



SEC Adopts Final Rules Regarding Codes of Ethics and Audit Committee Financial Experts

SECTIONS 406 AND 407 of the Sarbanes-Oxley Act of 2002 established new disclosure requirements for public companies relating to codes of ethics for senior financial officers and audit committee financial experts. On January 23, 2003, the SEC adopted final rules effective as of March 3, 2003 to implement these sections of the Act. Except as otherwise noted, these requirements also apply to foreign private issuers.

Timing

Companies must comply with the new disclosure requirements regarding both codes of ethics and audit committee financial experts in their annual reports required to be filed with the SEC (Form 10-K, 10-KSB, 20-F or 40-F) for fiscal years ending on or after July 15, 2003. For small business issuers, compliance with the audit committee financial expert disclosure rules begins with annual reports for fiscal years ending on or after December 15, 2003. Alternatively, the audit committee financial expert disclosure may be included in the company's proxy if the company will incorporate the proxy statement into the company's annual report filed with the SEC.

Code of Ethics for Senior Financial Officers

The new rules direct a public company to disclose whether or not the company has adopted a code of ethics for certain offi-

cers and, if not, to disclose the reasons why the company does not have such a code. This code of ethics must apply to the company's principal executive officer, principal financial officer, and principal accounting officer or controller, or persons performing similar functions. We anticipate that, given the current corporate climate, most public companies will choose to adopt codes of ethics complying with the SEC rule.

Definition of Code of Ethics The new SEC rule defines "code of ethics" as written standards that are 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. Full, fair, accurate, timely and understandable disclosure in reports and documents that a registrant files with, or submits to, the SEC and in other public communications made by the registrant;
3. Compliance with applicable governmental laws, rules and regulations;
4. Prompt internal reporting to an appropriate person or persons identified in the code of violations of the code; and
5. Accountability for adherence to the code.

The SEC acknowledges that specific provisions of the code of ethics, such as compliance procedures and disciplinary measures for ethical breaches, will properly vary from company to company depending upon each company's circumstances. It has therefore concluded that the details are best left to each company, and the rules do not provide guidance in these areas.

The SEC has confirmed that a company may have separate codes of ethics for different officers. The specific sections of the code required by the new rules may be part of a broader code of ethics or code of conduct that addresses additional topics or applies to a larger class of individuals.

How to Disclose Companies that have a code of ethics for senior financial officers must make this code publicly available. The rules allow companies to choose one of three methods by which they can meet the disclosure requirements:

1. File the code of ethics as an exhibit to the company's annual report required to be filed with the SEC;
2. Post the code of ethics on the company's web site and disclose the company's Internet address and intention to provide disclosure in this manner in its annual report filed with the SEC; or
3. Provide an undertaking in the annual report filed with the SEC that the company will provide a copy of its code of ethics to any person without charge upon request.

Disclosure Regarding Changes to, or Waivers from, the Code of Ethics

The new rules also direct companies to disclose any change to, or waiver from, the company's code of ethics for its senior financial officers. A company must disclose any waivers (including implicit waivers) for any "material departures" from a provision of its code. Implicit waivers occur when a company fails to take action within a reasonable period of time regarding a material departure from the code of ethics that has been made known to an executive officer. This rule for disclosure of amendments or waivers to a code of ethics relates only to provisions required by the SEC rule. If the company includes the code of ethics within a broader code of conduct, disclosure is not necessary for an amendment or waiver of other parts of the code that are not required by the rules.

Companies must report amendments and waivers by filing a Form 8-K or by posting the information on the company's web site within five business days after making the change or granting the waiver. To use the web site disclosure option, the company must have disclosed its web site in its most recently filed annual report as the location to find the company's code of ethics, and also must have disclosed its intention to disclose any amendments and waivers using the same method. A company electing to provide disclosure in this manner must make the disclosure available on its web site for at least one year after the initial disclosure, and must retain the disclosure (to be available to the SEC upon request) for no fewer than

five years. The five business day period is an interim deadline, and may be shortened to two days in conjunction with a shortened two-day deadline proposed by the SEC for Form 8-K filings.

Foreign private issuers are not required to immediately report an amendment or waiver to their code of ethics. Instead, foreign private issuers must disclose any amendment or waiver that has occurred during the past fiscal year in their annual report filed with the SEC. Foreign private issuers may, and are strongly encouraged to, disclose any amendments or waivers on a Form 6-K or on their Internet web site.

Note that both the Nasdaq Stock Market and the NYSE have proposed rules that would require all of their listed companies to adopt codes of ethics that are applicable to all directors, officers and employees. Under Nasdaq's proposed rule, any waivers of the code for directors or executive officers must be approved by the board of directors and disclosed in the company's public filings not later than the next periodic report.

Audit Committee Financial Experts

The SEC has also adopted a final rule related to financial experts on audit committees. The new rule requires a public company to disclose the identity of at least one "audit committee financial expert" (defined below) that serves on its audit committee. If the company does not

have an audit committee financial expert serving on its audit committee, the company must disclose why it does not have such an expert. The rule permits, but does not require, a company to disclose that it has more than one audit committee financial expert serving on its audit committee.

In addition to the new SEC rule, the NYSE and Nasdaq also address audit committee membership. The NYSE's rules require that at least one member of the audit committee have "accounting or related financial management expertise," and that all members of the audit committee be financially literate. In October 2002, Nasdaq proposed a rule change that would have required every audit committee member to be able to read and understand financial statements at the time of his or her appointment to the audit committee, and also would have required a financial expert on each audit committee.

In January 2003, Nasdaq withdrew the financial expert portion of its proposal because of the narrow definition of a "financial expert" in the SEC's prior proposed rule. Nasdaq has indicated that it will review the ability of companies to comply with the SEC's final rule before taking any further action on its proposal. We can expect more changes in the rules of the stock exchanges to parallel, and perhaps expand on, the provisions of the now final SEC Rules.

The SEC rule requires companies to disclose whether the person or persons identified as the audit committee financial expert are independent of management. This disclosure regarding independence will not initially apply to foreign private

issuers, though this requirement will likely be added in conjunction with the adoption of additional rules under Sarbanes-Oxley. The current proposals would trigger this disclosure requirement for foreign private issuers in 2004. The SEC solicited comments regarding a possible exemption from this independence rule for foreign private issuers with boards of auditors or similar bodies or statutory auditors meeting certain criteria. This comment period ended February 18, 2003, and we await further SEC action on this point.

Definition of Audit Committee Financial Expert

The original SEC proposal related to financial experts included a very narrow definition of who qualified as a "financial expert," which in effect would have limited the "expert" designation to directors with experience as auditors, chief financial officers or chief accounting officers. This was one of the most heavily criticized of all the rules proposed under Sarbanes-Oxley. In response, the SEC adopted a more realistic definition of what it now calls an "audit committee financial expert" in the final rule.

The final rule defines an audit committee financial expert as a person who has all of the following attributes:

1. An understanding of GAAP and financial statements;
2. **The ability to assess the general application of such principles** in connection with accounting for estimates, accruals and reserves;

3. Experience preparing, auditing, **analyzing or evaluating** financial statements that present accounting issues "generally comparable" to those that can reasonably be expected to be raised in the company'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.

By changing the second attribute from actual experience applying GAAP to estimates, accruals and reserves to the highlighted language and by adding the highlighted language in attribute No. 3, the SEC expanded the pool of available candidates. This expanded pool now includes investment bankers, venture capitalists and financial analysts, as well as principal executive officers who actively supervised the preparation of, but did not personally prepare, financial statements. The final definition is significantly less restrictive than the SEC's original proposal.

The SEC also clarified that "generally comparable" does not mean that the expert's experience need be in the same industry. Rather, the focus is on the breadth and level of complexity of the accounting issues with which the person has had experience.

Foreign private issuers should note that the audit committee financial expert's understanding must be of GAAP used by the foreign private

issuer in preparing its primary financial statements filed with the SEC. Although the SEC noted that an understanding of the reconciliation to U.S. GAAP would be helpful, the SEC believed that the proper focus of the audit committee financial expert should be on the principles used to prepare the primary financial statements.

How an Individual Acquires Expertise

Under the final rules, a person must have acquired the attributes of an audit committee financial expert through any one or more of the following activities:

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 a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;
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.

The SEC eliminated the proposed requirement that an audit committee financial expert must have gained the relevant experience with a company that, at the time, was a reporting company. Experience with a private company is acceptable.

Note that if an audit committee financial expert qualifies by “other relevant experience” and not under any other category, the company’s disclosure must briefly list that person’s experience.

Safe Harbor In an attempt to avoid discouraging qualified individuals from serving as audit committee financial experts, the SEC included safe harbor provisions in the final rule, clarifying that:

1. Any individual who is designated or identified as an audit committee financial expert will not be deemed an “expert” for general securities laws purposes;
2. The designation does not impose any duties, obligations or liability greater than those imposed on audit committee members who are not audit committee financial experts; and
3. The designation 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.

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