

January 31, 2003

## SEC Adopts Rules for Disclosure Regarding Codes of Ethics and Audit Committee Financial Experts

The SEC has adopted rules implementing Sections 406 and 407 of the Sarbanes-Oxley Act of 2002 (the "Act"). These rules require each SEC reporting company, U.S. and non-U.S., to:

- disclose in its annual SEC filing whether it has adopted a code of ethics for its principal executive officer and senior financial officers, or if not, why not; and disclose amendments to, and waivers from, the code of ethics relating to any of those officers; and
- disclose in its annual SEC filing the determination of its board of directors as to whether or not the company has at least one "audit committee financial expert" serving on its audit committee; if not, why not; and if so, the name of such expert and whether or not the person is independent of management.

The disclosure called for by the new rules will be required in annual reports for fiscal years ending after July 15, 2003.

### I. Disclosure Regarding Codes of Ethics

#### A. Required Disclosure

The SEC has added new Item 406 to Regulation S-K, and similar disclosure requirements to Forms 20-F and 40-F, requiring a reporting company to disclose in its annual report:

- whether the company has adopted a code of ethics that applies to the company's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions; and
- if the company has not adopted such a code of ethics, the reasons why it has not done so.

In addition to providing the required disclosure, the new rules require a reporting company to either:

- file a copy of its code of ethics as an exhibit to its annual report;
- post the text of its code of ethics on its Internet web site, provided that the company discloses its Internet address and its intention to provide disclosure in this manner in its annual report; or
- provide an undertaking in its annual report to provide a copy of its code of ethics to any person without charge upon request.

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New Item 406 goes beyond the requirements of Section 406 of the Act in expanding the coverage of the code of ethics disclosure to a company's principal executive officer as well as its senior financial officers.

#### **B. Definition of Code of Ethics**

For purposes of this new disclosure item, the term "code of ethics" is defined as a codification of standards that is reasonably designed to deter wrongdoing and to promote:

- honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
- full, fair, accurate, timely, and understandable disclosure in reports and documents that a company files with, or submits to, the SEC and in other public communications made by the company;
- compliance with applicable governmental laws, rules and regulations;
- the prompt internal reporting of violations of the code to an appropriate person or persons identified in the code; and
- accountability for adherence to the code.

The SEC pointed out that the fourth and fifth elements of the definition go beyond the requirements specified by Section 406 of the Act, but in a manner it believes to be consistent with the objectives of Section 406. In addition, the SEC emphasized that while it has provided minimum requirements of the code, it fully expects there to be wide variation in the codes actually adopted by different companies.

Instructions make clear that a company may have separate codes for different types of officers and that the code of ethics called for by the rules may be a portion of a broader document that addresses more topics and that applies to more persons than those specified in Item 406 (and that only the relevant portion needs to be filed as an exhibit, posted on the web site or provided).

#### **C. Disclosure Regarding Changes to, or Waivers from, the Code of Ethics**

As previously suggested in its release regarding proposed rules for accelerated disclosure of certain events on Form 8-K, the SEC has added an item to the list of Form 8-K triggering events to require disclosure by a U.S. reporting company of:

- the nature of any amendment to the company's code of ethics that applies to its principal executive officer or senior financial officers; or
- the nature of any waiver, including an implicit waiver, from a provision of the code of ethics granted by the company to one of these specified officers, the name of the person to whom the company granted the waiver and the date of the waiver.

The rules define the term "waiver" as the approval by the company of a material departure from a provision of the code of ethics. They define the term "implicit waiver" as the company's 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 of the company.

A company must file a Form 8-K within five business days after it has made a change or granted a waiver. The SEC is currently considering shortening the filing deadlines for Form 8-Ks to two days. The SEC indicated that it will consider similarly reducing the five-day requirement of the new rules to two days when it takes final action on its Form 8-K proposals.

Only amendments or waivers relating to the standards described in the definition of code of ethics and the specified officers must be disclosed. Technical, administrative and other non-substantive amendments need not be disclosed.

The SEC also provided that as an alternative to reporting this information on Form 8-K, a company may disclose this information on its own Internet web site, but only if it had disclosed in its most recently filed annual report on Form 10-K:

- that it intends to disclose these events on its Internet web site; and
- its Internet web site address.

Web site disclosure has to be made within the same five-business day time period proposed for Form 8-K filings, and the information must be kept available on the web site for a period of at least 12 months after the initial posting. The information could be removed from the web site after the 12-month posting period, but the company would have to retain the disclosure for at least five years and make it available to the SEC upon request.

#### **D. Applicability to Foreign Private Issuers**

The rules specify that foreign private issuers are required to disclose the existence of a code of ethics just as domestic reporting companies are. Because foreign private issuers are not required to file current reports on Form 8-K, the adopted rules require that a foreign private issuer disclose any change to, or waiver from, its code of ethics that applies to its senior officers made during the past fiscal year in its annual report on Form 20-F or Form 40-F, and to file any such change as an exhibit to the annual report. The SEC noted that a foreign private issuer could also make the disclosure under cover of a Form 6-K or on its Internet web site, and that it strongly encourages such prompt disclosure (without requiring it).

#### **E. Transition Period**

The SEC has provided a limited transition period for the code of ethics disclosure requirements. Companies must comply with the disclosure requirements in their annual reports for fiscal years ending on or after July 15, 2003. They must also comply with the requirements regarding disclosure of amendments to, and waivers from, their ethics codes on or after the date on which they file their first annual report in which disclosure of their code of ethics is required.

## **II. Audit Committee Financial Experts**

### **A. Background**

The SEC has also adopted disclosure requirements regarding the presence of audit committee financial experts on reporting companies' audit committees. Although the initially proposed version of the disclosure requirements referred to "financial expert," the SEC changed the term to "audit committee financial expert" in the final version of the rules to suggest more pointedly that the designated person must possess characteristics that are particularly relevant to the functions of an audit

committee. Under the adopted rules as described below, audit committee financial experts must have experience preparing, auditing, analyzing or evaluating financial statements (or experience actively supervising persons engaged in such activities) and an understanding of internal controls and procedures for financial reporting. Moreover, they must have acquired such attributes through specified education and experience.

## **B. Disclosure Requirements**

### **1. Determination of Audit Committee Financial Expert**

The adopted rules add a new Item 401(h) to Regulation S-K, and similar disclosure requirements for Forms 20-F and Form 40-F, to require reporting companies to disclose in their annual reports:

- whether the board of directors has determined that there is at least one audit committee financial expert serving on the company's audit committee;
- if so, the name of the audit committee financial expert and whether the financial expert is "independent" and if not, an explanation of why he or she is not; and
- if the company does not have an audit committee financial expert serving on its audit committee, the company must disclose that fact and explain why it has no audit committee financial expert.

Because the required new disclosure is included in Part III of Form 10-K, domestic companies that wish to do so may include the required disclosure in their annual meeting proxy statement and incorporate it by reference into the Form 10-K.

The requirement to disclose the name of the audit committee financial expert goes beyond what was required by the Act, but the SEC noted in its commentary that it believes that this information is helpful to investors in evaluating the background and business experience of a company's directors.

### **2. Affirmative Determination**

Every company subject to the audit committee disclosure requirements must determine whether or not it has at least one audit committee financial expert. A company may not disclose that its board has not made a determination as to whether or not its audit committee includes an audit committee financial expert. Furthermore, if the company's board determines that at least one audit committee member qualifies as an expert, it must disclose that fact; it is not appropriate for a company to disclose that it does not have an expert on its audit committee if the board has determined that such an expert serves on the audit committee.

The rules permit, but do not require, a company to disclose that it has more than one audit committee financial expert on its audit committee. Therefore, once a company's board determines that a particular audit committee member qualifies as an audit committee financial expert, it may, but is not required to, determine whether additional audit committee members also qualify as experts.

### 3. Independence

Although Section 407 of the Act does not require disclosure of whether an audit committee financial expert is independent, the new rules require disclosure as to whether or not the identified audit committee financial expert is independent of management.

As adopted, the new rules define independence with reference to Item 7(d)(3)(iv) of Schedule 14A, which in turn relies on the listing standards of the New York Stock Exchange, American Stock Exchange and Nasdaq.

### 4. Safe Harbor

In response to a number of comments urging the SEC to clarify that identification of an audit committee financial expert will not increase or decrease his or her duties, obligations or potential liabilities as an audit committee member, the SEC has included a safe harbor in the new audit committee disclosure rules to clarify that:

- a person who is determined to be an audit committee financial expert will not be deemed an “expert” for any purpose, including without limitation for purposes of Section 11 of the Securities Act, as a result of being designated or identified as an audit committee financial expert;
- the designation or identification of a person as an audit committee financial expert does not impose on such person any duties, obligations or liability that are greater than the duties, obligations and liability imposed on such person as a member of the audit committee and board of directors in the absence of such designation or identification; and
- the designation or identification 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.

In providing the safe harbor, the SEC emphasized that all directors bear significant responsibility under state law, none of which is altered by the new rules or the new safe harbor.

#### C. Definition of “Audit Committee Financial Expert”

The instructions to Item 401(h) of Regulation S-K define the term “audit committee financial expert” to mean a person who has the following attributes:

- an understanding of generally accepted accounting principles and financial statements;
- the ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;
- 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;
- an understanding of internal controls and procedures for financial reporting; and

- an understanding of audit committee functions.

An audit committee financial expert must possess all five attributes included in the definition of audit committee financial expert.

Under the final rules, a person must have acquired such attributes through any one or more of the following:

- 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;
- experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;
- 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 (a brief description of which must be disclosed if it is the basis for the person being considered an audit committee financial expert).

The attributes represent a broadening of the group of persons that would qualify as an “audit committee financial expert” when compared to the SEC’s initially proposed rules. For example, the second attribute, as adopted, eliminates portions in the original proposal that called for the expert to have experience “applying” accounting principles (as opposed to the “ability to assess the general application” of accounting principles) that are generally comparable to those used in the company’s financial statements. In addition, the third attribute as adopted includes “analyzing or evaluating” in addition to “preparing or auditing” financial statements and includes persons with experience “actively supervising” these activities as well as engaging in them directly. This change reflects the SEC’s recognition that people engaged in investment banking, venture capital investment and other activities have significant direct exposure to, and experience with, financial statements. The SEC indicated that it does not intend the “generally comparable” language in the third attribute to require that a person have previous experience in the same industry as the company, or that the person’s experience must have been with a company subject to Exchange Act reporting requirements. Rather, this attribute is meant to focus on the breadth and level of complexity of accounting issues with which the person has experience.

According to the adopting release, the term “active supervision” means more than the mere existence of a traditional hierarchical reporting relationship between supervisor and those being supervised. Rather, it means that a person engaged in active supervision participates in, and contributes 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. A principal executive officer should not be presumed to qualify. A principal executive officer with considerable operations involvement, but little financial or accounting involvement, likely would not be exercising the necessary active supervision. Active participation in, and contribution to, the process, albeit at a supervisory level, of addressing financial and accounting issues that demonstrates a general expertise in the area would be necessary.

The SEC added a provision in response to comments 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 in-depth knowledge and experience of accounting and financial issues. For example, certain individuals serving in governmental, self-regulatory and private-sector bodies overseeing the banking, insurance and securities industries work on issues related to financial statements on a regular basis.

The original proposal stated that a person who had not served in one of the specified positions alternatively could have acquired the relevant attributes and experience in a position that results, in the judgment of the board of directors, in the person's having similar expertise and experience. The final rules state simply that a person may acquire the necessary attributes of an audit committee financial expert through other relevant experience, and no longer require the company to disclose the basis for the board's determination that a person has "similar expertise and experience." Because the board is already required to make the determination as to whether a person qualifies as an expert, this reference is redundant and was eliminated in the final version of the rules.

Previous service on a company's audit committee will not by itself "grandfather" a person as an audit committee financial expert under the definition. Similarly, the fact that a person has experience as a public accountant or auditor, or a principal financial officer, controller or principal accounting officer or experience in a similar position does not, by itself, justify the board of directors in deeming the person to be an audit committee financial expert. In addition to determining that a person possesses an appropriate degree of knowledge and experience, the SEC has stated that the board must ensure that it names an audit committee financial expert who embodies the highest standards of personal and professional integrity. In this regard, the SEC has stated that 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.

The Act does not explicitly state who at a company should determine whether a person qualifies as an audit committee financial expert. The SEC indicated that it chose the board in its entirety to make the determination because the board is the most broad-based body within a company and is therefore best-equipped to make the determination. The SEC also indicated its view that any such determination be subject to relevant state law principles such as the business judgment rule. The SEC has added an instruction stating that, in the case of a foreign private issuer, the term "board of directors" means the supervisory or non-management board for companies with two-tier boards.

#### **D. Foreign Private Issuers**

The final rules do not require foreign private issuers to disclose whether its audit committee financial expert is independent. Unlike domestic issuers, foreign private issuers currently are not required to disclose whether their audit committee members are independent. Imposing the independence disclosure requirement immediately may compel a foreign private issuer to disclose that its expert is not independent under the new definition even though there has been no prior context in which that issuer has been required to consider the SEC's definition of the term. In addition, immediate imposition of the SEC's current definition of "independent" would require foreign private issuers to familiarize themselves with rules which the SEC expects to revise within one annual reporting period. However, in conjunction with the adoption of rules under Section 301 of the Act, which will apply to foreign private issuers, the SEC intends to amend Forms 20-F and 40-F to require such disclosure.

#### **E. Transition Period**

The SEC has provided a limited transition period for complying with the audit committee financial expert disclosure requirements. Companies, other than small business issuers, must comply with the audit committee financial expert disclosure requirements in their annual reports for fiscal years ending on or after July 15, 2003. Because 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.

### **III. Applicability of Proposed Rules to Certain Issuers**

#### **A. Registered Investment Companies**

The SEC had proposed similar disclosure rules relating to codes of ethics for all registered investment companies (whether or not they are reporting companies) to those for operating companies. In adopting final rules regarding Sections 406 and 407 of the Act, the SEC indicated that it would take separate action with respect to registered investment companies. On January 22, 2003, the SEC approved amendments relating to codes of ethics and audit committee financial experts for investment companies. Although the final rules have not been published, the SEC has stated that the amendments will be similar to those adopted for operating companies.

#### **B. Asset-Backed Security Issuers**

Because asset-backed security issuers are not required to file financial statements like other reporting companies, the SEC has excluded them from the audit committee financial expert disclosure requirement.

### **IV. Opportunity to Comment on Further Proposal Regarding Foreign Private Issuers with Boards of Auditors or Statutory Auditors**

In the adopting release, the SEC made an additional request for comment on the application of the independence disclosure requirement to foreign private issuers. The comment period ends February 18, 2003.

In the release implementing Section 301 of the Act, the SEC proposed a special accommodation for certain audit committee requirements for foreign private issuers with a board of auditors or statutory auditors under home country legal or listing provisions, subject to certain conditions. Specifically, foreign private issuers with boards of auditors or similar bodies or statutory auditors meeting the requirements of the SEC's proposals would be exempt from the requirements regarding the independence of audit committee members. The SEC has requested comment on whether the disclosure requirements related to audit committee financial experts should apply to such issuers.

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The summary of the newly adopted rules set forth herein is intended to be general in nature. This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any member of the Paul Weiss Securities Group, including:

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