experience.

In addition, although not provided in the rule, the SEC has stated that the board of directors should consider disciplinary actions to which a potential audit committee financial expert is or has been subject to. (See Adopting Release I.A.4.C).

SEC rules -- Item 401(e) of Regulations S-B and Item 401(h) of Regulation S-K, Item 16A of Form 20-F and General Instruction B(8) of Form 40-F

The SEC rules differ in some respects from the provisions of Sec. 407. They require a company, including a majority owned subsidiary that is a public company to disclose in its Form 10-K or 10-KSB or Form 20 or 40-F, but not in quarterly reports:

- The name of the individual that the company's board of directors has determined to be an audit committee financial expert serving on the "audit committee" (A company does not have to name more than one audit committee financial expert, even if it has identified more than one.);¹¹ and
- Whether the audit committee financial experts are "independent," as that term is defined in the SEC's proxy rules by reference to SRO independence listing standards, and, if not, and explanation of why not.¹²

If a company does not have a financial expert serving on its audit committee, it must explain why it does not. One explanation could be that the audit committee has the authority to retain a financial expert if it determines the need for one.

⁸ The SEC's rules do not mandate that a company have a financial expert on its audit committee. However, the NYSE has proposed that at least one member of the audit committee must be a financial expert. It so far has deferred to the SEC's definition of financial expert. The NASD also would require at least one member of the audit committee of a company with securities admitted to the Nasdaq Stock Market to be a "financial expert," but it so far has deferred to the SEC's definition of that term. These SROs may not require that their listed companies have an "audit committee financial expert" as defined by the SEC, but may use a less restrictive definition. The SROs rules are not expected to be adopted for some months and would not be effective until 2004. If these proposed listing standards are adopted, it will become mandatory for a listed company to have a financial expert on its audit committee.

⁹ Under the SEC's rule, a financial expert familiar with home country GAAP need not be familiar with reconciliation of that home country GAAP to U.S. GAAP.

¹⁰ "Actively" supervising means that the person supervising must be actively involved in these accounting issues. Thus, a CEO would not be presumed to qualify as an audit committee financial expert, although a CEO could qualify.

¹¹ The term "audit committee" is defined in section 3(a)(58) of the Exchange Act, as amended by Sec. 2(a)(3) and 205 of Sarbanes-Oxley to mean:

(A) A committee (or equivalent body) established by and among the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of financial statements of the issuer; and
(B) If no such committee exists . . . the entire board of directors.

¹² These SRO independence rules could change if pending SRO proposals are adopted. Any such change is not expected to take effect until 2004. Section 10A(m), as added by Sec. 301 of Sarbanes-Oxley, however, defines the term "independence," as it relates to members of an audit committee to mean that:

- Each member of the audit committee is a member of the board of directors;
- Members of the audit committee may not accept any consulting, advisory or other compensatory fee from the issuer, other than in their capacities as members of the board of directors or a committee of the board of directors, including the audit committee; and
- No member of the audit committee may be any affiliate of the issuer or any of its subsidiaries.

Safe harbor

The SEC had stated in the Proposing Release Rel. 33-8138 that "the mere designation of the financial expert should not impose a higher degree of individual responsibility or obligation on a member of the audit committee" and that the SEC does not intend that such a person would be an "expert" for purposes of the liability provisions of section 11 of the Securities Act of 1933 "solely" as the result of being designated as a financial expert. The SEC also stated in the Adopting Release that it does not intend for the financial expert designation to decrease the duties and obligations of the other members of the audit committee. The SEC final rules codified these positions in a "safe harbor" rule. (See Adopting Release I.A.5)

The disclosure required by Item 401 must be included in Part III of Form 10-K and 10-KSB. Thus, if included in a proxy statement filed within 120 days at the end of the company's fiscal year, the disclosure could be incorporated by reference in the annual report. Otherwise, the disclosure must be included in the Form 10-K or Form 10-KSB or an amendment to that report.¹³

Foreign Companies

Foreign private issuers are subject to this requirement and the board of directors of a foreign private issuer should consider a person's experience with the issuer's home country GAAP.

In the case of foreign private issuers that have been two-tier boards of directors, the term "board of directors" means the supervisory or non-management board.¹⁴

Small business issuers

These rules apply to small business issuers, with the transition relief mentioned above. Also, small business issuers will not have to provide disclosure about audit committee financial experts in their first annual reports after an IPO.

Conclusion

These rules further add to the burden on public companies imposed by Sarbanes-Oxley and the SEC's rules. However, they are intended to help restore investor confidence and this benefit may outweigh these burdens.

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Client Alert

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¹³ In Rel. 33-8173, the SEC proposed rules to implement the provisions of Sec. 301. Thus, the SRO rules, at a minimum will have to comply with Sec. 301.

¹⁴ Foreign issuers are not required to file their proxy statements with the SEC, and, thus, must include this disclosure in their Forms 20-F or 40-F. Also, the SEC has proposed rules that would require disclosure by domestic companies, in Forms 8-K, of the arrival or departure of a director within two business days that would apply to the arrival or departure of "financial experts" on the audit committee. See Rel. 33-8106 (June 17, 2002). Foreign private issuers are required to report the arrival or departure of a financial expert in their annual report but are not subject to current reporting on Form 8-K. If the arrival or departure of a financial expert is a material event and is publicly disclosed, a foreign company would be required to "furnish" the information to the SEC on a form 6-K.