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CLIENT ADVISORY

SEC Proposed New Disclosure Regarding Financial Experts, Internal Controls and Codes of Ethics

New Securities and Exchange Commission rules would mandate public disclosure regarding financial experts serving on audit committees, internal controls and procedures and codes of ethics.¹ On October 22, 2002, the SEC proposed to implement Sections 404, 406, and 407 of the Sarbanes-Oxley Act of 2002.² In some cases, the proposed rules go further than the specific requirements of the Sarbanes-Oxley Act. The proposals are subject to a 30-day public comment period, after which the SEC is expected to issue final rules, which may vary from the proposed versions.

Financial Experts

Disclosure Requirements

Under the SEC's proposed rules, a public company would be required to disclose 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. The company would also have to disclose whether the financial experts are independent of management and if not, an explanation of why they are not. Companies without financial experts on the audit committee would need to explain why they have none.

The disclosure would appear as a new item in annual reports on Form 10-K (for domestic issuers) and Form 20-F or 40-F (in the case of foreign issuers subject to U.S. reporting requirements). The SEC has not indicated whether or not the requirements will be subject to a transition period after their final adoption.

Definition of Financial Expert

The new rules would define "financial expert" as a person who has each of the following attributes:

1. An understanding of generally accepted accounting principles and financial statements;
2. 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;
3. Experience preparing or auditing financial statements that present accounting issues that are generally comparable to those raised by the company's financial statements;
4. Experience with internal controls and procedures for financial reporting; and
5. An understanding of audit committee functions.

¹ With the exception of the rules relating to internal controls, similar rules have been proposed for registered investment companies. As proposed, the rules would not apply to issuers of asset-backed securities.

² For a summary of the Sarbanes-Oxley Act, see the ZAG/S&W LLP client advisory: "The Sarbanes-Oxley Act of 2002: Reforms in Corporate Governance, Accounting and Disclosure."

The rules contemplate that a person would obtain these attributes 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 under the Securities Exchange Act of 1934 (the “Exchange Act”). These attributes may also be obtained through 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. Despite the list of five required attributes, the SEC acknowledges that the board of directors may determine that individuals who are particularly knowledgeable or experienced in accounting and financial issues may qualify even if they have not served in one of the specified capacities listed in the definition. The board would have to disclose the basis for its determination that such a person qualifies as a financial expert.

The board of directors will determine whether a potential financial expert has all of the requisite attributes. In doing so, the board must evaluate “the totality of an individual’s education and experience.” According to the SEC, a company 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 CPA, or the equivalent, in good standing, and the length of time that the person actively has practiced as a CPA 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 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 required to file reports under the Exchange Act, 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 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 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 required to file reports under the Exchange Act;
- 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 company’s financial statements and other financial information and to make knowledgeable and thorough inquiries whether (1) 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 (2) the financial statements and other financial information, taken together, fairly present the financial condition, results of operations and cash flows of the company.

In the case of a foreign private issuer, the board of directors also should consider the person's experience with public companies in the foreign private issuer's home country, generally accepted accounting principles used by the company, and the reconciliation of financial statements with U.S. generally accepted accounting principles.

Although the financial expert must possess all five of the specified attributes, the SEC has stated that there will not be a bright-line test to determine whether a person has those attributes. The board of directors must make a qualitative assessment of the potential expert's level of knowledge and experience. The list of factors above is not meant to be exhaustive and there is no set number of considerations that must be met that would automatically be sufficient to qualify a person as a financial expert.

In the rule proposal, the SEC states that the mere designation of a financial expert should not impose a higher degree of individual responsibility or obligation on a member of the audit committee or decrease the duties and obligations of other audit committee members. Financial experts will not be considered "experts" for purposes of Section 11 of the Securities Act of 1933 relating to registration statements. The SEC has not addressed the relationship between a financial expert and the term expert as used in other securities laws.

Exchange Requirements

Current New York Stock Exchange, American Stock Exchange and Nasdaq listing requirements already specify that at least one member of the audit committee must have extensive financial experience. The NYSE requires that at least one member of the audit committee have accounting or related financial management expertise, as the board of directors interprets that qualification in its business judgment. Nasdaq and the Amex require that at least one member have past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.

An audit committee member's qualifications may be sufficient to meet listing standards but not rise to the level of making that member a financial expert for purposes of SEC disclosure rules. For example, CEO experience would no longer be explicitly listed as sufficient, as it now is for Nasdaq and Amex. In addition, the necessary experience would have to be with a public company that faced generally comparable financial issues and principles. Under current or expected proposals, we expect stock exchange listing standards to be changed to reflect the requirements of the Sarbanes-Oxley Act and the SEC final rules.

Internal Controls and Procedures

Under the SEC proposals, companies would be required to include annually in Form 10-K, 20-F or 40-F, as applicable, an internal control report of management that includes:

- A statement of management's responsibilities for establishing and maintaining adequate internal controls and procedures for financial reporting;
- Conclusions about the effectiveness of the company's internal controls and procedures for financial reporting based on management's most recent evaluation of those controls and procedures; and
- A statement that the registered public accounting firm that prepared or issued the company's audit report relating to the financial statements in the company's annual report has attested to, and reported on, management's evaluation of the company's internal controls and procedures for financial reporting.

The accounting firm's attestation would have to be filed with the annual report.

In defining “internal controls and procedures”, the SEC specifically references the definition of internal controls in existing accounting literature, including the AICPA’s Codification of Statements on Auditing Standards Section 319, subject to revision by the newly-created Public Company Accounting Oversight Board. Internal controls and procedures should ensure that companies have processes designed to provide reasonable assurance that the company’s transactions are properly authorized, the company’s assets are safeguarded against unauthorized or improper use and the company’s transactions are properly recorded and reported in order to permit the preparation of the company’s financial statements in conformity with generally accepted accounting principles. *Internal* controls and procedures are narrower in scope than the SEC’s recently mandated *disclosure* controls and procedures. Internal controls and procedures relate to financial information and reporting and in that sense are a subset of disclosure controls and procedures. They also relate, however, to auditing integrity matters not directly covered in disclosure documents.

The SEC has also proposed changes to its recently adopted rules providing for CEO and CFO certifications pursuant to Section 302 of the Sarbanes-Oxley Act.³ These rules would be amended to require quarterly and annual certifications and quarterly evaluations of internal controls and procedures for financial reporting. Certifications regarding disclosure controls and procedures and internal controls and procedures would be combined into one form of certification for each officer.⁴ Other proposed changes include moving the date for evaluation from within 90 days prior to filing of the report to as of the end of the period covered by the report.

If adopted as proposed, these rules would take effect for reports for fiscal periods ending on or after September 15, 2003. In the meantime, the CEO and CFO certifications would remain unchanged.

Code of Ethics

Companies would be required to disclose in annual reports on Form 10-K, 20-F or 40-F, as applicable, whether they have adopted a written code of ethics that applies to their principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions, or if they have not, an explanation of why they have not. The SEC has not indicated any transition period for these rules after they are finalized. Under the proposal, a code of ethics is defined as a codification of standards that is reasonably designed to deter wrongdoing and to promote:

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

³ For a summary of the rules relating to CEO and CFO certifications, see the August 2002 ZAG/S&W LLP client advisory: “Certifications by Principal Executive Officers and Principal Financial Officers” and the September 2002 ZAG/S&W LLP client advisory: “SEC Requires Additional CEO and CFO Certifications.”

⁴ As of now, the “302” certifications are still separate and distinct from the certifications required under Section 906 of the Sarbanes-Oxley Act.

The code should include guidelines requiring avoidance of conflicts of interests and material transactions or relationships involving potential conflicts of interests without proper approval. In addition, the SEC has emphasized that an effective code of ethics should describe the company's system for the internal reporting of code violations and should state clearly the consequences of non-adherence to code provisions. If a company has adopted a code of ethics, it would need to be filed with the SEC as an exhibit to the company's annual report.

Companies also would be required to disclose amendments to, and waivers under, the code of ethics relating to any of the specified officers on either a Form 8-K or on the company's website within two business days. Website disclosure would be permitted only if the company had disclosed its intention to do so in its annual report. Foreign private issuers would need only provide disclosure of amendments and waivers in each Form 20-F or voluntarily on a Form 6-K or on their websites. If posted on the company's website, the code of ethics would have to remain accessible for at least 12 months.

Note that although this is merely a disclosure requirement, the NYSE, Amex and Nasdaq have proposed or are expected to propose a requirement that listed companies actually adopt a code of ethics and disclose waivers not only for the SEC's specified officers, but also for directors and possibly additional officers.

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Although these are only proposed rules, we believe it is likely that these rules will be adopted in the coming months in substantially similar form. Companies must begin analyzing whether or not their audit committees have financial experts as members and, if not, whether they want to attempt to recruit such members. In addition, as part of the process of formalizing and evaluating disclosure controls and procedures, companies must continue to focus on and assess the effectiveness of their internal controls and procedures and set up or improve systems for evaluation and monitoring by management in cooperation with their internal and outside auditors. Finally, companies should begin the process of reviewing existing, or preparing new, codes of ethics that would fit within the proposed SEC definition and stock exchange listing standards. To discuss these topics further, please contact your lawyer at ZAG/S&W LLP or the lawyer below.

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