

Capital Markets and Securities

A bulletin prepared by the Capital Markets Group at Vedder Price designed to keep corporate executives and investment banking professionals informed of major developments in the securities industry.

January 28, 2003

SEC MANDATES DISCLOSURES RELATING TO FINANCIAL EXPERTS AND CODES OF ETHICS

The SEC adopted new rules requiring public companies to disclose information about audit committee financial experts and corporate codes of ethics. The new rules, which do not require disclosure until the filing of a public company's annual report for its first fiscal year ending on or after July 15, 2003, were required by Sections 406 and 407 of the Sarbanes-Oxley Act.

Disclosure Requirements

The rules will require each public company to include the following two new types of disclosures in its annual report on Form 10-K or Form 10-KSB:

- whether its board of directors has determined that it has at least one "audit committee financial expert" on its audit committee, and if so, the name of the expert and whether the expert is independent. A company that does not have an audit committee financial expert will be required to disclose why it does not have one.
- whether the company has adopted a code of ethics for its principal executive officer and its principal financial and accounting officers. If a company has not adopted a code of ethics, it will be required to explain why. The rules also will require a company to disclose amendments to, and waivers from, the code of ethics.

It is worth noting that the new rules are only disclosure rules, and do not mandate that public companies have an audit committee financial expert or adopt a code of ethics. Requirements relating to such matters are contained in the listing standards of the stock exchanges and Nasdaq, which are currently under review.

Audit Committee Financial Experts

The new audit committee financial expert disclosure rules are set out in new paragraph (h) to Item 401 of Regulation S-K and new paragraph (e) to Item 401 of Regulation S-B. The new rules

require the board of directors to determine whether its audit committee has an “audit committee financial expert” and to make the appropriate disclosure based on its determination.

Definition of Audit Committee Financial Expert. An “audit committee financial expert” is a person who has the following 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 registrant’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.

An individual must possess *all* of the attributes listed above to qualify as an audit committee “financial expert.” A person must have acquired such attributes through any one or more of the following means:

- (1) 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;
- (2) experience actively supervising such a person;
- (3) experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or
- (4) other relevant experience.

Adopted Definition of “Audit Committee Financial Expert” is Broader than Originally Proposed. The definition of “audit committee financial expert” is significantly broader than that originally proposed. The rule as adopted:

- eliminates the proposed requirement that a person must have “experience” applying generally accepted accounting principles in connection with accounting for estimates, accruals and reserves that are “generally comparable” to those used in the registrant’s financial statements. Instead, candidates must only have an “ability to assess” the application of GAAP in accounting for estimates, accruals and reserves generally.

- broadens the proposed requirement that a candidate have experience “preparing or auditing” financial statements to allow for candidates that alternatively have experience “analyzing or evaluating” financial statements. This change broadens the scope of the definition to include people such as investment bankers, venture capitalists and financial analysts to the extent they otherwise meet the standards of the rule.
- broadens the range of persons who qualify as an audit committee financial expert by including persons who have experience “actively supervising” a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions. A person with CEO experience will not be presumed to qualify. The SEC noted that, to qualify as an audit committee financial expert, such a candidate must have actively participated in, and made a contribution to, the process of addressing financial and accounting issues in a manner that demonstrates a general financial and accounting expertise.
- eliminates the requirement that a person have “experience” with internal controls and procedures for financial reporting, but requires only that the person have an “understanding” of such matters.
- eliminates the requirement that a candidate have obtained the requisite experience with a *public* company.
- provides for a candidate to have acquired the requisite attributes through “other relevant experience,” which experience must be briefly disclosed.

Liability Protections for Audit Committee Financial Experts. The rules makes clear that an audit committee financial expert will not be deemed an “expert” for any purpose, including for purposes of Section 11 of the Securities Act of 1933. The rules as adopted also specify that the designation of a person as an audit committee financial expert does not impose any duties, obligations or liabilities on the person that are greater than those imposed on such a person as a member of the audit committee in the absence of such designation, nor does it affect the duties, obligations or liabilities of any other member of the audit committee or board of directors.

Application to Foreign Private Issuers. Form 20-F (the annual report for foreign private issuers) has been revised to incorporate the requirements described above, although Form 20-F will not immediately require disclosure as to whether such audit committee financial expert is independent. The SEC cautioned that such independence disclosure will likely apply to foreign private issuers upon new rulemaking in the near future.

The new rules also make clear that, in the case of foreign private issuers, the requisite understanding of GAAP must relate to the generally accepted accounting principles used by the registrant in preparing its financial statements filed with the SEC. Reconciliation of non-US GAAP financial statements will not, by itself, require that the audit committee financial expert have familiarity with US GAAP.

Codes of Ethics

The new code of ethics disclosure rules are set out in new Item 406 of Regulation S-K and new Item 406 of Regulation S-B. Under the new rules, public companies will be required to disclose in their annual reports whether they have 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 not, why not.

Definition of Code of Ethics. A code of ethics is defined as written standards that are reasonably necessary 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) 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;
- (3) compliance with applicable governmental laws, rules and regulations;
- (4) the prompt internal reporting of code violations to an appropriate person or persons identified in the code; and
- (5) accountability for adherence to the code.

Making the Code of Ethics Publicly Available. Public companies will be required to make available to the public a copy of their codes of ethics. A company can make its code of ethics available to the public by filing it as an exhibit to its annual report. Alternatively, public companies may post their codes on their Web sites or indicate that their codes are available without charge upon request, in each case as disclosed in their annual report. Companies may have several separate codes of ethics applicable to different personnel, or the code of ethics contemplated by the new rules may be part of a more comprehensive code of ethics or code of conduct that applies to a broader range of personnel and covers a broader range of conduct. In such case, companies need only make publicly available the code, or portion of a more comprehensive code, contemplated by the new rules.

Disclosure of Amendments to or Waivers of the Code of Ethics. Public companies also will be required to disclose any changes to, or waivers of, the code of ethics within five business days. A waiver is defined as the approval of a "material departure" from a provision of the code. Only amendments or waivers relating to the specific elements of the code contemplated by the new rules and applying to the specified officers must be disclosed. A company can provide this disclosure on Form 8-K or on its Web site. Web site disclosures are permitted only if the company has disclosed in its most recent annual report its Web site address and its intention to disclose waivers and amendments on its Web site.

Proposed NYSE and Nasdaq Code of Conduct Requirements. Each of the New York Stock Exchange and Nasdaq have proposed requiring their listed and quoted companies to adopt and disclose codes of conduct. Once these rules are finalized (currently expected in the second quarter of this year), public companies may wish to consider combining into a single document a code that satisfies both the new SEC rules and stock exchange requirements.

Application to Foreign Private Issuers. Foreign private issuers will be required to disclose in their annual report on Form 20-F whether they have adopted the contemplated code of ethics. However, because foreign private issuers are not required to file current reports, they will not be required to promptly disclose amendments to or waivers of their codes of ethics. Nonetheless, the SEC “strongly encouraged” foreign private issuers to make prompt disclosure of such events, either on their Web sites or by furnishing such information to the SEC on Form 6-K.

Date of Effectiveness

Public companies will not be required to make the above disclosures until the annual report for their first fiscal year ending on or after July 15, 2003. For calendar year companies, the new rules will therefore not apply until the spring of 2004. Small business issuers will be required to provide the new audit committee financial expert disclosure in annual reports for fiscal years ending on or after December 15, 2003. Disclosures concerning amendments to or waivers of codes of ethics will not be required until after the filing of the first annual report required to include code of ethics disclosure. However, it is expected that many public companies will want to comply with the disclosure requirements in the 2002 annual report, particularly those that already have a code of ethics complying with the new rules and whose audit committees currently have a financial expert within the meaning of the new rules.

© 2003 Vedder, Price, Kaufman & Kammholz. This bulletin is a publication of Vedder, Price, Kaufman & Kammholz and should not be construed as legal advice or legal opinion on any specific facts or circumstances. The contents are intended for general informational purposes only. Reproduction of this bulletin is permitted only with credit to Vedder, Price, Kaufman & Kammholz.

If you have any questions regarding material in this bulletin, please contact the executive editor, Jennifer R. Evans, at 312/609-7686 or at jevans@vedderprice.com.

Contributing Author: John T. Blatchford

VEDDER, PRICE, KAUFMAN & KAMMHOLZ

About Vedder Price

Vedder, Price, Kaufman & Kammholz is a national, full-service law firm with more than 200 attorneys in Chicago, New York City and Livingston, New Jersey. The attorneys in the firm's Capital Markets Group regularly represent corporations and investment bankers, both foreign and domestic, in a wide variety of matters, including:

- debt and equity offerings, including initial public offerings, structured debt financings, aircraft securitizations, dual-class equity structures, and sophisticated preferred stock instruments;
- capital formation for initial capitalization, financing ongoing operations, and acquisitions;
- corporate disclosure, periodic reporting, proxy solicitations, and insider trading and beneficial ownership compliance matters;
- private placement of securities, including Rule 144A and Regulation S transactions;
- tender offers, mergers and acquisitions, and recapitalizations and restructurings;
- international offerings of securities and compliance by foreign issuers with U.S. securities laws;
- litigation and administrative and arbitration proceedings involving various securities fraud claims, disclosure issues, and regulatory enforcement matters; and
- municipal bond financings.

Principal Members of the Capital Markets Group:

Steven R. Berger (<i>New York</i>)	212/407-7714
John T. Blatchford	312/609-7605
Thomas P. Desmond	312/609-7647
Jennifer R. Evans	312/609-7686
Robyn B. Goldman	312/609-7662
Steven J. Gray (<i>Chair</i>)	312/609-7528
Jennifer Durham King	312/609-7835
James W. Morrissey	312/609-7717
Meeghan O'Donnell	312/609-7529
Jason K. Zachary	312/609-7757

Participating Members of the Capital Markets Group:

James A. Arpaia	312/609-7618
William J. Bettman	312/609-7776
Deborah B. Eades	312/609-7661
Karin Jagel Flynn	312/609-7805
Dean N. Gerber	312/609-7638
Dan L. Goldwasser (<i>New York</i>)	212/407-7710
Douglas M. Hambleton	312/609-7684
John T. McEnroe	312/609-7885
Daniel C. McKay II	312/609-7762
Maureen A. Miller	312/609-7699
Robert J. Moran	312/609-7517
Michael A. Nemeroff	312/609-7858
Cathy G. O'Kelly	312/609-7657
Daniel O'Rourke	312/609-7669
John R. Obiala	312/609-7522
Ronald Scheinberg (<i>New York</i>)	212/407-7730
Guy E. Snyder	312/609-7656
Robert J. Stucker	312/609-7606
David A. Sturms	312/609-7589
Dalius F. Vasys	312/609-7623
Donald A. Wassall (<i>New York</i>)	212/407-7707
Richard L. Williams III	312/609-7588