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SEC Proposes Rules on Codes of Ethics and Disclosure of "Financial Experts"

The SEC has proposed rules implementing Sections 406 and 407 of the Sarbanes-Oxley Act of 2002 (the "Act"). These proposed rules would require each SEC reporting company, whether U.S. or 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 it has not, why it has 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 number and names of the "financial experts" serving on its audit committee, and whether or not they are independent of management, as determined by the company's board of directors.

I. Disclosure Regarding the Code of Ethics

A. Background

Section 406(a) of the Act directs the SEC to issue rules requiring a reporting company to disclose whether or not the company has adopted a code of ethics for its senior financial officers that applies to the company's principal financial officer and controller or principal accounting officer, or persons performing similar functions. The Act states that the rules also must require companies that have not adopted such a code of ethics to explain why they have not done so.

The Act defines the term "code of ethics," as used in Section 406, to mean such standards as are reasonably necessary 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 the periodic reports required to be filed by the issuer; and
- compliance with applicable governmental rules and regulations.

Section 406(b) of the Act further directs the SEC to require a reporting company to immediately disclose on Form 8-K, or by Internet or other electronic means of dissemination, any change in, or waiver of, a provision of its code of ethics for its senior financial officers.

B. Disclosure of Code of Ethics

The proposed rules would add a new Item 406 to Regulation S-K, and similar disclosure requirements for Forms 20-F and 40-F, to require a reporting company to disclose:

- whether the company has adopted a written 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 it has not done so.

In addition to providing the required disclosure, a company also would have to file a copy of its ethics code as an exhibit to its annual filing.

The SEC's proposal goes beyond the requirements of Section 406 of the Act in expanding the coverage of the code of ethics to a company's principal executive officer as well as its senior financial officers and in defining what is required in a code of ethics in greater detail.

C. Definition of Code of Ethics

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

1. honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
2. avoidance of conflicts of interest, including disclosure to an appropriate person or persons identified in the code of any material transaction or relationship that reasonably could be expected to give rise to such a conflict;
3. 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;
4. compliance with applicable governmental laws, rules and regulations;
5. the prompt internal reporting to an appropriate person or persons identified in the code of violations of the code; and
6. accountability for adherence to the code.

The SEC pointed out that the second, fifth and sixth elements of the proposed 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 has emphasized that while it has provided minimum requirements of the code, it fully expects there to be wide variations.

D. 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 in Form 8-Ks, the SEC has proposed adding an item to the list of Form 8-K triggering events to require disclosure of:

- a change to a company's code of ethics that applies to the principal executive officer or senior financial officers; or
- a grant of a waiver of an ethics code provision to any such specified officer.

The company would have to file the Form 8-K within two business days after it made the change or granted the waiver.

The SEC has also proposed 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 would have to be made within the same two-business day time period proposed for Form 8-K filings, and the information would have to 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.

E. Applicability to Foreign Private Issuers

The proposed 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 SEC has proposed requiring 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 has also 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 plans to strongly encourage such prompt disclosure (without requiring it).

II. "Financial Experts" on Audit Committees

A. Background

Section 407 of the Act directs the SEC to adopt rules requiring reporting companies to disclose in their periodic reports whether or not their audit committees include one member that is a financial expert, and defining the term "financial expert." It also specifies several attributes to be considered in crafting the definition. Although various stock exchanges and the Nasdaq already have rules regarding the financial expertise of audit committee members, not all reporting companies are subject to these requirements. The attributes specified in Section 407 of the Act are also more detailed and rigorous than those reflected in the current rules of the stock exchanges and Nasdaq.

The SEC has now proposed disclosure requirements regarding audit committee financial experts and a definition of "financial expert" that may disqualify certain individuals who previously qualified as a financial expert under the broader guidelines of stock exchange or Nasdaq rules. In particular, under the proposed rules as described below, financial experts must have had experience preparing or auditing financial statements of a company that files reports with the SEC and experience with internal controls and procedures for financial reporting (or similar expertise and experience in the board of directors' judgment). The SEC has also stated that it will attempt to reconcile the definitions of "financial expert" used by the various stock exchanges and Nasdaq to the extent possible.

B. Disclosure Requirements

The proposed rules would add a new Item 309 to Regulation S-K, and similar disclosure requirements for Forms 20-F and Form 40-F, to require a reporting company to disclose annually:

- the number and names of persons that the board of directors has determined to be the financial experts serving on the company's audit committee; and
- whether the financial expert or experts are "independent" and if not, an explanation of why they are not. For this purpose, "independent" would mean, among other things, that other than in his/her capacity as a member of the board or a board committee, such person does not receive any consulting, advisory or other compensatory fee from the issuer and is not an affiliated person of the issuer or any subsidiary of the issuer.

If the company does not have a financial expert serving on its audit committee, the company must disclose that fact and explain why it has no financial expert.

The requirement to disclose the number and names of the financial experts is beyond what was required by the Act, but the SEC notes in its commentary that it believes that this information is helpful to investors in evaluating the background and business experience of the company's directors.

The SEC stated that the mere designation as a financial expert should not impose a higher degree of individual responsibility or obligation on such a member of the audit committee, nor decrease the duties and obligations of other audit committee members or the board of directors. In addition, an individual is not considered an "expert" for purposes of Section 11 of the Securities Act solely as a result of his or her designation as a financial expert on the audit committee.

Section 407 of the Act also does not require disclosure of whether the financial expert is independent. However, the SEC has gone beyond this in its proposed rules because it believes such disclosure may be important to investors, particularly if the only financial expert on the audit committee is the company's chief financial officer or another individual who is responsible for, or participates in, the preparation of the company's financial statements.

Section 301 of the Act directs the SEC to propose rules directing the stock exchanges and Nasdaq to require a listed company to have a completely independent audit committee as a condition to listing. The proposing release states the SEC's intention to propose these rules, without making any reference to separate treatment for non-U.S. issuers. This may require non-U.S. issuers to alter their board and/or committee structures to accommodate the independence requirement. In the meantime, the reference to *audit committee* members qualifying as financial experts should, for non-U.S. issuers that do not have separate audit committees, be read as *directors* qualifying as financial experts. For non-U.S. issuers with two-tiered board structures, the supervisory or non-management board would make the determination.

C. Definition of "Financial Expert"

The SEC has proposed that the instructions to Item 309 of Regulation S-K would define the term "financial expert" to mean a person who has, through education and experience as a public accountant or auditor or a principal financial officer, controller, or principal accounting officer of a company that, at the time the person held such position, was a reporting company, or experience in one or more positions that involve the performance of similar functions (or that results, in the judgment of the company's board of directors, in the person's having similar expertise and experience), the following attributes:

- an understanding of generally accepted accounting principles and financial statements;

- experience applying such generally accepted accounting principles in connection with the accounting for estimates, accruals, and reserves that are generally comparable to the estimates, accruals and reserves, if any, used in the company's financial statements;
- experience preparing or auditing financial statements that present accounting issues that are generally comparable to those raised by the registrant's financial statements;
- experience with internal controls and procedures for financial reporting; and
- an understanding of audit committee functions.

The SEC has proposed that in determining whether a potential financial expert has all of the requisite attributes, the board of directors of a company must evaluate the totality of an individual's education and experience. The board should consider a variety of factors in making that evaluation, including:

- the level of the person's accounting or financial education, including whether the person has earned an advanced degree in finance or accounting;
- 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;
- whether the person is certified or otherwise identified as having accounting or financial experience by a recognized private body that establishes and administers standards in respect of such expertise, 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;
- whether the person has served as a principal financial officer, controller or principal accounting officer of a company that, at the time the person held such position, was a reporting company, and if so, for how long;
- the person's specific duties while serving as a public accountant, auditor, principal financial officer, controller, principal accounting officer or position involving the performance of similar functions;
- 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 reports filed under Section 13(a) or 15(d) of the Exchange Act;
- the level and amount of the person's direct experience reviewing, preparing, auditing or analyzing financial statements that must be included in reports filed under Section 13(a) or 15(d) of the Exchange Act;
- 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 reporting companies;
- the person's level of familiarity and experience with the use and analysis of financial statements of public companies; and
- whether the person has any other relevant qualifications or experience that would assist him or her in understanding and evaluating the registrant's financial statements and other financial information and to make knowledgeable and thorough inquiries whether:
    - 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

- the financial statements and other financial information, taken together, fairly present the financial condition, results of operations and cash flows of the company.

The SEC has noted also that in the case of a foreign private issuer, the board of directors should also consider the person's experience with 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.

The SEC has stated that the factors listed above are not intended to be exhaustive, nor are a minimum number of the factors required to be satisfied. A qualitative assessment of a potential expert's mix of level of knowledge and experience is what is required. The SEC has stated that it has deliberately chosen not to provide a "bright-line test" for this purpose. Previous service on a company's audit committee will not by itself "grandfather" a person as a financial expert under the SEC's proposed definition, and some individuals who are particularly knowledgeable and experienced in accounting and financial issues may have the requisite attributes and mix of knowledge and experience to qualify, even though they may not have the specific experience mentioned in the factors above.

Finally, the SEC has stated that given the important role of the audit committee in the filing of a public company's financial statements, and in filing and preparing its own report, the financial expert, if he or she is an accountant, must be practicing before the SEC, and must not have been suspended or barred from practice under Rule 102(e) of the SEC's Rules of Practice.

III. Applicability of Proposed Rules to Certain Issuers

A. Registered Investment Companies

The SEC has proposed similar disclosure rules relating to codes of ethics for all registered investment companies (whether or not they are reporting companies) to those for reporting companies. In the case of registered investment companies, the code of ethics must apply to the entity, its investment adviser and its principal underwriter (if affiliated). With respect to unit trusts, which do not have a corporate-type management structure, the code of ethics requirement is proposed to apply to the trust's sponsor, depositor, trustee or principal underwriter (if affiliated).

With respect to the disclosure of financial experts on the audit committee, the SEC has also proposed rules requiring similar disclosure for all registered management investment companies (whether or not they are reporting companies). The independence requirement of the financial expert for management investment companies has an additional requirement that the expert not be an "interested person" under the definition in Section 2(a)(9) of the Investment Company Act of 1940, as is appropriate for such companies. The financial expert requirement is not proposed to apply to unit trusts, which do not have a corporate-type management structure.

B. Asset-Backed Security Issuers and Non-Board Companies

Since asset-backed security issuers are not required to file financial statements like other reporting companies, the SEC has proposed that they be exempt from the requirement of disclosure of financial experts on their audit committees. However, some companies that do not have boards of directors and therefore do not have board audit committees, such as limited liability companies and limited partnerships that do not have a corporate general partner or an oversight body that is the equivalent of an audit committee, have not been exempted from the financial expert disclosure requirement in the SEC's proposed rules. The SEC has stated that investors should be aware that such entities do not have oversight bodies, and so such entities

must explain that their organizational structures do not provide for such a body and that therefore they do not have an audit committee.

IV. Opportunity to Comment

In the proposing release, the SEC made several requests for comment on the proposed rules. The comment period is 30 days. The SEC is required to issue final rules implementing Sections 406 and 407 of the Act by January 2003.

The Code of Ethics proposal is straightforward and should not generate controversy. Although the financial expert concept is a well-meaning one, it remains to be seen how easy it will be for boards, particularly boards of smaller companies and non-U.S. issuers, to attract a director that meets the definition of a financial expert. Although the Act does not mandate a financial expert (this is only a disclosure requirement), companies are likely to feel pressured to make the right disclosure and hence have the financial expert on their audit committee. The comment process is the appropriate forum for this concern to be raised with the SEC.

For non-U.S. issuers with securities listed in the United States, the more significant related concern will be the extent to which they will be required to have audit committees and, if so, the extent to which all of the audit committee members will have to be independent. The thrust of Section 301 of the Act is that the body that oversees the auditors is to be composed solely of members that are independent. Interestingly, in making the proposals described above, the SEC recognizes that a financial expert (and hence an audit committee member) might not be independent (hence the disclosure requirement as to independence). One possible explanation is that they were thinking only of companies that are SEC reporting companies, but are not listed (e.g., privately held companies with public debt). Were the SEC and the stock exchanges to build in exclusions for all, or certain, non-U.S. issuers from the independent audit committee requirement, the proposed disclosure requirement as to independence of the financial expert would make sense in this context as well. It remains to be seen how the SEC will address these concerns. In the meantime, it is entirely appropriate for non-U.S. issuers to raise their more general concerns through this comment process.

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The recommendations set forth herein are 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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