

Client Advisory

February 2003

SEC Adopts Additional Rules to Implement Provisions of the Sarbanes-Oxley Act

Over the last two weeks of January 2003, the Securities and Exchange Commission adopted rules and amendments designed to implement various provisions of the Sarbanes-Oxley Act of 2002 relating to auditors, audit committees and financial executives. These rules:

- Require public companies to disclose whether their audit committees include an “audit committee financial expert”;
- Require public companies to disclose whether they have adopted a code of ethics that applies to their principal officers;
- Require auditors to retain workpapers for seven years; and
- Provide for enhanced auditor independence and require disclosure by public companies regarding the provision of certain services by the independent auditor.

This Advisory describes these rules in greater detail. We will release shortly a second Client Advisory describing additional rules adopted by the SEC under the Sarbanes-Oxley Act.

Financial Experts Serving on Company Audit Committees

On January 15, 2003, the SEC adopted rules under the Sarbanes-Oxley Act (Section 407) that will require public companies to disclose in their annual reports whether they have at least one “audit committee financial expert” serving on their audit committees.

Responding to comments on its earlier proposal, the SEC broadened the definitions in the final rule to allow for the inclusion of more individuals who will likely be “audit committee financial experts.” For example, the rule has been expanded to allow persons with experience performing extensive financial statement analysis or evaluation, such as investment bankers and venture capitalists with appropriate experience, to qualify as experts. The final rule also eliminated the proposed requirements (i) that an audit committee financial expert must have gained the relevant experience with a company that, at the time the person held such position, was required to file reports pursuant to Section 13(a) or 15(d) of the Securities and Exchange Act of 1934 and (ii) that the expert must have experience with the accounting for estimates, accruals and reserves that are generally comparable to these items in the registrant’s financial statements.

The final rule release emphasizes that a board of directors should consider all the available information when determining whether one qualifies as an audit committee financial expert. Specifically, the release provides that the fact that a person has experience as a public accountant or auditor, or a principal financial officer, controller or principal accounting officer or experience in a similar position does not, by itself, qualify the individual as an expert.

- *Disclosure Requirements*

If a company discloses that it has an audit committee financial expert, it also must disclose the expert's name. The rules permit, but do not require, a company to disclose that it has more than one audit committee financial expert serving on its audit committee. Thus, once a company's board determines that a particular audit committee member qualifies as an audit committee financial expert, the company must disclose the expert's name and may, but is not mandated to, determine whether additional audit committee members qualify as experts. If it does so, it may, but is not required to, name the additional experts. It will not be sufficient for a company to disclose that it has not determined whether its audit committee has at least one such expert, nor will it be sufficient to simply disclose the qualifications of all of its audit committee members without making a declaration.

A company also must disclose whether individuals identified as audit committee financial experts are independent of management. The rules refer to the definition of "independent" used in the Proxy Statement rules. If a company determines that its audit committee is not comprised of at least one audit committee financial expert, the company must disclose this fact and explain why it does not have such an expert. The final rule release notes that in the event a company discloses that its audit committee does not have an audit committee financial expert, it would be appropriate for a company to explain the aspects of the definition (provided below) that various members of the committee do satisfy.

- *"Audit Committee Financial Expert" Defined*

The rules define an audit committee financial expert as a person who possesses the following attributes:

- An understanding of generally accepted accounting principles and financial statements;
- The ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;
- 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;
- An understanding of internal controls and procedures for financial reporting; and
- An understanding of audit committee functions.

A person must have acquired all of these attributes through any one or more of the following means: (i) 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; (ii) experience actively supervising any such persons; (iii) experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or (iv) other relevant experience. If, however, a person qualifies as an expert by virtue of possessing "other relevant experience," the company must briefly disclose that person's experience.

- *Safe Harbor*

One concern expressed during the comment period was that by designating a member of the audit committee the “audit committee financial expert,” it may suggest that the expert has greater duties or obligations, or will face greater liability than other members of the committee. To address this concern, the SEC has included safe harbor provisions to clarify that the designation of an individual as the audit committee financial expert does not make him an “expert” for purposes of liability under the securities laws and does not impose any additional duties, obligations or liabilities that are greater than the duties, obligations and liabilities already imposed on other individuals serving on the audit committee or the board of directors.

One question remaining is how these rules will affect rules proposed by the New York Stock Exchange and Nasdaq. These SROs have proposed rules that differ with respect to financial expertise on the audit committee. The NYSE’s proposal would require each member of an audit committee to be “financially literate” and that at least one member have “accounting or related financial management expertise.” The Nasdaq proposal would require the company to certify that its audit committee has at least one “financial expert,” as defined by the SEC. It remains to be seen whether the SEC will induce the SROs to “harmonize” their approaches and/or conform to the rules promulgated by the SEC.

- *Effective Date*

The rules require companies to include the new disclosure in their annual reports on Forms 10-K, 10-KSB, 20-F or 40-F. The disclosure requirement is included in Part III of Forms 10-K and 10-KSB, thereby enabling a domestic company that voluntarily includes the disclosure in its proxy or information statement to incorporate the information by reference into its Form 10-K or 10-KSB if it files the 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. Companies, other than small business issuers, must comply with the disclosure requirements in their annual reports for fiscal years ending on or after July 15, 2003. Small business issuers must comply with the disclosure requirements in their annual reports for fiscal years ending on or after December 15, 2003. The disclosure requirement will be set forth in Item 401(h) of Regulation S-K and Item 401(e) of Regulation S-B.

Code of Ethics Disclosure

The SEC also adopted rules under Section 406 of the Sarbanes-Oxley Act that require a public company to disclose whether it has adopted a code of ethics that applies to the registrant’s principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. If the company has adopted such a code of ethics, it must disclose the relevant portions of the code. If the company has not adopted such a code, it must explain the reasons it has not done so.

- *Disclosure Requirements*

The final rules offer three alternative methods by which a company may disclose its code of ethics. First, a company may file a copy of the relevant portions of its code of ethics as an exhibit to its annual report. Second, a company may choose to post the relevant text of its code of ethics on its Internet website. A company may only choose this option if it discloses its Internet address and intention to provide disclosure in this manner in its annual report on Form 10-K, 10-KSB, 20-F or 40-F. The final alternative allows a company to offer in its annual report to provide a copy of its code of ethics to any person upon request without charge. The disclosure requirement will be set forth in new Item 406 of Regulation S-B and Item 406 of Regulation S-K.

- *“Code of Ethics” Defined*

The rule defines the term “code of ethics” as written standards that are reasonably designed to deter wrongdoing and 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 reports and documents that a registrant files with, or submits to, the SEC and in other public communications made by the registrant;
- 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.

- *Disclosure of Change or Waiver*

The rule mandates immediate disclosure on Form 8-K or via the company’s Internet website of certain amendments to, or waivers from, the company’s code of ethics. Those triggering events require disclosure of: (i) the nature of any amendment to the company’s code of ethics that applies to its principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions; and (ii) the nature of any waiver, including an implicit waiver, from a provision of the code of ethics granted by the company to one of these specified officers, the name of the person to whom the company granted the waiver and the date of the waiver. A company choosing to provide the required disclosure on Form 8-K must do so within five business days after it amends its code of ethics or grants a waiver. Alternatively, a company may use its Internet website to disseminate this information, but only if the company previously disclosed in its most recently filed annual report on Form 10-K or 10-KSB the company’s intention to disclose these events on its website and its website address.

- *Effective Date*

Companies must comply with the code of ethics disclosure requirements in their annual reports for fiscal years ending on or after July 15, 2003. Companies also must comply with the requirements regarding disclosure of amendments to, and waivers from, their code of ethics on or after the date on which they file their first annual report in which disclosure of their code of ethics code is required.

Auditor’s Workpaper Retention

The SEC adopted Rule 2-06 of Regulation S-X to implement Section 802 of the Sarbanes-Oxley Act. Rule 2-06(a) requires that auditors retain records relevant to the audit or review, including workpapers and other documents that form the basis of the audit or review of an issuer’s or a registered investment company’s financial statements, and memoranda, correspondence, communications, other documents, and records (including electronic records) that meet two criteria. The two criteria are that the materials (i) are created, sent or received in connection with the audit or review; and (ii) contain conclusions, opinions, analyses or financial data related to the audit or review.

The rule requires that records be retained for seven years after the auditor concludes the audit or review of the financial statements. The proposal originally contained a five-year retention period but was revised to conform to Section 103 of the Sarbanes-Oxley Act, which directs the Public Company Accounting Oversight Board to require an auditor to retain for seven years audit workpapers and other materials that support the auditor’s conclusions in any audit report.

Rule 2-06(c), as proposed, would have required the retention of records that support or “cast doubt” on the final conclusions reached by an auditor. In response to comments received by the SEC during the comment period, the final rule has been revised to require the retention of records that either support the auditor’s final conclusions or contain information or data, relating to a significant matter, that is inconsistent with the final conclusions of the auditor on that matter or on the audit or review. The rule also provides that the documents and records to be retained include, but are not limited to, those documenting consultations on or resolutions of differences in professional judgment. Accounting firms are required to be in compliance with these rules no later than October 31, 2003.

Auditor Independence

The SEC adopted amendments to its existing rules regarding auditor independence designed to enhance the independence of accountants that audit and review financial statements and prepare attestation reports filed with the SEC. The final rules also recognize the importance of a registrant’s audit committee and the vital role an audit committee plays in assuring accurate financial reporting. The amendments relate to new subsections (g) through (l) of Section 10A of the Securities Exchange Act of 1934 (the “Exchange Act”). The new rules related to these subsections are more specifically outlined below.

- *Prohibited Non-Audit Services*

Rules under subsections (g) and (h) of Section 10A of the Exchange Act include a list of non-audit services that, if provided by the issuer’s auditor, are deemed to impair the firm’s independence. The list is based on three basic principles: (i) an auditor cannot function in the role of management; (ii) an auditor cannot audit his or her own work; and (iii) an auditor cannot serve in an advocacy role for his or her client. A brief summary of the prohibited services follows.

- Bookkeeping or other services related to the accounting records or financial statements of the audit client, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client’s financial statements.
- Any service related to the audit client’s financial information systems design and implementation, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client’s financial statements.
- Appraisal or valuation services, fairness opinions or contribution-in-kind reports, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client’s financial statements.
- Any actuarially oriented advisory service involving the determination of amounts recorded in the financial statements and related accounts for the audit client, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client’s financial statements.
- Any internal audit service that has been outsourced by the audit client that relates to the audit client’s internal accounting controls, financial systems or financial statements, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client’s financial statements.
- Acting, temporarily or permanently, as a director, officer or employee of an audit client, or performing any decision-making, supervisory, or ongoing monitoring function for the audit client or providing various other human resource functions to the audit committee.
- Acting as a broker-dealer (registered or unregistered), promoter or underwriter on behalf of an audit client or providing similar investment banking services.
- Any service that, under the circumstances, could be provided only by someone licensed, admitted or otherwise qualified to practice law in the jurisdiction in which the service is provided.

- Providing expert opinions or other expert services to an audit client, or a legal representative of an audit client, for the purposes of advocating that audit client's interests in litigation or in a regulatory or administrative proceeding or investigation.
- This list of prohibited services only applies to those services provided by independent accountants to their audit clients. These rules do not prohibit an accounting firm from providing these services to non-audit clients. The rules provide that until May 6, 2004, the provision of these services will not impair an accountant's independence as long as these services were provided pursuant to contracts in existence on May 6, 2003.
- *Pre-Approval for Services*

Section 201 of the Sarbanes-Oxley Act provides that "a registered public accounting firm may engage in any non-audit service, including tax services," that is not specifically prohibited, after audit committee pre-approval. Accordingly, the new rules permit accountants to continue to provide tax compliance, tax planning and tax advice to audit clients, subject to audit committee pre-approval requirements. There are, however, some circumstances where providing certain tax services to an audit client would impair the independence of an accountant, such as representing an audit client in tax court or other situations involving public advocacy. In addition, the final rule release warns that audit committees should carefully scrutinize the retention of an accountant in a transaction initially recommended by the accountant, the sole business purpose of which may be tax avoidance and the tax treatment of which may not be supported by the IRS and related regulations.

Rules under new subsection (i) of Section 10A of the Exchange Act require an issuer's audit committee to pre-approve all audit and allowable non-audit services provided to the issuer by the auditor. Specifically, the rules require that before an accountant is engaged by the issuer or its subsidiaries to render services, the engagement is either: (i) approved by the issuer's or registered investment company's audit committee; or (ii) entered into pursuant to pre-approval policies and procedures established by the audit committee of the issuer or registered investment company, provided the policies and procedures are detailed as to the particular service, the audit committee is informed of each service and such policies and procedures do not include delegation of the audit committee's responsibilities to management. The rules also provide a narrow de minimis exception solely related to the provision of non-audit services. The exception waives the pre-approval requirement for non-audit services if: (i) all the non-audit services do not aggregate to more than five percent of total revenues paid by the audit client to its accountant in the fiscal year when services are provided; (ii) the services were not recognized by the issuer at the time of the engagement to be non-audit services (not likely to be the case too often); and (iii) the services are promptly brought to the attention of the audit committee and approved by the audit committee prior to completion of the audit.

Pursuant to these rules, issuers will be required to disclose, in their annual reports, fees paid to the independent auditor for (i) audit services; (ii) audit related services; (iii) tax services; and (iv) other services. The issuer will also be required to disclose, in qualitative terms, the types of services (other than audit services) provided by the independent auditor. This information will be required for the two most recent years and must be provided in the issuer's proxy statement or its periodic annual filing. In addition, the disclosure also must include the audit committee's policies and procedures for pre-approval of services by the independent accountant as well as the percent of fees paid subject to the de minimis exception.

While these rules apply to all audit, review and attest services and non-audit services "entered into" after May 6, 2003 many public companies are applying these rules sooner. Accounting firms will have until May 6, 2004 to complete any non-audit services that were "entered into" prior to May 6, 2003. "Entered into" is not defined in the final rule Release; hopefully, the SEC will clarify the meaning of the phrase before the first of these relevant dates.

- *Partner Rotation*

Rules under new subsection (j) of Section 10A of the Exchange Act require mandatory rotation for all “audit partners,” a new term defined as partners on the audit engagement team who have responsibility for decision-making on significant auditing, accounting and reporting matters that affect the financial statements or who maintain regular contact with management and the audit committee. Audit partners include lead and concurring partners, as well as other audit engagement team partners who provide more than ten hours of audit, review or attest services in connection with the annual or consolidated financial statements of the issuer. Audit partners also include the lead partner on subsidiaries of the issuer whose assets or revenues constitute 20% or more of the consolidated assets or revenues of the issuer. Lead and concurring partners are required to rotate after five years and will be subject to a five-year “time out” period after rotation. All audit partners other than lead and concurring partners are required to rotate after seven years with a two-year time out period. Accounting firms with fewer than five audit clients and fewer than ten partners will be exempt from this rule if they are reviewed by the Public Company Accounting Oversight Board at least once every three years.

The rotation requirements for lead partners will be effective for the first fiscal year ending after May 6, 2003. In order to stagger the rotation of lead and concurring partners, the rotation requirements for concurring partners will be effective as of the end of the second fiscal year after May 6, 2003. Time served in the capacity of a lead or concurring partner prior to May 6, 2003 will be included when determining when the lead and concurring partner must rotate. For other partners subject to rotation requirements, the rules will be effective as of the beginning of the first fiscal year after May 6, 2003. In determining time served for these partners, the first fiscal year after May 6, 2003 will constitute the first year of service.

- *Other*

Rules under new subsection (k) of Section 10A of the Exchange Act require accounting firms to report, prior to the filing of its audit report with the SEC, certain information to the issuer’s audit committee. Specifically, the rules require that the auditor report to the audit committee: (i) all critical accounting policies used by the registrant; (ii) alternative accounting treatments within GAAP that have been discussed with management along with the potential ramifications of using those alternatives; and (iii) other written communications provided by the auditor to management, including a schedule of unadjusted audit differences.

Rules under new subsection (l) of Section 10A of the Exchange Act address certain potential conflicts of interest. The rules provide that an accounting firm is not independent if a member of management of the issuer involved in overseeing financial reporting matters was the lead partner, the concurring partner, or any other member of the audit engagement team for that issuer and provided more than ten hours of audit, review or attest services for the issuer within the one-year period preceding the commencement of the audit of the current year’s financial statements. These rules are effective for employment relationships with the issuer that commence after May 6, 2003.

Finally, the SEC also adopted rules specifying that an accountant will not be considered independent if, at any point during the audit and professional engagement period, any “audit partner” earns or receives compensation based on that partner procuring engagements with the audit client to provide any services other than audit, review or attest services. This will obviously be difficult to determine and is likely to generate future SEC interpretive releases. This rule will not apply to specialty partners who have a low level of involvement with the issuer’s senior management and little responsibility for the overall presentation of the issuer’s financial statements. These rules will be effective in the fiscal periods of the accounting firm that commence after May 6, 2003. Accounting firms with fewer than five audit clients and fewer than ten partners are exempt from this rule.

We Can Help

Please direct questions regarding the issues discussed in this Client Advisory to the Co-Chairs of Katten Muchin Zavis Rosenman's Securities Practice:

Robert L. Kohl
212.940.6380
robert.kohl@kmzr.com

Lawrence D. Levin
312.902.5654
lawrence.levin@kmzr.com

Mark D. Wood
312.902.5493
mark.wood@kmzr.com

or to the following additional contacts in KMZ Rosenman's Washington, D.C. and Los Angeles offices:

Washington, D.C.

Terrance L. Bessey
202.625.3523
terrance.bessey@kmzr.com

Los Angeles

Mark A. Conley
310.788.4690
mark.conley@kmzr.com

*Published for clients as a source of information about current developments in the law. The material contained herein is not to be construed as legal advice or opinion.
© 2003 Katten Muchin Zavis Rosenman. All rights reserved. Katten Muchin Zavis Rosenman is a law partnership including professional corporations.*

KMZ Rosenman
KATTEN MUCHIN ZAVIS ROSENMAN

www.kmzr.com

525 West Monroe Street
Suite 1600
Chicago, IL 60661-3693
Tel 312.902.5200
Fax 312.902.1061

575 Madison Avenue
New York, NY 10022-2585
Tel 212.940.8800
Fax 212.940.8776

2029 Century Park East
Suite 2600
Los Angeles, CA 90067-3012
Tel 310.788.4400
Fax 310.788.4471

1025 Thomas Jefferson St., N.W.
East Lobby, Suite 700
Washington, DC 20007-5201
Tel 202.625.3500
Fax 202.298.7570

401 South Tryon Street
Suite 2600
Charlotte, NC 28202-1935
Tel 704.444.2000
Fax 704.444.2050

260 Sheridan Avenue
Suite 450
Palo Alto, CA 94306-2047
Tel 650.330.3652
Fax 650.321.4746

One Gateway Center
Suite 2600
Newark, NJ 07102-5397
Tel 973.645.0572
Fax 973.645.0573