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SEC ADOPTS FINAL RULES UNDER THE SARBANES-OXLEY ACT: FINANCIAL EXPERTS AND CODES OF ETHICS

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On January 15, 2003, the Securities and Exchange Commission adopted final rules and revisions to SEC forms to implement Sections 406 and 407 of the Sarbanes-Oxley Act of 2002 (the "Act").[1] The final rules require each registrant to disclose:

- whether it has a "financial expert" on its audit committee and, if not, why not; and
- whether it has a code of ethics applicable to its chief executive officer and senior financial officers and, if so, any amendments and waivers with respect thereto.

The final rules differ in several key respects from the rules proposed by the SEC in October 2002 (the "Proposed Rules"),[2] including the definition of financial expert and the requirements for making codes of ethics available to the public.

The SEC has recently adopted final rules regarding several other provisions of the Act. We are preparing separate memoranda regarding these other important developments (including a separate memorandum for registered investment companies), each of which will be distributed to our mailing list and will be available upon request or at our website at *www.simpsonthacher.com*.[3]

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1 Release Nos. 33-8177 and 34-47235 (the "Release"). The SEC set forth final rules to apply the financial expert and code of ethics requirements to registered investment companies in a separate release, Release No. IC-25914, adopted on January 22, 2003.

2 The Proposed Rules were released on October 22, 2002 in Release Nos. 33-8138 and 34-46701, and were discussed in our memorandum dated November 11, 2002 entitled "*SEC Proposes Rules Pursuant to the Sarbanes-Oxley Act: Financial Experts, Codes of Ethics, Internal Controls Assessments and Improper Influence on Auditors*" (the "Proposed Rules Memorandum").

3 This memorandum supplements our earlier memoranda regarding the Act, which are available upon request or at our website at *www.simpsonthacher.com*. If you would like to be added to our mailing list, please e-mail *sbussy@stblaw.com*.

Listed companies should also be aware that each of the New York Stock Exchange and the Nasdaq Stock Market has filed with the SEC proposed new corporate governance and disclosure standards (the "Proposed NYSE Standards" and the "Proposed Nasdaq Standards," respectively) that include requirements that overlap with the SEC's rules regarding financial experts and codes of ethics. The relationship between the SEC's rules and the related Proposed NYSE Standards and Proposed Nasdaq Standards is discussed below. The Proposed NYSE Standards and Proposed Nasdaq Standards remain subject to SEC approval and may be revised prior to final approval. The SEC has stated that it intends to work towards harmonizing the Proposed NYSE Standards and Proposed Nasdaq Standards, but it has not indicated when it expects to finalize these proposed listing standards.

EXECUTIVE SUMMARY

The SEC's final rules require reporting companies to include:

- disclosure in annual reports of whether the company has at least one "audit committee financial expert" serving on its audit committee and:
  - if so, the name of the audit committee financial expert and whether the audit committee financial expert is independent of management; and
  - if not, an explanation of why the company does not have at least one audit committee financial expert; and
- disclosure in annual reports of whether the company has a code of ethics applicable to its principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions, and also requiring prompt disclosure (*i.e.*, within five business days) of any amendments to, or waivers from, the code of ethics for the specified officers.

The final rules introduce the new term "audit committee financial expert," which is defined more broadly than the term "financial expert" was defined in the Proposed Rules. The new definition has significantly expanded the range of experiences that can serve as a basis for acquiring the necessary financial and accounting expertise, including by recognizing experience with:

- *financial analysis* and *evaluation*, including as an investment banker, venture capitalist or private equity or other investment professional, or oversight at a regulatory body;
- *active supervision* of others engaged in preparing, auditing, analyzing or evaluating financial statements;

- *financial statements of companies in industries unrelated to the issuer*, as long the accounting issues raised by the other companies' financial statements present a breadth and level of complexity comparable to those raised by the company's financial statements; and

- *financial statements of non-public companies*.

These changes to the definition of audit committee financial expert substantially broaden the pool of potentially qualified candidates. Companies that are, nevertheless, unable to identify and/or nominate an audit committee financial expert should understand that the rules impose only a *disclosure* obligation. As a result, if a company remains unable to recruit an audit committee financial expert, it can, in addition to so stating, include additional disclosure that may address investor concerns, such as describing the collective financial experience of all audit committee members or disclosing an intention to retain third party expert financial services consultants to advise the audit committee in connection with complicated accounting issues. Such additional disclosure may prove beneficial from an investor relations standpoint.

With respect to the rules regarding codes of ethics, the principal difference between the proposed and final rules relates to the requirements for making the code of ethics publicly available. In addition to permitting a company to attach its code of ethics as an exhibit to its annual report, the final rules permit a company to make its code publicly available by posting it on the company's website or by sending it in response to individual requests.

EFFECTIVE DATES FOR NEW RULES

The audit committee financial expert disclosure requirements apply to annual reports filed in respect of fiscal years ending on or after July 15, 2003. In the case of small business issuers, the final rules apply for annual reports in respect of fiscal years ending on or after December 15, 2003.

The new code of ethics disclosure requirements apply for all issuers to annual reports filed in respect of fiscal years ending on or after July 15, 2003. The requirement to disclose amendments to, or waivers from, the code of ethics applies to a particular company on or after the date on which such company files its first annual report in which the code of ethics disclosure is required.

DISCLOSURE REQUIREMENTS RELATING TO AUDIT COMMITTEE FINANCIAL EXPERTS

STATUTORY BACKGROUND

Section 407 of the Act directs the SEC to issue rules requiring each issuer to disclose whether its audit committee has at least one member who is a "financial expert" and, if not, an

explanation of why it has no financial expert on its audit committee. The Act also requires the SEC to define "financial expert," taking into consideration whether a person, through education and experience as a public accountant or auditor or a principal financial officer, comptroller, or principal accounting officer of an issuer, or from a position involving the performance of similar functions, has:

- an understanding of generally accepted accounting principles and financial statements;
- experience in the preparation or auditing of financial statements of generally comparable issuers and the application of generally accepted accounting principles in connection with the accounting for generally comparable estimates, accruals and reserves;
- experience with internal accounting controls; and
- an understanding of audit committee functions.

FINAL RULES

General

The SEC's final rules under Section 407 of the Act (the "Financial Expert Rules") require all domestic companies and foreign private issuers filing annual reports on Forms 10-K, 10-KSB, 20-F or 40-F in respect of fiscal years ending on or after July 15, 2003 (or, in the case of small business issuers, ending on or after December 15, 2003) to disclose in those reports either:[4]

- that the company has at least one "audit committee financial expert"[5] serving on its audit committee and, if so, the name of such expert and whether the expert is independent of management; or

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[4] The Financial Expert Rules are codified as additional requirements of Item 10 of Part III of Form 10-K requiring the disclosure specified by new Item 401(h) of Regulation S-K; additional requirements of Item 9 of Part III of Form 10-KSB requiring the disclosure specified by new Item 401(e) of Regulation S-B; new Item 16A to Form 20-F; and new General Instruction B.(8) to Form 40-F. With respect to Forms 10-K and 10-KSB, Part III permits a domestic issuer that voluntarily chooses to include the disclosure in its proxy or information statement to incorporate the disclosure by reference if it files the definitive proxy or information statement with the SEC no later than 120 days after the end of the fiscal year covered by the Form 10-K or 10-KSB. The additions of the requirements to Item 401 of Regulation S-K will also have the effect of requiring the inclusion of the new disclosure in registration statements on Forms S-1 and certain registration statements on Form S-4.

[5] The Financial Expert Rules use the term "audit committee financial expert" instead of the Act's term "financial expert." The Release states that the "term [audit committee financial expert] suggests more

- that the company does not have an audit committee financial expert serving on its audit committee and an explanation of why the reporting company does not have at least one audit committee financial expert.

The Financial Expert Rules require that the board of directors conduct the evaluation of audit committee members to determine if any qualify as an audit committee financial expert. The Release states that this determination should be subject to relevant state law principles, such as the business judgment rule, although it is possible that a court could disregard this guidance from the SEC.

The Financial Expert Rules also require each reporting company's board of directors to actually evaluate its audit committee members to determine whether at least one member qualifies as an audit committee financial expert. A company may not disclose that it does not have an audit committee financial expert with the explanation that it has decided not to make the determination or that, in lieu of making the determination, it is providing the qualifications of all its audit committee members. In addition, a company may not disclose that it does not have an audit committee financial expert if the company's board of directors has actually determined that at least one audit committee member satisfies the applicable criteria.[6] Once a board of directors has identified at least one audit committee financial expert, it is not required to evaluate the qualifications of its other audit committee members, although, in practice, we would expect the qualifications of all members of the audit committee to be considered at the same time.[7]

While a reporting company cannot determine that it has an audit committee financial expert by pooling all the attributes of its audit committee members, the SEC indicated that if a company has determined that it does not have an audit committee financial expert, it would be appropriate for the company to disclose those attributes its audit committee members do possess. The company may also wish to disclose, if applicable, the audit committee's intention to access other sources of financial or accounting expertise for advice with respect to complicated accounting issues.

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pointedly that the designated person has characteristics that are particularly relevant to the functions of the audit committee, such as a thorough understanding of the audit committee's oversight role, expertise in accounting matters as well as understanding of financial statements, and the ability to ask the right questions to determine whether the company's financial statements are complete and accurate."

6 While the SEC would resist any effort by a director to evade proper identification as an audit committee financial expert, a board in making its evaluation may wish to consider whether a board member believes that he or she is a financial expert. The views of such a board member, however, would not relieve the board from making its own determination.

7 The Financial Expert Rules permit, but do not require, the disclosure of the names of other audit committee members who the board of directors determines satisfy the definition of "audit committee financial expert." If an additional audit committee financial expert is disclosed, the disclosure must also specify whether the additional audit committee financial expert is independent.

The Financial Expert Rules do not require disclosure of changes in an audit committee financial expert's status as an expert or as a member of the audit committee, except in connection with the board's subsequent annual determinations regarding audit committee financial expert disclosure.[8]

Definition of "Audit Committee Financial Expert"

Definition. The Financial Expert Rules define the term "audit committee financial expert" to mean a person who has *all* of the following attributes (the "Required Attributes"):

1. an understanding of generally accepted accounting principles and financial statements;

2. the ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;

3. 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 issuer's financial statements, or experience actively supervising one or more persons engaged in such activities;

4. an understanding of internal controls and procedures for financial reporting; *and*

5. an understanding of audit committee functions.

Analysis of the Required Attributes. In response to substantial criticism of the definition of financial expert in the Proposed Rules, the Financial Expert Rules significantly expanded the definition and thus the field of potential candidates. The following is a brief discussion of each of the Required Attributes, highlighting changes from the definition in the Proposed Rules.

1. *An understanding of generally accepted accounting principles and financial statements.*

This item was adopted substantially as proposed and should not pose difficulty for most issuers. Individuals in the financial community, even non-accountants, may understand financial statements and generally accepted accounting principles if, for example, they regularly review and analyze in depth financial statements prepared using generally accepted accounting principles. The essential distinction between the proposed and final rules in this regard relates

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[8] However, the pending proposed amendments to Form 8-K would require a company to disclose all changes in the composition of a board of directors within two business days of the occurrence of the change. Such disclosure was proposed in Release Nos. 33-8106 and 34-46084 (June 17, 2002) (the "Form 8-K Proposals"), which we discuss in our memorandum dated June 27, 2002, entitled "*SEC Proposes New Rules Relating to 8-K Disclosure and Officer Certifications*."

to foreign private issuers. The Financial Expert Rules exclude the onerous requirement in the Proposed Rules that audit committee financial experts of foreign private issuers understand both home country generally accepted accounting principles *and* U.S. generally accepted accounting principles, as well as the reconciliation between them. The final rules require only that audit committee financial experts for foreign private issuers have an understanding of the principles used by the foreign private issuer in the preparation of its primary financial statements to be included in SEC filings.

2. *The ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves.*

The final rules also substantially modified item two of the definition. Many persons commenting on the Proposed Rules had expressed concern that the rule as proposed would substantially narrow the pool of eligible financial experts as it not only required *experience applying generally accepted accounting principles* to estimates, accruals and reserves, but also required that such estimates, accruals and reserves be *generally comparable to those of the issuer* (*i.e.*, in the same or similar industry).[9]

Unlike the proposed item two, final item two does not require that an individual have actual *experience applying* generally accepted accounting principles, but rather requires only that an individual be able to assess the general application of generally accepted accounting principles in connection with accounting for estimates, accruals and reserves. Furthermore, the final rules no longer specifically require that the individual have such ability with respect to estimates, accruals and reserves that are *generally comparable* to those of the issuer on whose audit committee he or she would sit. Whereas item two as proposed appeared to require significant actual experience in the same or related industry as the issuer, final item two appears to require only that an audit committee financial expert have had experience that provides him or her with the ability to evaluate and analyze accounting for estimates, accruals and reserves. The SEC indicates in the Release that it believes that final item two better satisfies the intent of the statute and the role to be played by audit committees, focusing the requirement less on a need for highly specialized technical knowledge within a particular industry and more on ensuring that individuals understand the general application of accounting principles in connection with accounting for estimates, accruals and reserves.

[9] Item two as initially proposed required "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 registrant's financial statements."

3. *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 issuer's financial statements, or experience actively supervising one or more persons engaged in such activities.*

Final item three also establishes criteria that are notably broader than those originally proposed by the SEC. As proposed, item three would have required a financial expert to have actual experience *preparing* or *auditing* financial statements.[10] In addition to individuals with experience preparing or auditing financial statements, final item three also permits individuals with experience performing financial statement analysis or evaluation to qualify as audit committee financial experts. The SEC indicates in the Release that it believes this revision conforms more closely to the intent of the statute that an audit committee financial expert must have experience working "directly and closely" with financial statements in a way that provides familiarity with the contents of such statements and the processes behind them. The SEC also recognizes that individuals actively engaged in industries such as investment banking, venture capital and professional financial analysis may have had sufficient direct and close exposure to, and experience with, financial statements and related processes to be capable of adequate scrutiny and diligent and zealous questioning of management and the issuer's auditor with respect to financial statements.

The other significant change in final item three is that the financial statements that have been prepared, audited, analyzed or evaluated by a candidate need not present accounting issues that are generally comparable to those *raised by the issuer's financial statements*. Rather, the financial statements need only present a "breadth and level of complexity" of accounting issues that are generally comparable to the breadth and complexity of those raised by the issuer's financial statements. This modification clarifies that an audit committee financial expert need not have had experience in the same or a related industry as the issuer, nor have had experience with a public company. Candidates who have prepared, audited, analyzed or evaluated financial statements of an issuer in a completely separate industry should be eligible to satisfy item three, as long as those financial statements present issues having a breadth and level of complexity commensurate with those faced by the issuer.[11] Satisfaction of this criteria requires a "facts and circumstances" inquiry. Accordingly, a board should focus on a variety of factors, such as the size of the company with which the person has had experience, the scope of that

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[10] Item three as initially proposed required "experience preparing or auditing financial statements that present accounting issues that are generally comparable to those raised by the registrant's financial statements."

[11] We believe, for example, that an individual with experience with an energy company, whose financial statements require complex accounting for energy trading contracts (including mark-to-market), might have sufficient experience to serve as an audit committee financial expert for a financial institution, whose financial statements involve accounting issues of a similar breadth and level of complexity.

company's operations and the complexity of its financial statements and accounting. No particular financial reporting or accounting issues, or any other narrow area of experience, should be dispositive.

Final item three also expands the universe of individuals eligible to serve as audit committee financial experts by including those with experience *actively supervising* individuals responsible for preparing, auditing, analyzing or evaluating financial statements. According to the SEC, "active supervision" means more than the mere existence of a traditional hierarchical reporting relationship between supervisor and those being supervised, however, and a principal executive officer should not be presumed to qualify. The Release suggests that "active supervision" involves having some experience comparable to that of the individuals being supervised. For example, the SEC states that a principal executive officer with considerable operations involvement, but little financial or accounting involvement, likely would not have exercised the necessary active supervision. 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." This new aspect of the definition may permit senior level officers or executives with only supervisory experience in this area to satisfy this item.

4. *An understanding of internal controls and procedures for financial reporting.*

Whereas the Proposed Rules would have required that an individual have actual *experience* involving internal controls for financial reporting, under final item four, an individual need have only an *understanding* of such internal controls. The SEC believes that the important focus should be on understanding the reasons for and purposes of a company's internal controls and procedures for financial reporting, their design and their operation, so that an audit committee financial expert can properly evaluate them.

5. *An understanding of audit committee functions.*

This item was adopted as proposed. Individuals who have served on boards of directors or audit committees for public companies, individuals who have served in management positions that involved meaningful interaction with audit committees or individuals who have been an auditor of a public company may have an understanding of audit committee functions sufficient to satisfy this requirement.

Required Experience for Obtaining the Required Attributes

The Financial Expert Rules provide that a person must have obtained the Required Attributes through any 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.[12]

While the Proposed Rules in effect limited the field of potential candidates to individuals with experience as a chief financial officer, controller or accountant, the Financial Expert Rules recognize a broader range of experiences as potential sources of financial expertise, including the following:

- An audit committee financial expert may have obtained the required expertise through *experience with a "non-public company"* (*i.e.*, a company that is not required to file reports pursuant to Section 13(a) or 15(d) of the Exchange Act), such as a private company that is contractually required to prepare audited financial statements that comply with generally accepted accounting principles.

- An audit committee financial expert may have obtained the required expertise *overseeing or assessing the performance of companies or accountants* with respect to the preparation, auditing or evaluation of financial statements. The Release specifies, for example, that individuals working for governmental, self-regulatory and private-sector bodies who oversee the banking, insurance or securities industries may have had sufficient experience with financial statement issues to qualify as audit committee financial experts. In addition, an individual in the venture capital, private equity, investment banking or other investment professional fields may have had the

[12] If an audit committee financial expert has acquired the Required Attributes through "other relevant experience," the company must briefly list the relevant experience. This disclosure may be made by reference to disclosure regarding the director's business experience that is already required under separate Exchange Act rules and regulations. The "other relevant experience" category replaces a provision in the Proposed Rules that would have permitted a board of directors to determine that an individual has acquired the necessary expertise through "similar expertise and experience" to that otherwise required by the Proposed Rules, with a list of ten suggested factors to consider in making such determination. These factors have not been incorporated in the Financial Expert Rules, although the list may still provide a useful point of reference in determining whether an individual has appropriate "other relevant experience."

requisite experience assessing companies to qualify as an audit committee financial expert.

- An individual may have obtained the required expertise *actively supervising* a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions. For example, an individual who has substantial experience serving on an audit committee may have had the requisite experience actively supervising the preparation, auditing, analysis or evaluation of financial statements to qualify as an audit committee financial expert, so long as he or she possesses the Required Attributes. A person who has served as a CFO is also likely to have the requisite expertise, but in many cases, CEOs may not have had sufficient experience actively supervising unless they have been actively involved in the financial reporting or other financial aspects of a company's business.

The Independence Determination

The Financial Expert Rules also require disclosure as to whether the audit committee financial expert is "independent." Independence is defined, for purposes of the Financial Expert Rules, by reference to the definition of "independent" in Item 7(d)(3)(iv) of Schedule 14A. At present, this definition has the effect of requiring companies that are listed on the NYSE or American Stock Exchange or quoted on Nasdaq to use the definition of "independent" in the listing standards of the NYSE, AMEX or NASD, as applicable, and other companies to choose a definition of independence from among the three.

Under Section 301 of the Act and the SEC's rules to be promulgated thereunder, national securities exchanges and associations will be required to adopt rules prohibiting the listing of any security of an issuer that does not, among other things, maintain an audit committee comprised solely of independent directors. Under the SEC's proposed rules under Section 301 of the Act (the "Proposed 301 Rules"), for an audit committee member to be independent, the member:

- May not receive, directly or indirectly, any consulting, advisory or other compensatory fee from the issuer (other than ordinary director's fees); and

- May not be an "affiliated person" of the issuer.

Section 301 of the Act requires the SEC to adopt rules by April 26, 2003. Once the exchanges have adopted listing standards implementing the new rules, the definition of "independent"

that applies for purposes of the Financial Expert Rules will, at a minimum, have to satisfy this two-prong definition, as well as any additional standards the exchanges adopt.[13]

For companies with listed equity, disclosure of the independence of an audit committee financial expert should not pose a problem as all audit committee members for these companies will have to be independent to satisfy listing standards. Other companies, however, such as reporting companies that do not have listed securities and companies with listed debt that are exempt from the final SEC rules under Section 301,[14] will be required to publicly disclose information about the qualifications and independence of their audit committee members that they likely were not previously required to disclose.

Foreign private issuers are currently exempt from the requirement to disclose whether or not their audit committee financial expert is independent, but the SEC intends to require foreign private issuers to make the disclosure after it has finalized the definition of "independent" (as more fully discussed below on page 14 under the caption "Foreign Private Issuers").

COMPARING FINANCIAL EXPERT RULES, PROPOSED NYSE STANDARDS AND PROPOSED NASDAQ STANDARDS

Each of the NYSE and Nasdaq has filed with the SEC proposed new listing standards regarding corporate governance which, among other things, address the composition of a listed company's audit committee.[15] The Proposed Nasdaq Standards currently would require each issuer's audit committee to have at least one "financial expert" as defined pursuant to the Financial Expert Rules. The critical distinction between the SEC's Financial Expert Rules and the Proposed Nasdaq Standards is that the Financial Expert Rules require only *disclosure*, while the Proposed Nasdaq Standards mandate that companies *actually have* a financial expert on their audit committees.

The Proposed NYSE Standards currently would require each member of the issuer's audit committee to be "financially literate" and at least one member to "have accounting or related financial management expertise" (these requirements are the same as the NYSE's current standards). Although the Proposed NYSE Standards do not presently require that audit

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[13] For a full discussion of the Proposed 301 Rules, see our memorandum dated February 11, 2003, "*SEC Proposes Audit Committee Rules Pursuant to Sarbanes-Oxley*," which is available upon request or at our website at *www.simpsonthacher.com*.

[14] The Proposed 301 Rules would provide exemptions for certain listed companies, such as majority-owned subsidiaries that list debt and non-convertible, non-participating preferred securities (so long as the parent company lists an equity security).

[15] The corporate governance listing standards would apply only to companies listing common stock.

committees include a "financial expert," the NYSE indicated that it would await the SEC's interpretation of the definition of "financial expert" before acting.

The NYSE's and Nasdaq's proposed requirements regarding financial experts may be reconsidered and revised in light of the SEC's rulemaking. The SEC has stated its intention to work toward harmonizing NYSE and Nasdaq requirements.

LIABILITY OF AUDIT COMMITTEE FINANCIAL EXPERTS – "SAFE HARBOR"

One of the most significant concerns relating to Section 407 of the Act and the SEC's related rulemaking has been the question of whether an individual designated as a "financial expert" or "audit committee financial expert" would be exposed to greater potential liability because of such designation. The Financial Expert Rules seek to provide comfort on this point by including a "safe harbor" provision, which states 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 of 1933, 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 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.

The SEC indicates in the Release that its intention in including these provisions is, among other things, to clarify that any information in a registration statement reviewed by the audit committee financial expert is not "expertized" by virtue of the audit committee financial expert reviewing the registration statement solely in his or her capacity as an audit committee financial expert,[16] and that an audit committee financial expert is not subject to a higher level of due diligence with respect to the registration statement.

Despite the Financial Expert Rules' "safe harbor" provision and the SEC's stated position disclaiming additional potential liability for audit committee financial experts, we would note there is precedent in state and federal law for holding an individual to a standard of

[16] If the audit committee financial expert is acting in some other type of traditionally recognized expert capacity, then the registration statement might be "expertized."

liability commensurate with the individual's experience, access to information and expertise. In this regard, an audit committee member who is identified as an audit committee financial expert by virtue of his or her special knowledge, experience and expertise could be held to a higher standard of responsibility than other audit committee members under state law. While designation as a financial expert, in and of itself, should not *change* an individual's liability, the formal designation that a person is an "audit committee financial expert" may make it more difficult for an audit committee member to disclaim effectively expertise in specific areas of finance and accounting. The implications of the "financial expert" designation in this context have yet to be developed.

COMPANIES WITHOUT AUDIT COMMITTEES OR BOARDS OF DIRECTORS

The Financial Expert Rules apply to companies that have boards of directors but do not have separate audit committees, because the Act defines the term "audit committee" to mean the entire board of directors in the absence of a separate audit committee. As for companies without boards of directors, such as limited liability companies and limited partnerships that do not have a corporate general partner, the Financial Expert Rules do not provide exemptions. Such companies are required to explain in their disclosure that their organizational structure does not provide for a board of directors and that they therefore do not have an audit committee.[17]

FOREIGN PRIVATE ISSUERS

The Financial Expert Rules require the same audit committee financial expert disclosure by foreign private issuers in annual reports filed on Forms 20-F and 40-F as the disclosure required by domestic issuers on Forms 10-K and 10-KSB, except that foreign private issuers are presently not required to disclose whether their audit committee financial experts are independent. The SEC has indicated that it intends to require foreign private issuers to provide the independence disclosure once it has adopted rules that finalize the relevant definition of "independent."[18]

In addition, references in the Financial Expert Rules to "generally accepted accounting principles" mean, with respect to a foreign private issuer, the body of generally accepted accounting principles used by the foreign private issuer in its primary financial statements filed

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[17] In the release containing the Proposed Rules, the SEC stated that such companies would have to explain in their disclosure that their organizational structure does not provide for a board of directors and that they therefore do not have an audit committee. While the Release does not discuss this issue, the SEC has confirmed to us telephonically that the SEC's position on this point remains unchanged.

[18] The Release states that it would be unfair to require foreign private issuers to familiarize themselves with the current definition of "independent" (and the current standards of the NYSE and Nasdaq) when the relevant definition is expected to change within one calendar year, upon adoption of the rules implementing Section 301 of the Act.

with the SEC. This definition in the Financial Expert Rules relieves foreign private issuers of the more onerous requirement in the Proposed Rules that would have required audit committee financial experts of foreign private issuers to understand both their own country's generally accepted accounting principles and U.S. generally accepted accounting principles.

With respect to foreign private issuers that have a two-tiered board structure comprised of a management board and a supervisory or non-management board, the Financial Expert Rules provide that the supervisory or non-management board is considered the "board of directors" for purposes of the Financial Expert Rules.

The Release has requested comments concerning a possible special accommodation exemption from the independence requirements for foreign private issuers with a board of auditors or similar body or statutory auditors. A similar accommodation with respect to certain audit committee requirements was proposed in the Proposed 301 Rules.

The Proposed NYSE Standards regarding financial experts would not apply to foreign private issuers. Rather, foreign companies would be required to disclose any material differences between their home country corporate governance practices and the applicable NYSE listing standards. Nasdaq's current listing standards regarding corporate governance provide that Nasdaq will not require a foreign private issuer to act contrary to the law or generally accepted business practice of its home country and that Nasdaq has the ability to provide exemptions as appropriate to carry out the intent of its corporate governance requirements. Nasdaq has historically applied exemptions for foreign private issuers in a manner broadly similar to those provided by the NYSE. The Proposed Nasdaq Standards do not contemplate changing Nasdaq's current treatment of foreign private issuers with respect to the availability of exemptions. The Proposed Nasdaq Standards would, however, require these issuers to disclose on an annual basis (and at the time of their first U.S. listing) any exemptions on which they are relying, as well as any alternative measures taken in lieu of the waived requirements.

ASSET-BACKED ISSUERS

The Financial Expert Rules exempt asset-backed issuers from the financial expert disclosure requirements.

CODES OF ETHICS

STATUTORY BACKGROUND

Section 406 of the Act requires the SEC to issue rules requiring each issuer to disclose whether or not it has adopted a code of ethics for senior financial officers and, if not, the reason for not having done so. The Act defines "code of ethics" to mean any standards that 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 issuer's periodic reports; and

- compliance with governmental rules and regulations.

The Act directs the SEC to require the immediate disclosure by any issuer, by means of the filing of a Form 8-K, dissemination by the Internet or by other electronic means, of any change to, or waiver from, its code of ethics for senior financial officers.

FINAL RULES

General

The SEC's final rules under Section 406 of the Act (the "Code of Ethics Rules") require all domestic companies and foreign private issuers filing annual reports on Forms 10-K, 10-KSB, 20-F or 40-F in respect of fiscal years ending on or after July 15, 2003 to disclose in such reports:[19]

- 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 (the "specified officers"); and

- if the company has not adopted such a code of ethics, the reasons for not having done so.

Although the Act requires that the code of ethics apply only to senior financial officers, the Code of Ethics Rules require that the code of ethics apply to the principal executive officer as well (*i.e.*, in most cases, the CEO). The Code of Ethics Rules also require an issuer to make a copy of its code of ethics available to the public through any one of the following means:[20]

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[19] The Code of Ethics Rules are codified as additional requirements of Item 10 of Part III of Form 10-K and Item 9 of Part III of Form 10-KSB, each requiring the disclosure specified by new Item 406 of Regulations S-K and S-B, as applicable; new Item 16B to Form 20-F; and new General Instruction B.(9) to Form 40-F. With respect to Forms 10-K and 10-KSB, Part III permits a domestic issuer that voluntarily chooses to include the disclosure in its proxy or information statement to incorporate the disclosure by reference if it files the definitive proxy or information statement with the SEC no later than 120 days after the end of the fiscal year covered by the Form 10-K or 10-KSB.

[20] The Code of Ethics Rules permit issuers to have separate codes of ethics applicable to directors, officers and employees that need not be disclosed. Furthermore, if a company incorporates the required "code of

- filing it as an exhibit to its annual report;
- posting it on its website;[21] or
- undertaking in its annual report to provide it to any person without charge upon request.

If a company chooses to make a copy of its code of ethics available through posting on its website, the company must disclose, in the annual report immediately preceding such posting, its intent to make its code of ethics available in such manner and the website address where the code may be found. For companies with more than one website, this website should be the website the company normally uses for its investor relations function. Similarly, if the company chooses to make its code of ethics available to the public in response to requests, the company must disclose such intent in its annual reports, accompanied by an explanation of the manner in which such requests may be made.

Definition of "Code of Ethics"

The Code of Ethics Rules define "code of ethics" to mean written standards that are 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;[22]
- 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;

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ethics" for the specified officers within a broader document, such as an all-employee policy manual, the Code of Ethics Rules clarify that the disclosure obligations apply only to the portions of the broader document that address the subject areas covered by the rules' definition of "codes of ethics" and only with respect to their application to the specified officers.

[21] If the code of ethics has been posted to the company's website, inclusion of the company's website address in the annual report will not, by itself, include or incorporate by reference the company's code of ethics into the annual report, unless the company otherwise acts to incorporate the information by reference. This is consistent with previous guidance that the SEC provided with respect to information on a company's website more generally, in Release No. 33-7856 (April 28, 2000).

[22] The SEC eliminated the proposed component of the definition of code of ethics requiring the code to promote the "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," because it believed such conduct was already addressed by the first prong of the definition.

- 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 indicates in the Release that a company retains discretion to determine the appropriate person to whom a violation of the code should be reported, with the caveats that the person not be involved in the matter giving rise to the conflict of interest and that the person have sufficient authority in the company to adequately deal with the violator. Because codes of ethics are required to apply to officers who carry substantial authority within the company, we believe that a reasonable interpretation of the SEC's guidance suggests that the company should designate its general counsel or a comparable senior officer.

The Code of Ethics Rules impose only a *disclosure* obligation and would not require an issuer to adopt a code of ethics if it has not already done so, or even to amend its existing code of ethics.[23] We expect, however, that virtually all reporting companies will adopt codes of ethics as contemplated by the Code of Ethics Rules. We also note that Proposed NYSE Standards and Proposed Nasdaq Standards would actually require companies to adopt codes of ethics.

Current Disclosure Regarding Amendments or Waivers

General. The Code of Ethics Rules require issuers to disclose on a current basis (within five business days),[24] either of the following occurrences:

- any amendment to its code of ethics as it applies to the specified officers, accompanied by a brief description of the nature of such amendment; or
- any grant to a specified officer of a waiver from its code of ethics, accompanied by a brief description of the nature of such waiver, the name of the person for whom such waiver was granted and the date thereof.

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[23] The SEC did, in the Release, encourage companies adopting codes to adopt codes that may be broader and more comprehensive than may be strictly required to meet the new disclosure requirements.

[24] The SEC initially proposed a two business day filing period to be consistent with proposed accelerated Form 8-K filing deadlines in the Form 8-K Proposals. Because those proposals have not yet been adopted, the SEC adopted an interim deadline of five business days for disclosure of amendments to and waivers from the code of ethics, which is the shortest Form 8-K reporting deadline currently in effect. The SEC stated its intention to consider reducing the deadline to two business days when it considers adopting accelerated Form 8-K filing deadlines. The five business day deadline applies to Form 8-K filings as well as website postings of the required disclosure.

Only amendments or waivers relating to the specified elements of the code of ethics and the specified officers must be disclosed. For example, if a director subject to the same code of ethics as a specified officer is granted a waiver, no disclosure of a waiver granted to the director is required. The Code of Ethics Rules do not require disclosure of amendments to the code of ethics that are "technical," "administrative" or "non-substantive."

These requirements are effective with respect to a company on or after the date on which the company files its first annual report in which the code of ethics disclosure is required.

An issuer may provide the required disclosure on a Form 8-K report or by posting the information on the company's website. To post the required disclosure on its website, an issuer must have notified investors in advance by having disclosed in its most recently filed annual report its intention to provide the information on its website and the address of its website.[25]

The rules define "waiver" as approval by the issuer of a material departure from a provision of the code of ethics, including through an "implicit waiver." An "implicit waiver" is defined as 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.[26]

Because all waivers would be required to be disclosed within five business days of the grant of the waiver, implicit waivers could present issues as to whether a company is in compliance with reporting requirements. We believe that no implicit waiver should be deemed to exist while the incident is being investigated and the appropriate remedy or sanction is being considered, provided that the process is conducted in a reasonable manner and on a timely basis.

Furthermore, as long as the company responds to a violation of the code of ethics by one of the specified officers in accordance with the terms of the code of ethics and, thus, no waiver from the code is granted, the Code of Ethics Rules do not require disclosure of the fact that a violation of the code has occurred. In light of the desirability of minimizing the need to grant waivers that would trigger disclosure of violations of codes of ethics by specified persons, we recommend that codes of ethics be drafted to provide maximum flexibility in determining whether a violation has occurred and in holding violators accountable.

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[25] If an issuer elects to post the disclosure on its website, the issuer is required to maintain the posting for at least the 12-month period following its initial posting and to retain the disclosure in its records for a period of not less than five years from the conclusion of that 12-month period.

[26] Issuers should remember that the definition of "code of ethics" requires that a company maintain adequate internal procedures for the reporting of violations, as well as provisions for ensuring adherence to the code, *e.g.*, provisions applying sanctions for not complying with the code.

COMPARING CODE OF ETHICS RULES, PROPOSED NYSE STANDARDS AND PROPOSED NASDAQ STANDARDS

The Code of Ethics Rules differ in several important respects from the requirements of the Proposed NYSE Standards and Proposed Nasdaq Standards:

- *Nature of obligation*. The Code of Ethics Rules impose a disclosure obligation as to whether a company has a code of ethics, while the Proposed NYSE Standards and Proposed Nasdaq Standards would actually *require* listed companies to adopt codes of ethics.

- *Individuals covered*. The Code of Ethics Rules require that a code apply only to the principal executive officer and the specified principal financial officers. The Proposed NYSE Standards and Proposed Nasdaq Standards would require that codes apply to all directors, all officers and all employees.

- *Issue-areas covered*. The Proposed NYSE Standards suggest a specific list of topics that listed companies should address in their code of ethics, as compared to the Code of Ethics Rules which are much more general in nature. For example, the Proposed NYSE Standards specifically state that confidentiality and protection and proper use of company assets are topics that should be covered in a listed company's code of ethics. The Proposed Nasdaq Standards require only that codes address "the issues of conflicts of interest and compliance with laws, rules and regulations."

- *Waivers*. The Code of Ethics Rules require disclosure of waivers within five business days. The Proposed NYSE Standards and Proposed Nasdaq Standards require "prompt" disclosure. Furthermore, the Proposed NYSE Standards and Proposed Nasdaq Standards would require disclosure of any waiver for directors or executive officers as compared to the Code of Ethics Rules, which require disclosure of waivers only for the specified officers.

Companies may need to make modifications to their existing codes of ethics or even create new codes of ethics to comply with the requirements of the various rules. In light of the differing applicability and requirements of the Code of Ethics Rules and the Proposed NYSE Standards or Proposed Nasdaq Standards, listed companies may confront the issue of whether to use a single code of ethics or two or more codes of ethics. When the Proposed Rules were issued, some listed companies considered creating a separate code of ethics for senior officers so that they would not have to disclose the portions of their code of ethics that did not apply to those officers. Because the Code of Ethics Rules require companies to make available only the portions of their code of ethics corresponding to the requirements of the Code of Ethics Rules and only insofar as applicable to the specified officers, this concern has been largely eliminated. Similarly, the requirement under the Code of Ethics Rules to disclose amendments to and waivers from the code of ethics applies only to the specified provisions of the code and the specified officers. Accordingly, companies may find that there is no compelling justification for

adopting separate codes of ethics for differing groups of employees and/or directors, particularly in light of the fact that the Proposed NYSE Standards and Proposed Nasdaq Standards would require listed companies to disclose their codes of ethics applicable to all officers, employees and directors.[27]

Many companies historically included their codes of ethics as part of employee handbooks or more comprehensive codes of conduct. We recommend that such companies consider separating their codes of ethics from any human resource information, operational policy guidelines and other information included in their current code of conduct. This separation will obviate the need to publicize proprietary administrative matters and eliminate the possibility of confusion regarding whether a waiver for a breach of the company's operating policies would constitute a waiver from the code of ethics that would need to be publicly disclosed.

FOREIGN PRIVATE ISSUERS

The Code of Ethics Rules require foreign private issuers to make the same disclosure in annual reports filed on Forms 20-F and 40-F as domestic issuers are required to make on Forms 10-K or 10-KSB. Foreign private issuers must also make their codes publicly available through one of the same three means as domestic issuers.

Unlike domestic issuers, however, foreign private issuers are not required to disclose amendments to, or waivers from, their codes of ethics for specified officers on a current basis (*i.e.*, within five business days). Instead, foreign private issuers are required to make such disclosure annually on Form 20-F or Form 40-F. In lieu of providing this disclosure in annual reports, a foreign private issuer may provide the disclosure on a current basis by posting the disclosure on its website (under the terms applicable to that election for domestic issuers). The SEC *strongly encourages* this form of alternative current disclosure. Although not provided for in the Code of Ethics Rules themselves, the Release states that foreign private issuers may also satisfy this disclosure requirement through current filings on Form 6-K.[28]

The Proposed NYSE Standards regarding codes of ethics would not apply to foreign private issuers. Rather, foreign companies would be required to disclose any material differences between their home country corporate governance practices and the applicable NYSE listing standards. Nasdaq's current listing standards regarding corporate governance provide that Nasdaq will not require a foreign private issuer to act contrary to the law or

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[27] Companies that do not have a written code of ethics or do not have listed equity, however, may wish to adopt a code of ethics that applies only to the specified officers.

[28] Although the Release states that the Code of Ethics Rules would permit a foreign private issuer to provide the required disclosure on Form 6-K, the actual text of the amendments to Form 20-F and 40-F, respectively, do not mention this Form 6-K alternative method of disclosure.

generally accepted business practice of its home country and that Nasdaq has the ability to provide exemptions as appropriate to carry out the intent of its corporate governance requirements. Nasdaq has historically applied exemptions for foreign private issuers in a manner broadly similar to those provided by the NYSE. The Proposed Nasdaq Standards would, however, require these issuers to disclose on an annual basis (and at the time of their first U.S. listing) any exemptions on which they are relying, as well as any alternative measures taken in lieu of the waived requirements.

ASSET-BACKED ISSUERS

The Code of Ethics Rules exempt asset-backed issuers from the code of ethics requirements.

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This memorandum is for general informational purposes and should not be regarded as legal advice. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as additional memoranda regarding recent corporate governance developments, can be obtained from our website, *www.simpsonthacher.com*.

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