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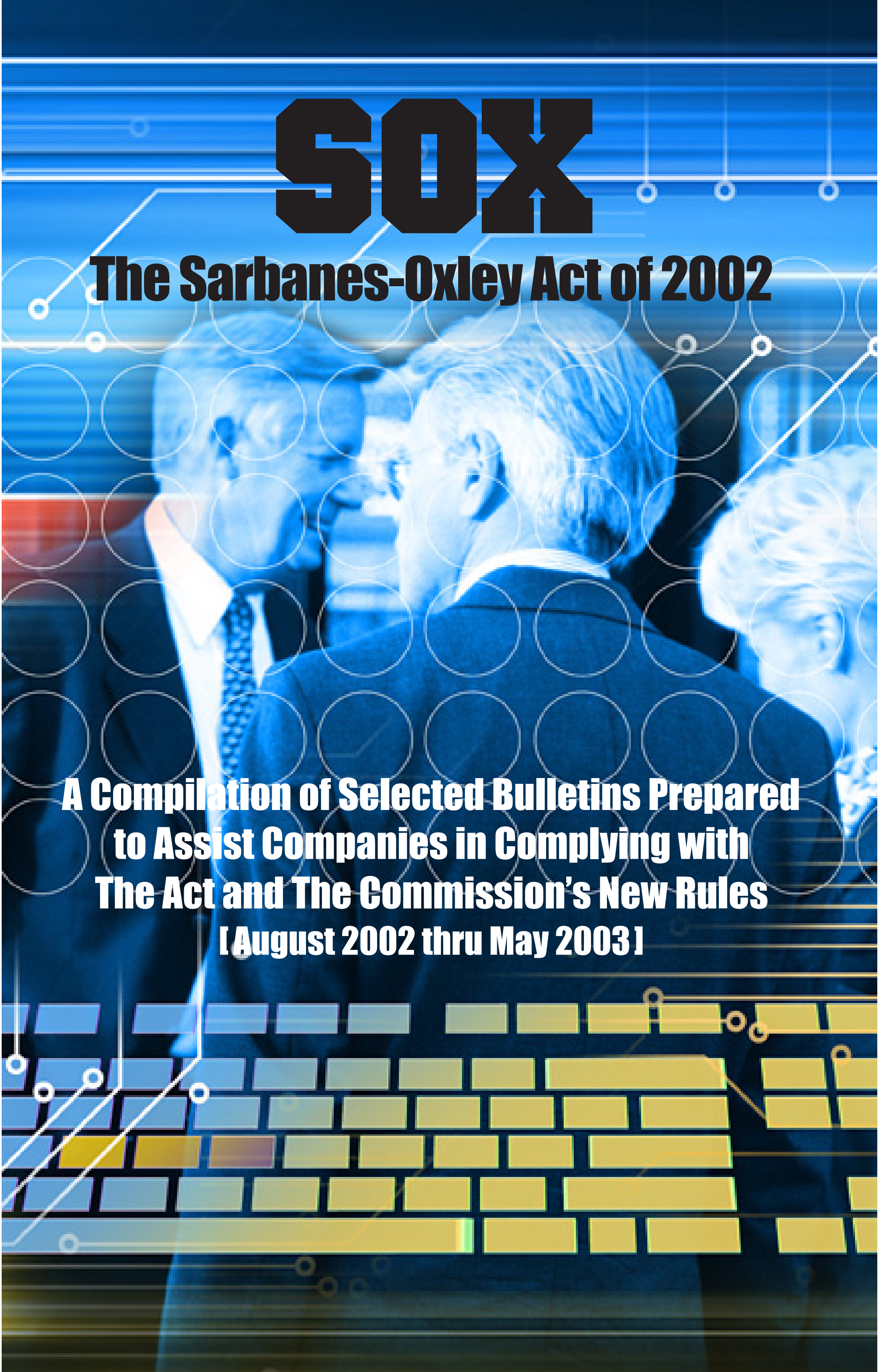
The Sarbanes-Oxley Act of 2002



A Compilation of Selected Bulletins Prepared to Assist Companies in Complying with The Act and The Commission's New Rules

[August 2002 thru May 2003]

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The Sarbanes-Oxley Act of 2002

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[August 2002 thru May 2003]

PREPARED BY:

ReedSmith

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FOREWORD

The Sarbanes-Oxley Act of 2002 has forever changed the legal landscape for corporate governance of public companies in the U.S. and for foreign companies with securities publicly traded in the U.S.

By its nature, the Act sets forth a general framework for these revisions to the way in which public companies operate. Many of the Act's major provisions are implemented through Rules prescribed by the Securities and Exchange Commission. This rulemaking effort, which is still underway, has resulted in numerous detailed Rules, including a new Regulation G on earning releases and use of pro forma financial information, as well as complex ethical rules for attorneys appearing and practicing before the Commission. In addition, the Act mandates changes in listing requirements by the New York Stock Exchange, the American Stock Exchange and NASDAQ.

Reed Smith's corporate and securities lawyers have taken a leading role in educating our clients in the rigorous new policies and procedures which must be adopted under the Act and the Commission's rulemaking, as well as changes in corporate governance to ensure that our clients maintain a "best practices" approach to compliance with these new requirements. We have counseled senior management, Boards of Directors, Audit Committees, General Counsel and other in-house counsel, as well as compliance officers, at a variety of U.S. and foreign public companies.

The Client Bulletins included in this booklet are a sample of the materials we have prepared to assist our clients and friends in complying with the Act and the Commission's new Rules. Readers with any questions or who need assistance with other provisions of the Act should feel free to contact any of the Reed Smith lawyers listed for those Bulletins for advice and counseling in this complex area.

Arlie R. Nogay
Securities & Tax Practice Group Leader

Our Firm

Reed Smith celebrated its 125th anniversary in 2002, and in those 125 years we moved from being the two-partner firm of Knox & Reed to a major player internationally. Over the past two years we have grown rapidly through a series of strategic mergers and lateral additions, with the result that we now have nearly 1,000 lawyers located in 16 offices, including two offices in the United Kingdom.

We are now a global top 20 law firm: We are counsel to 29 of the top 30 United States banks; 26 of the Fortune e-50 companies; nine of the top 10 pharmaceutical companies; and we represent 40 percent of the top global energy companies.

One of the reasons for Reed Smith's success is its proven ability to evolve with the changing marketplace and adapt to the many needs of our varied clients. We have successfully represented the interests of clients both large and small, in a broad spectrum of legal concerns, including:

Antitrust
Appellate
Bankruptcy & Reorganization
Benefits
Business Immigration
Communications
Construction
Consumer Financial Services
Corporate
Education
Employment
Energy & Natural Resources
Environmental
ERISA Litigation
Financial Services
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Government Contracts
Government Relations
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Labor
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Non-Profit & Charitable
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Public Contracts, Infrastructure & Privatization
Real Estate
Securities Compliance & Litigation
Tax
Technology
Trusts & Estates
Venture
White Collar Crime

Another reason for Reed Smith's success is its commitment—to quality, to the community and, most importantly, to our clients:

- *Quality* – 51 of our partners were named among The Best Lawyers in America in the 2003-2004 edition, and our senior partner in the U.K. was named as one of London's top 100 lawyers.
- *Community* – Reed Smith received national and international recognition for its pro bono representation of the photographic archives of Charles "Teenie" Harris, one of the United States' leading African-American photographers. Reed Smith also received the U.S. Department of Health and Human Services "Adoption Excellence" Award for its pro bono work involving more than 600 child welfare adoptions in the past six years.
- *Clients* – Reed Smith has adopted the tagline "It's not just business. It's personal." which we believe captures the passion and attention to detail that we bring to our work for you.

Much has changed during Reed Smith's first 125 years, but one thing that remains constant is our commitment to providing you with the highest-quality service, now on a global basis.

For additional information on the firm or any of our practice groups, please visit us at reedsmith.com.

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Background

On July 30, 2002 (the "Enactment Date"), President Bush signed the Sarbanes-Oxley Act of 2002 (the "Act"). This landmark legislation, and the resulting regulations, will have a significant impact on management of reporting companies, auditors, attorneys and securities analysts. The impact of the Act will be more thoroughly identified in the coming weeks and months as the various provisions become effective and detailed regulations are adopted and implemented by the Securities and Exchange Commission (the "SEC"), which has the lead role in interpreting and administering many of the provisions of the Act. Below, we have provided a short summary of some of the more critical aspects of the Act:

Corporate Responsibility and Disclosure

Section 906 of the Act, effective immediately, requires that a certification by the CEO and CFO accompany each periodic report containing financial statements filed with the SEC (e.g., Form 10-Q or Form 10-K). The required certification is a written statement from the CEO and CFO of the issuer certifying that the report complies with Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act") and that the information provided in the report fairly presents, in all material respects, the financial condition and results of operations of the issuer. Criminal penalties—both significant monetary fines and imprisonment—are established under the Act for any certification that is knowingly or willfully false.

Further, under Section 302 of the Act, the SEC must adopt regulations, to be effective within 30 days of the Enactment Date, requiring that a certification by the CEO and CFO of the issuer accompany each annual and quarterly report filed under Section 13(a) or 15(d) of the Exchange Act. The CEO and CFO must certify, among other things, that:

- the signing officer has reviewed the report,
- to the officer's knowledge, (a) the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading, and (b) the financial statements, and other financial information included in the report, fairly present in all

material respects the financial condition and results of operations of the issuer, and

- the officers have disclosed to the company's auditors or the audit committee, among other things, (a) all material weaknesses in internal controls and (b) any fraud, whether or not material, involving management or employees with a significant role in the company's internal controls.

If an issuer is required to restate its financial statements because of material noncompliance, as a result of misconduct, with any financial reporting requirement under the securities laws, the CEO and CFO are required to reimburse the company for any profits from the sale of securities and for any bonuses or other incentive-based or equity-based compensation, received in the 12-month period following the first public issuance or filing of the offending financial statements.

The Section 906 and 302 certifications are supplemental to the certifications to be issued by officers of the 947 largest reporting companies by August 14, and the scope of the Act is not limited to these large companies.

The Act also amends Section 16 of the Exchange Act to accelerate the filing deadline for reporting changes in the beneficial ownership of directors, officers and 10-percent beneficial owners. Effective August 29, the filing deadline for Form 4 reports of changes in beneficial ownership will be the second business day following the change rather than the tenth day of the month following the change. New procedures should be promptly established, and each company should ensure that all Section 16 filers are advised of the expedited timing and new process.

Effective 180 days after the Enactment Date, executive officers and directors may not purchase, sell or otherwise transfer company securities acquired in connection with the individual's employment or service as an officer or director, during pension fund blackout periods. Any profits realized from such transactions are recoverable by the company.

Effective immediately, companies may not directly or indirectly make loans or otherwise extend credit to any executive officer or director. One of the limited exceptions is any loan that existed on July 30, 2002, as long as it is not renewed or materially modified.

Auditor Regulation and Auditor Independence

The SEC has 90 days to appoint the five, full-time members of the Public Company Accounting Oversight Board (the "Board") which will oversee the audit of public companies. The primary duties of the Board will include:

- registering public accounting firms performing audits of public companies,
- establishing auditing, quality control, ethics, independence and other standards for registered public accounting firms,
- conducting periodic inspections of all registered public accounting firms, and
- conducting investigations and disciplinary proceedings and imposing appropriate sanctions upon registered public accounting firms and associated persons.

The Board is required to be fully operational not later than nine months after the Enactment Date. The Board will replace the current self-regulatory system.

In addition, the Act prohibits registered public accounting firms from performing specified non-auditing services for an issuer for which it performs auditing services. The list of prohibited services includes:

- bookkeeping or other related services;
- financial information systems design and implementation;
- appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- actuarial services;
- internal audit outsourcing services;
- management functions or human resources;
- broker or dealer, investment adviser, or investment banking services;
- legal services and expert services unrelated to the audit; and
- any other services proscribed by the Public Company Accounting Oversight Board.

With limited exceptions, a company's audit committee must pre-approve all services, audit and non-audit, provided by its auditing firm. Audit committee approvals must be disclosed in periodic filings with the SEC.

Reporting of Securities Violations by Lawyers

Within six months of the Enactment Date, the SEC must promulgate rules which require lawyers who represent issuers to report to the issuer's chief executive officer or chief legal officer "evidence" of material violations of securities law or breaches of fiduciary duty or "similar" violations by the issuer or any agent.

If the officer "does not appropriately respond (adopting, as necessary, remedial measures or sanctions with respect to the violation)," the lawyer must report the evidence to the audit committee, another committee comprised solely of independent directors or the board of directors.

Other Highlights

Other highlights of the Act include:

- enhanced disclosure requirements for off-balance sheet items;
- regular SEC review of disclosures;
- expedited disclosure of certain material changes in financial condition;
- stricter audit committee membership requirements, including a requirement that all audit committee members be independent;
- a requirement that audit partners rotate every five years;
- an amendment to the U.S. Bankruptcy Code which prevents judgments and settlements resulting from violations of securities laws from being discharged in bankruptcy;
- new criminal provisions and increased criminal penalties for existing crimes;
- expanded statute of limitations for securities fraud;
- rules governing conflicts of interest for securities analysts; and
- protection for so-called "whistleblowers."

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Bulletin 02-32

Securities and Exchange Commission Rulemaking
August 27, 2002 Meeting

On August 27, the Securities and Exchange Commission took rulemaking action in three areas of general interest to publicly held corporations.

First, the Commission adopted amendments to rules and forms relating to accelerated reporting of transactions in issuer equity securities by directors, officers and 10 percent holders. Section 403 of the Sarbanes-Oxley Act of 2002 amended Section 16(a) of the Securities Exchange Act of 1934, effective August 29, 2002, to require such reporting "before the end of the second business day following the day on which the subject transaction has been executed." The rule and form amendments adopted August 27, effective August 29, conform all references to the Form 4 filing deadline to the amended statutory filing deadline and reflect that Form 4 no longer is a monthly form. Also, under the amendments, transactions between officers or directors and the issuer exempted from Section 16b short-swing profit recovery by Rule 16b-3, previously reportable annually on Form 5, will be required to be reported within two business days after execution, on Form 4.

Section 403 authorized the Commission to establish by rule other reporting deadlines in any case in which the Commission determines that the two business day period is not feasible. Amendments adopted August 27, effective August 29, would calculate the statutory period differently for two categories of transactions in which the insider does not control and may not be able to predict when the transaction will occur. These are transactions pursuant to a contract, instruction or written plan that satisfies the affirmative defense conditions of Exchange Act Rule 10b5-1(c) and so-called discretionary transactions pursuant to employee benefit plans such as fund switching transactions. In either case, the date on which the executing broker-dealer or plan administrator notifies the insider of transaction execution would be deemed the date of execution, so long as that notification is no later than the third business day following the trade date.

Second, the Commission adopted amendments to accelerate the filing deadlines for quarterly reports on Form 10-Q and annual reports on Form 10-K required under the Exchange Act, and also to require new disclosure regarding access to reports on company websites. The recommended changes would accelerate reports for domestic companies that have a public float of at least $75 million, have been reporting for at least 12 months, have previously filed at least one annual report, and are not eligible to use the Commission's special forms for small business issuers. Changes to the filing deadlines will be phased in over three years, with no change for the first year. The annual report deadline would remain 90 days for the first year, change to 75 days for year two and change to 60 days for year three and thereafter. The quarterly report deadline would remain 45 days for the first year, change to 40 days for year two and change to 35 days for year three and thereafter. The ultimate acceleration of the quarterly report deadline would thus be less than originally proposed. The first reductions, to 75 days for annual reports and 40 days for quarterly reports, would occur for accelerated filers with fiscal years ending on or after December 15, 2003. The Commission also adopted conforming amendments to the timeliness requirements for other Commission filings.

Under the new rules, an accelerated filer is required to disclose in its Form 10-K, beginning with reports for the fiscal year ending on or after December 15 of this year, whether the company makes its periodic and current reports available free of charge on its website as soon as reasonably practicable after such material is electronically filed with or furnished to the Commission.

Third, the Commission adopted new rules and rule and form amendments to implement Section 302 of the Sarbanes-Oxley Act. New rules 13a-14 and 15d-14 require an issuer's principal executive and financial officers each to certify in the issuer's quarterly and annual reports that:

1. Based on the officer's knowledge, the report does not contain any untrue statement of a material fact, or omit to state a material fact necessary in order to make a statement made, in light of the circumstances under which such statement was made, not misleading; and

2. Based on the officer's knowledge, the financial statements and other financial information included in the report fairly present in all material respects, the financial condition, results of operations and cash flows of the issuer as of and for the period presented in the report.

In addition, such officers are required to certify that:

1. They are responsible for establishing, maintaining and regularly evaluating the effectiveness of the issuer's disclosure controls and procedures;
2. They have made certain disclosures to the issuer's auditors and the audit committee of the board of directors about the issuer's internal controls; and
3. They have included information in the issuer's quarterly and annual reports about their evaluation and whether there have been significant changes in the issuer's internal controls or other factors that could significantly affect internal controls subsequent to the evaluation.

These rules apply to any issuer that files quarterly and annual reports with the Commission under Section 13(a) or 15(d) of the Exchange Act.

In addition, new Rules 13a-15 and 15d-15 require an issuer to maintain disclosure controls and procedures to provide reasonable assurance that the issuer is able to record, process, summarize and report the information required in the issuer's Exchange Act reports, and also require a periodic review and evaluation of these controls and procedures.

The new rules are effective August 29, 2002 and apply to reports filed after that date. Certification statements regarding controls and procedures are required in reports for periods ending after August 29, 2002.

* * * * * * *

Bulletin 02-33

Sarbanes-Oxley Should Not Preclude All Broker-Assisted Cashless Option Exercises by Insiders

Although some law firms have advised public issuers to suspend broker-assisted cashless stock option exercises for executive officers and directors in light of Section 402 of the Sarbanes-Oxley Act, we believe, subject to certain limitations, that such suspension is not necessary.

The Statute

Section 402 of the Sarbanes-Oxley Act of 2002 ("SO") amends Section 13 of the Securities Exchange Act of 1934 ("Exchange Act") by adding a new subsection (k). This subsection, which became effective immediately upon SO's enactment on July 30, 2002, imposes the following prohibition:

> "It shall be unlawful for any issuer (as defined in section 2 of the Sarbanes-Oxley Act of 2002), directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer."

Section 2(a)(7) of SO defines "Issuer" as follows:

> "The term 'issuer' means an issuer (as defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c), the securities of which are registered under section 12 of that Act (15 U.S.C. 78l), or that is required to file reports under section 15(d) (15 U.S.C. 78o(d)), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn."

"Executive Officer" is defined in Rule 3b-7 under the Exchange Act as follows:

> "The term 'executive officer,' when used with reference to a registrant, means its president, any vice president of the registrant in charge of a principal business unit, division or function (such as sales, administration, or finance), any other officer who performs a policy making function or any other person who performs simi-

> lar policy making functions for the registrant. Executive officers of subsidiaries may be deemed executive officers of the registrant if they perform such policy making functions for the registrant."[1]

"Director" is defined in §3(a)(7) of the Exchange Act as:

> "any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated."

The new statute, then, prohibits issuers subject to its coverage from directly or indirectly (including through a subsidiary):

> extending or maintaining credit;
>
> arranging for the extension of credit; or
>
> renewing an extension of credit;
>
> in each case in the form of a personal loan;
>
> to any of the enumerated class of persons.

The terms "extend," "maintain," "credit," "arrange," and "personal loan" are used in the statute but are not defined. And, unlike many other provisions of SO, this section does not contemplate any clarifying or implementing regulations by the SEC or other regulatory agencies. SEC representatives have informally indicated that no regulatory action is likely under this section in the near term. So the bare statutory text is likely to be all the guidance which is available for the foreseeable future.

Mechanics of Broker-Assisted Cashless Option Exercises

Broker-assisted cashless option exercises are customarily conducted with the assistance of a brokerage firm, in one of the following fashions:

- At the time of exercise of the option, the broker receives from the optionee a copy of the optionee's irrevocable notice to the issuer of exercise of the option, together with a copy of the optionee's irrevocable instructions to the issuer to deliver the option stock to the broker against the broker's simultaneous payment to the issuer of the option exercise price. On the date of receipt of such documentation, prior to the actual issuance by the company of the subject shares, the broker will sell for the optionee's account the number of shares of company stock necessary to satisfy the exercise price and applicable tax withholding obligations. When the broker receives the cash proceeds from such sale (typically three trading days after the sale), the broker will forward such proceeds to the issuer against simultaneous delivery by the issuer of the subject stock to the broker; or

- The broker makes a loan to the insider of the proceeds necessary to exercise the option, and delivers payment to the company on the same day as the exercise upon the broker's receipt of the exercise notice with irrevocable instructions to the issuer to deliver the option stock. Although the shares necessary to satisfy the option holder's payment obligation are almost always sold contemporaneously with the exercise, the broker will generally be paid interest on the funds advanced.

We believe that Section 402 would prohibit these procedures only if, first, they are viewed as an extension of credit by the broker to the optionee executive officer/director, *and* second, the extension of credit was viewed as having been arranged by the company.[2] The legislative history of this provision of SO contains no indication of Congressional intent as to whether cashless option exercises were intended to be within or without SO's prohibition.[3]

Extension of Credit by Broker

The above-described broker-assisted cashless exercise procedures involve the sale or advance of funds by the broker relating to shares the optionee has not yet received, against assurance of delivery of such shares a short time later from the company. If for some reason the shares were not forthcoming by the company, the broker would be required to honor its settlement obligation for the shares from some other source, either from shares it owned itself or shares it purchased from others. In this sense, the procedure could be characterized as a loan by the broker of shares to the optionee for sale for his account, to be repaid by the issuance of shares by the company.[4]

These broker-assisted cashless exercise procedures are specifically considered to be outside the coverage of Regulation T, which generally imposes limitations upon extensions of credit by brokers.[5]

Section 220.3(e)(4) of Regulation T provides:

> "To temporarily finance a customer's receipt of securities pursuant to an employee benefit plan registered on SEC Form S-8 or the withholding taxes for an employee stock award plan, a creditor may accept, in lieu of the securities, a properly executed exercise notice, where applicable, and instructions to the issuer to deliver the stock to the creditor. Prior to acceptance, the creditor must verify that the issuer will deliver the securities promptly and the customer must designate the account into which the securities are to be deposited."

Reference to the regulatory restrictions upon extensions of credit by brokers under Regulation T provides less than clear guidance for Section 402 purposes. The above provision could suggest that since these types of arrangements are not prohibited by the Regulation T restrictions on broker extensions of credit, they should not be considered to constitute extensions of credit for purposes of Section 402. On the other hand, the provision could be read to suggest that although these activities will not be subject to the constraints imposed by Regulation T, they in fact do constitute "financing."

More generally, caution is in order in using Regulation T as a reference point for interpreting Section 402. Despite its use of similar terms ("extension of credit," "maintaining," "arranging") and its specific focus here on the precise type of transaction for which 402's applicability is being analyzed (cashless option exercises), Regulation T has a completely different policy basis than Section 402.[6]

Ultimately, reference to Regulation T, as with the legislative history of Section 402, does not provide a solid basis for reaching a conclusion on whether the activity of brokerage firms in effecting cashless option exercises constitutes an "extension of credit" in the form of a "personal loan" to the optionee, as such terms are used in Section 402.

Arranging Extension of Credit by Issuer

If broker facilitation of cashless exercises as described above is considered to constitute an "extension of credit" to executives, Section 402 would prohibit the company from "arranging" such extension.

The concept of "arranging" extensions of credit has been the subject of extended Federal Reserve Board and SEC interpretation under Regulation T, which restricts the ability of brokers to arrange such extensions from other parties. The general tenor of such interpretation is that the concept of "arranging" under Regulation T context has been given a very broad meaning. The introduction of a customer to a lender has been interpreted to constitute "arranging" of the lender's extension of credit under Regulation T. The recommendation of a specific lender has been held to constitute such arranging. Even the simple delivery of securities to a lender against receipt of the proceeds of a loan has been held to constitute an arranging of the loan under Regulation T.[7]

If such a broad conception of "arranging" was applied in interpreting Section 402, certain activities of an issuer in connection with a cashless exercise program might be considered to fall within the category of "arranging" the broker's extension of credit and thus be proscribed. Customarily, a company will agree to provide an acknowledgment to the broker that it has received the notice of exercise and instructions to deliver shares to the broker and (sometimes) that the notice of option exercise complies with the terms of the option plan and option agreement. Universally, the issuer will agree, pursuant to the optionee's instructions, to deliver the shares to the broker against the broker's simultaneous payment. Often companies will recommend brokerage firms to employees for cash option exercises. Frequently the company will reserve the right to approve the brokerage firm selected by the optionee for such purposes. Sometimes the issuer will designate one or more brokerage firms which optionees will be required to use for these purposes.

However, the differences in the policy bases behind Regulation T and Section 402 argue strongly that the term "arranging" under 402 should be interpreted more in accordance with the term's natural meaning than in the way followed under Regulation T.

Regulation T's primary purpose is to regulate the amount of credit directed into securities speculation and away from other sources. It is also intended to protect the securities markets from undue fluctuations and disruptions caused by excessive credit, and to protect investors against excessive securities credit. The protection of broker-dealers against excessive credit exposure to customers was not an original purpose behind the margin regulations.[8] In later years, the regulatory agencies have made reference to the desirability of protecting brokers from excessive credit extension; however, this is not the primary thrust of the margin regulations.

A regulatory purpose geared to a control of the overall supply of credit into the marketplace naturally lends itself to a broad prohibition on "arranging" such credit. The harm is deemed to be done by the unregulated supply of credit, even where its source is only tenuously connected with a directly regulated broker dealer.

The purpose of the Section 402 loan prohibition, on the other hand, is focused on the protection of investors in the corporation. The Report of the Senate Committee on S.2673[9] made reference to multimillion dollar loans to executives of Enron, WorldCom, Qwest, Global Crossing and AES Corp.[10] and multibillion dollar loans to the founder of Adelphia. Several of these loans were later forgiven by the corporation. The Committee noted that it was "aware that *investors* are concerned about loans to insiders." Inherent in corporate loan transactions to related parties is the risk to the corporation's shareholders posed by the fact that adequate credit analysis may not be conducted and even that loans may simply later be forgiven, in each case to the detriment of shareholders.

Section 402's prohibition on a corporation's "arranging" loans to executives should be analyzed consistent with this purpose. The concern here is not in protecting a trading marketplace against an increased credit supply through loans to executives. Neither is the concern to protect the executive against the consequences of excessive borrowing. The focus is upon the potential of harm to the corporation and its shareholders.

Where the nature of the company's involvement in the making of the loan imposes risk to the company's shareholders, the prohibition on "arranging" should apply. For example, if by stated or unstated understanding, the company will favor a lending broker with some type of business relationship with the company as an exchange for the broker facilitating cashless exercises, this should be viewed as an "arranging" by the company. To avoid a claim of "arranging" on this basis, we believe it would be preferable for a company not to recommend or require that executives use brokerage firms with whom the company has an investment banking relationship, or whose investment analysts report on the company, or with which the company has some other business relationship. It may be prudent for a company to suggest to executives that they use brokerage firms other than those with whom the company has a relationship, or even to require the use of firms other than these, without designating particular firms to use.

Within these constraints, we believe a cashless exercise program should not constitute an unlawful "arranging" under Section 402 if the company's involvement is limited to: (i) recommending one or more brokerage firms for executive to use for cashless option exercises; (ii) reserving the right to approve the chosen firm based on standards of administrative competence in handling cashless exercises; (iii) agreeing to forward to the broker an acknowledgment of receipt of exercise form and the optionees instructions to deliver shares to the broker; (iv) informing the broker that the exercise form complies with the applicable plan requirements; and (v) agreeing to forward the option stock to the broker against the broker's simultaneous payment of the option exercise price and necessary tax withholding.

Such an interpretation is consistent with the statute's purpose, and also, we believe, involves a less strained reading of the term "arranging." Under this approach, the term "to arrange" would require more than a tenuous connection between the issuer's actions and the broker's extension of credit. "Arranging" by the issuer would mean active involvement in bringing into effect the extension of credit in question, and would be equivalent to "devising," "engineering" or "formulating" a procedure for broker extensions of credit.[11]

We do recommend, except as specified below, that issuers refrain from requiring that a single specified broker be used by all executives for cashless option exercises. Even where it could be demonstrated that this poses no risk to the company or its shareholders, this level of involvement is significant enough that it could be deemed to constitute an "arranging," under the plain meaning of the term. Notwithstanding this, if the issuer can demonstrate that it is imposing the requirement of use of a single brokerage firm for cashless exercises as part of an overall program requiring all executive officers and directors to use a single broker for all of their transactions in company stock, and can demonstrate that the purpose of imposing the requirement is to facilitate compliance with the accelerated reporting requirements for such transactions imposed by Section 403 of SO, we believe this should not be deemed to constitute an unlawful "arranging."[12]

Timing Issues

Section 402, effective July 30, 2002, prohibits an issuer from "arranging for the extension of credit" to an executive officer or director. By its terms, if an issuer engaged in activity prior to July 30 resulting in an extension of credit prior to July 30, this would be beyond the statute's prohibition. Engaging in activity after July 30 in arranging credit extended after July 30 is prohibited.

Less clear is the application to issuer "arranging" activity occurring prior to July 30, 2002 which results in an extension of credit by another party after July 30, 2002. Section 402 exempts from its coverage "extensions of credit maintained by the issuer" after July 30 so long as they are not modified or renewed. Consistent with this provision, advances by an issuer after July 30 made pursuant to a contractual obligation entered into prior to July 30 should not be covered by the statute.

The statute contains no comparable provision relating to the timing of arranging activity. With regard to cashless exercise programs, however, if the participation by an issuer is such as to be deemed to constitute an arranging of broker extensions of credit, we believe the statute should be construed as excluding from its coverage such arranging activity insofar as it relates to broker actions after the effective date taken pursuant to contractual obligations entered into by the broker prior to the effective date. This could be the case, for example, in Rule 10b5-1 plans adopted prior to the effective date of the statute under which the broker is committed to facilitate cashless exercises under the terms of the plan.

Need for Interpretative Guidance

The loan prohibition of Section 402 has been interpreted by many practitioners to reach far beyond the scope of the abusive personal loans to insiders at which it appears to have been directed. Although interpretive guidance is clearly needed, it is unclear when and from whom interpretive guidance will come.

Until interpretive guidance is received, we believe that issuers are left with no choice but to consult with counsel and apply reasonable judgment to the interpretation of this difficult issue. While some issuers may decide to suspend all broker-assisted cashless exercises for executive officers/directors, we believe it is important for issuers to be aware that an alternative interpretation of Section 402 exists.

* * * * * * *

Bulletin 02-33b

Section 402 of the Sarbanes-Oxley Act of 2002:
New Loans to Executives

Section 402 of the Sarbanes-Oxley Act of 2002 ("SO") amends Section 13 of the Securities Exchange Act of 1934 ("Exchange Act") by adding a new subsection (k). This subsection, which became effective immediately upon SO's enactment on July 30, 2002, imposes the following prohibition:

> It shall be unlawful for any issuer (as defined in section 2 of the Sarbanes-Oxley Act of 2002), directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer.

Section 2(a)(7) of SO defines "Issuer" as follows:

> The term 'issuer' means an issuer (as defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c), the securities of which are registered under section 12 of that Act (15 U.S.C. 78l), or that is required to file reports under section 15(d) (15 U.S.C. 78o(d)), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn.

"Executive Officer" is defined in Rule 3b-7 under the Exchange Act as follows:

> The term 'executive officer,' when used with reference to a registrant, means its president, any vice president of the registrant in charge of a principal business unit, division or function (such as sales, administration, or finance), any other officer who performs a policy making function or any other person who performs similar policy making functions for the registrant. Executive officers of subsidiaries may be deemed executive officers of the registrant if they perform such policy making functions for the registrant.[13]

"Director" is defined in §3(a)(7) of the Exchange Act as:

> any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated.

The new provision prohibits issuers subject to its coverage from directly or indirectly (including through a subsidiary):

- extending or maintaining credit;
- arranging for the extension of credit; or
- renewing an extension of credit;
- in each case in the form of a personal loan;
- to any of the enumerated class of persons.

The terms "extend", "maintain", "credit", "arrange", and "personal loan" are used in the statute but are not defined. And the applicability of the statute to a number of heretofore customary arrangements with executive officers and directors will turn on the interpretation of these terms. Unlike many other provisions of SO, this section does not contemplating any clarifying or implementing regulations by the SEC or other regulatory agencies. SEC representatives have informally indicated that no regulatory action is likely under this section. So the bare statutory text is likely to be all the guidance which is available for the foreseeable future.

Cashless Option Exercises

The term "cashless option exercise" refers, as the name suggests, to a mechanism whereby an option holder can exercise his option, without any outlay of cash, and receive the cash differential between the exercise price and the market price, less necessary tax withholding and, perhaps, an interest factor. Broadly, the mechanism can work in one of two ways.

The terms of the stock option may provide that the optionee need not pay the option exercise price to the issuer until some short time, such as three days after exercise of the option. This would give the optionee the time to sell the option shares and receive proceeds in time to pay the option exercise price to the issuer, with the optionee retaining the excess.

Or, the optionee may have an arrangement with his brokerage firm whereby the broker would advance to the optionee the funds necessary to exercise the option, with a view to then immediately selling the shares received upon the option exercise, using the proceeds to repay the loan with any required interest. Here, the option price would be paid to the issuer against a contemporaneous transfer of the shares to the optionee.

For the first of these arrangements, the interpretive statutory issue is whether this amounts to an extension of credit by the issuer in the form of a personal loan to the optionee. Generally speaking, this arrangement would probably not be denominated a personal loan, and likely would not be evidenced by a debt instrument such as a note which customarily accompanies personal loans. Nevertheless, in substance, this appears little different from any arrangement which allows the purchase of an item while deferring the payment of the purchase price. The fact that the deferral is for a very short time would not appear to be relevant in determining whether it is an extension of credit in the form of a personal loan. In light of these factors, this type of cashless exercise seems to raise a significant risk of violating the new statute.

For the second of these arrangements, although there may well be an extension of credit in the form of a personal loan to the optionee, the loan is not being made by the company, but by the brokerage firm. However, this type of cashless exercise mechanism would still be prohibited by the statute if it involved an "arrangement" by the issuer of the extension of credit by the broker. As noted, the term "arrange" is not defined under the statute.

The concept of arrangement of extensions of credit is used in regulations adopted by the Federal Reserve Board restricting the extension of margin credit under Section 7 of the 1934 Act. Regulation T, for example, which regulates the extension of credit by broker-dealers, prohibits the extension of credit, or the arrangement of the extension of credit, by a broker-dealer outside of the limitations permitted by the Regulation. The Federal Reserve Board interpretations of what constitutes an arrangement of credit under Regulation T have been very broad. The prohibition has, for example, been interpreted to prohibit a broker from introducing or recommending a specific lender to a customer (although the furnishing of a list of possible lenders without recommendation of a specific one, has passed muster).

However, the policy concerns underlying the regulations restricting the extension of margin credit by brokers and others are fundamentally different than the concerns which led to the enactment of Section 402 of SO. The margin regulations were adopted for the purpose of controlling the extension of margin credit so as to prevent untoward volatility in the securities markets. A secondary purpose was to protect customers against attempts by brokers and others to persuade them to undertake unwise credit obligations. Both of these purposes require a broad prohibition on arranging, as well as extending , credit.

Section 402 of SO, on the other hand, was intended to protect corporate assets against the attempts by executives to engage in self-dealing credit transactions. Here, if a corporation recommends a third-party unaffiliated lender to an executive, and any loans are made without any explicit or tacit commitment of corporate assets, and without any understanding that the corporation would in some fashion favor the broker in corporate business relationships, the purpose of the statute would not appear to be violated.

If additional clarifying regulations on the question were expected, issuers might consider a temporary halt in all cashless exercise transactions involving executive officers and directors. However, with no such regulations in view, it may be overly conservative for issuers to feel they need to halt all such transactions on a long-term basis. If the issuer's involvement is limited to recommending to optionees particular brokerage firms which may be willing to advance funds for cashless exercises, without any financial compensation to the issuer from the broker for the referral, and without any credit support or collateralization furnished by the company to support the loan or any other informal business understanding between the company and the brokerage firm, an issuer can probably be comfortable that it is not "arranging" the extension of credit. A different situation is posed if the issuer requires optionees to use a designated broker to effect cashless exercises. Here, the prudent course may be for issuers to refrain from a requirement to use particular brokerage firms, to achieve a better comfort level that the statute is not violated by these arrangements.

Advancement of Expenses in Connection with Indemnification

It is virtually universal among public corporations to provide in the Articles or Bylaws that directors and officers are entitled as of right to be indemnified by the corporation to the fullest extent permitted by law against liability incurred in any action against them by reason of their being directors or officers. It is also virtually universal to provide that indemnitees have the right to have their legal expenses in any such action paid in advance by the corporation, subject to the indemnitee being obligated to return such payments if it is determined that the indemnitee is not legally entitled to such payments.[14] These contractual obligations are often also incorporated in indemnification agreements between the corporation and the indemnified individuals.

Would an advance of such expenses constitute an "extension of credit" in the form of a "personal loan" to the individual in violation of Section 402 of SO?

First, for existing officers and directors, this situation may be protected by the following provision of Section 402:

> An extension of credit maintained by the issuer on the date of enactment of this subsection shall not be subject to the provisions of this subsection, provided that there is no material modification to any term of any such extension of credit or any renewal of any such extension of credit on or after that date of enactment.

Existing directors are beneficiaries of contractual indemnification and advancement of expense obligations entered into prior to the effectiveness of the statute. The commitment on the part of these individuals to refund expense advances to which they are determined not to be entitled also was entered into before statutory effectiveness. For the purposes of the statute, it would seem appropriate to treat the extension of credit involved in these arrangements (if any) to have been made at the time the contractual obligation to extend the credit was entered into. This would be at the time the director entered into his indemnification agreement with the company. If that was prior to July 30, 2002, the statute would not apply.

The grandfathering provision probably would not apply to directors first elected after July 30, 2002. Here, there would be a need to focus on whether these types of arrangements represent an "extension of credit" in the form of a "personal loan" at all. The potential obligation to repay the amounts advanced carries with it a suggestion that the original advance is in the nature of an extension of credit or loan. On the other hand, the purpose of the repayment undertaking is simply to ensure that the corporation will not be paying indemnification in circumstances (such as willful misconduct or recklessness) where indemnification is beyond the power of the corporation under state law. The intent of the corporation in advancing expenses is not to lend funds to the individual in any traditional sense. The intention is to pay indemnification to the fullest extent provided by law. The contingent repayment obligation for expenses is statutorily required; in its absence corporations would likely opt to simply authorize the payment of such expenses without any repayment obligation whatsoever.

If the loan prohibition were deemed applicable here, corporations would not have the option of advancing expenses without requiring a contingent repayment undertaking. That would be prohibited under state law. The only alternative, a drastic one, would be to refrain from advancing expenses altogether. This being the case, it may be reasonable for a corporation to determine to leave its current provisions unchanged. In the event of a lawsuit against an executive officer or director, it may well be that the proposed advancement of expenses by the corporation would be challenged by the plaintiff as a violation of the new statute. If so, the corporation would need to be prepared to defend the advancement on the grounds that it does not constitute an extension of credit in the form of a personal loan, for the reasons described above.

Split Dollar Life Insurance

"Split dollar" life insurance is a compensation feature whereby the corporation pays the premium on a life insurance policy for the executive. When the executive dies, or when the cash surrender value of the policy reaches a certain level, the corporation receives a refund of the amounts it has paid.

It appears that this arrangement would constitute an extension of credit by the company in the form of a personal loan to the individual for the purpose of financing his payment of life insurance premiums. New arrangements of this type for executive officers and directors would appear to be prohibited by the statute. However, to the extent that the company has already entered such an arrangement, further premium payments pursuant to the prior contractual obligation should be covered by the "grandfather" clause. Care would need to be taken that no future modifications of the program were made, as these would also violate the statute.

Other Arrangements

Corporations often have arrangements for payment of travel and other legitimate business expenses for executive officers and directors. These arrangements can include provision for advancing such expenses on an estimated basis to the individuals involved, with an agreement on the part of the individual to repay the portion of the expenses not needed for the business purpose in question.

It could perhaps be argued that these arrangements allow the individual to have the use of corporate funds for the period from the date of the advance to the individual's payment of the business expense and/or repayment of the excess, and so constitute extensions of credit. However, the statute's prohibition goes only to extensions of credit "in the form of personal loans". In interpreting the statute's coverage, an important element is ascertaining whether the arrangement is intended to function to provide a personal benefit to the individual in a way comparable to a straightforward personal loan. To the extent that it can be demonstrated that the arrangement is set up for the purposes of simply facilitating the payment of legitimate business expenses, the "personal loan" aspect would seem to be missing. In this regard, it would be important to make sure that the amount of expense advances is not so disproportionate to the reasonably anticipated expenses as to call into question the actual purpose. Also, the timing of repayment of advances should be short enough that it does not appear that the program is a disguised personal loan.

Similar considerations would govern compensation arrangements where an individual who is compensated on the basis of sales commissions receives a regular salary draw as an advance against the earning of such commissions. If the draw represents a "base salary" to which the individual is entitled even if he earns no commissions, the statutory provision would not impose a prohibition. If the individual were required to repay the salary payment in the event commissions for a designated period were less than the amount advanced, further analysis would be required. If the amount of the salary was less than the amount of commissions which would be reasonably be expected to be earned (based upon past history or other factors), this still might legitimately be considered to be an arrangement not entered into for the purpose of extending credit in the form of a personal loan, but rather simply as a matter of appropriate timing of compensation.

Also, in a particular case, if the arrangement is pursuant to a previously entered into contractual obligation, the grandfathering provisions of the statute discussed above may come into play.

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Bulletin 02-37

Payment of Litigation Expenses of
Indemnified Directors and Officers
Under Section 402 of the Sarbanes-Oxley Act

Section 402 of the Sarbanes-Oxley Act of 2002, enacted July 30, 2002, prohibits public corporations from extending credit in the form of personal loans to executive officers or directors. Some law firms have questioned whether this provision prohibits corporate payments of litigation expenses for indemnified executive officers and directors, where the recipient agrees to repay the amounts if he is ultimately determined not to be legally entitled to them. As described below, we believe the Sarbanes-Oxley Act does not prohibit such arrangements.

Corporate Indemnification

Virtually universally, public corporations obligate themselves to indemnify their directors and officers against liabilities incurred in such roles and agree to pay litigation expenses of directors and officers in defending legal actions brought against them in such roles. These obligations may be set forth in the corporation's articles of incorporation, bylaws, or contracts with officers and directors, or in some combination of these.

Corporations are broadly authorized by state corporation laws to enter into such obligations, reflecting a policy judgment that allowing corporations to provide this financial protection is in the public interest.[15] For example, the Pennsylvania Business Corporation Law permits indemnification and payment of expenses in all cases relating to action in the person's official capacity and action in another capacity while holding the office, other than where the act or failure to act giving rise to the claim for indemnification is determined by a court to have constituted willful misconduct or recklessness.[16] Corporations may elect to impose their own additional limitations upon a director or officer's right to indemnification and payment of expenses.

Customarily, state law specifically authorizes payment of litigation expenses of the indemnitee in advance of the final disposition of the action or proceeding. The Pennsylvania Business Corporation Law states:

> Expenses (including attorneys' fees) incurred in defending any action or proceeding referred to in this subchapter may be paid by a business corporation in advance of the final disposition of the action or proceeding, upon receipt of an undertaking by or on behalf of the representative to pay the amount if it is ultimately determined that he is not entitled to be indemnified by the corporation as authorized in this subchapter or otherwise.[17]

The Model Business Corporation Act provides:

> A corporation may, before final disposition of a proceeding, advance funds to pay for or reimburse the reasonable expenses incurred by a director who is a party to a proceeding because he is a director if he delivers to the corporation:
>
> (1) a written affirmation of his good faith belief that he has met the relevant standard of conduct described in section 8.51 or that the proceeding involves conduct for which liability has been eliminated under a provision of the articles of incorporation as authorized by section 2.02(b)(4); and
>
> (2) his written undertaking to repay any funds advanced if he is not entitled to mandatory indemnification under section 8.52 and it is ultimately determined under section 8.54 or section 8.55 that he has not met the relevant standard of conduct described in section 8.51.[18]

The comment to this section of the Model Business Corporation Act explains the policy basis for this provision as follows:

> Section 8.53 reflects a determination that it is sound public policy to permit the corporation to advance (by direct payment or by reimbursement) the defense expenses of a director so long as the director believes in good faith that he was acting in accordance

> with the relevant standard for indemnification set forth in section 8.51 or that the proceeding involves conduct for which liability has been eliminated pursuant to section 2.02(b)(4) and agrees to repay any amounts advanced if it is ultimately determined that he is not entitled to indemnification….[A]dequate legal representation often requires substantial expenses during the proceeding and many individuals are willing to serve as directors only if they have the assurance that the corporation has the power to advance these expenses.

Pursuant to this statutory authority, many corporations have included provisions in their articles and bylaws, and have entered into agreements with officers and directors, obligating the corporation to indemnify and to pay litigation expenses. For such expenses, the provisions universally incorporate the statutorily mandated contingent repayment undertaking as described above.

This contingent repayment feature has caused some to question whether these arrangements run afoul of the Sarbanes-Oxley Act's prohibition on extensions of credit in the form of personal loans to executive officers and directors.

The Sarbanes-Oxley Act

Section 402 of the Sarbanes-Oxley Act of 2002 amends Section 13 of the Securities Exchange Act of 1934 ("Exchange Act") by adding a new subsection (k). This subsection, which became effective on July 30, 2002, imposes the following prohibition:

> It shall be unlawful for any issuer (as defined in section 2 of the Sarbanes-Oxley Act of 2002)[19], directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director[20] or executive officer[21] (or equivalent thereof) of that issuer.

The terms "extend," "maintain," "credit," "arrange," and "personal loan" are used in the statute but are not defined. And, unlike many other provisions of the Act, this section does not contemplate any clarifying or implementing regulations by the SEC or other regulatory agencies. SEC representatives have informally indicated that no regulatory action is likely under this section in the near term. So the bare statutory text is likely to be all the guidance which is available for the foreseeable future.

Extension of Credit in the Form of a Loan

Under the indemnification arrangements described above, payment of expenses is necessarily prospective, at a time and circumstance where there likely is little basis for a determination of ultimate entitlement. Such payments are made against an implicit or explicit representation by the individual that he falls within the statutory entitlement requirement (or stated another way, that he does not fall within one of the explicit statutory exclusions).[22] The repayment obligation is contingent, not absolute, and arises only in the event the (implicit or explicit) representation is breached.

The familiar legal structure of payment against representation of particular facts, with a remedy of refund in the event of breach of the representation, is not generally considered in common parlance to constitute an "extension of credit in the form of a loan." These terms typically refer to an arrangement permitting another to have use of funds or other property within the understanding that such use is inherently temporary.[23] In an extension of credit in the form of a loan, the timing of the termination of the recipient's use of the funds or property may be uncertain, as for example with a demand credit, or one whose stated termination date may be extended for various reasons. But the understanding that at some point the funds or property will be repaid is fundamental.[24]

The understanding in the case of the payment of litigation expenses is that likely the amounts will not be repaid.[25] Only in the case of a later determination of ineligibility will the repayment obligation arise.[26] The legislative history of Sarbanes-Oxley includes a description of abusive extensions of credit to executive officers and directors.[27] No mention was made in the legislative history of corporate obligations to pay litigation expenses of indemnified officers and directors, a practice virtually universal among public corporations for decades, and one with a sound public policy basis.

Particularly in light of the absence of specific legislative consideration of long-accepted, common corporate arrangements with indemnified officers and directors, and in light of the public policy underlying the specific statutory authorization of such arrangements, we believe the term "extension of credit" should be interpreted in Sarbanes-Oxley in accordance with the ordinary understanding of the term, and should not be viewed as prohibiting the described expense payment practices.

"Personal Loan"

Sarbanes-Oxley by its terms does not prohibit all issuer extensions of credit in the form of loans to executive officers and directors. The extension of credit in the form of a loan must be "personal" to be prohibited.

It is reasonable, we believe, to interpret this term such that arrangements having a clear nexus to the issuer's business, other than a nexus related simply to the compensation of personnel[28] , are not prohibited. For example, we believe that generally (absent facts suggesting abuse) there should be no prohibition on customary practices whereby a company advances to executives payments for business-related travel, meal and lodging expenses, against an agreement to repay any such amounts which are later determined not to have been business-related.

Agreements to pay litigation expenses of indemnified parties should fall into the same category. Customarily, such payments are only made in the case of actions brought against the individual by reason of the fact that he was a director or officer of the corporation, or was serving at the corporation's request as the director or officer of another entity.[29] The actions or omissions at issue, performed in such role, are clearly business-related. As such, we believe that the corporation's obligations to pay litigation costs in legal proceedings relating to such actions should not be considered to constitute "personal" arrangements for the individual within the meaning of §402 of Sarbanes-Oxley.

Pre-existing Contractual Obligations

Section 402 of Sarbanes-Oxley provides:

> An extension of credit maintained by the issuer on the date of enactment of this subsection shall not be subject to the provisions of this subsection, provided that there is no material modification to any term of any such extension of credit or any renewal of any such extension of credit on or after that date of enactment.

The date of enactment of Sarbanes-Oxley was July 30, 2002. Extensions of credit made prior to that date and "maintained" after that date are not prohibited by the statute in the absence of modification or renewal.

Under this provision, we believe it is clear that payments of litigation expenses prior to July 30, 2002 are not prohibited, even if such payments remain subject to a contingent repayment obligation after July 30; provided the repayment obligations are not modified after that date.

It is also our view that in applying this provision, credit should be deemed to have been extended (if at all) on the date the corporation enters into a legally binding contractual obligation to make the payment in question, as opposed to the date on which the payment is actually made pursuant to the prior contractual obligation. To do otherwise could require corporations to violate lawfully entered-into contractual obligations by virtue of a subsequent legislative enactment.[30] Consequently, if litigation expense-advance provisions in a particular case could be viewed as constituting legally binding obligations of the corporation entered into prior to July 30, these would be excluded from the statute's coverage. This would be the case, for example, where contracts were entered into with particular directors prior to that date, and would protect payments made pursuant to such contracts, even where such payments are made after July 30. This would also be the case, in our view, for persons who were officers or directors prior to July 30 where the indemnification and payment of expense provisions are embodied only in the corporate articles of incorporation or bylaws, not in separate contracts. The corporate articles/bylaw provisions should be considered as representing contractual obligations of the corporation in favor of persons who were directors or officers on July 30.

On the other hand, for persons becoming officers or directors after July 30, we do not believe this provision can be relied upon. In such a case, even if there is a preexisting charter and/or bylaw provision obligating the corporation to indemnify and pay expenses for officers and directors, it probably cannot be concluded that prior to the effective date a binding contractual obligation existed in favor of a person who was not an officer or director at such time.

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Bulletin 03-02

The Effect of the Sarbanes-Oxley Act on
Public Company Audit Committees

In this post-Enron era, the rules for corporate governance, especially for audit committees of public company boards of directors, are rapidly and radically changing. The most sweeping legislation in corporate governance in several decades, the Sarbanes-Oxley Act of 2002 (the "Act"), was signed into law on July 30, 2002. It creates, among other things, a new framework of responsibilities for audit committees and other members of boards of directors of public companies (referred to herein as "issuers"). The New York Stock Exchange ("NYSE"), NASDAQ and the American Stock Exchange ("AMEX") have each proposed new corporate governance rules, including rules related to audit committees for issuers subject to their jurisdiction. Several of these proposals have been submitted to the Securities and Exchange Commission (the "SEC") for approval. The NYSE, NASDAQ and AMEX rule proposals go above and beyond the requirements of the Act. This bulletin discusses the new requirements for audit committees and their members under the Act.

Audit Committee Requirement—General

Section 301 of the Act requires the SEC to promulgate rules by April 26, 2003 that will have the effect of prohibiting the national securities exchanges and NASDAQ from listing any security of an issuer that has failed, after a phase-in period, to establish an audit committee in accordance with the standards specified by the Act. If the issuer has no separate audit committee, the rules apply to the entire board of directors of the issuer.

The Act specifically requires each audit committee to:

- Consist entirely of independent directors with at least one member being a so-called "financial expert," defined as an individual with extensive experience in audit procedures and internal audit controls, and who understands generally accepted accounting principles ("GAAP") and financial statements;

- Be directly responsible for the appointment, compensation, and oversight of the work of the registered public accounting firm employed by the committee, for both audit and non-audit services;
- Resolve all disputes between the issuer and auditor regarding financial reporting;
- Establish procedures to receive, retain, and respond to complaints regarding the issuer's accounting and auditing matters;
- Be authorized to engage independent counsel and other advisors, and determine appropriate funding to be provided by the issuer, to pay such outside auditors, and any other counsel or advisors.

Qualification of Audit Committee Members

Independence. The Act requires each audit committee member to be "independent." Independence under the Act requires the absence of affiliation with the issuer or any of its subsidiaries. Depending on what the final rules say, this could be problematic for those issuers whose entire board is deemed to be the audit committee because no separate audit committee has been established. The Act also prohibits the audit committee members from receiving any consulting, advisory or other fees from the issuer other than director and committee fees. The Act empowers the SEC, however, to make exceptions to these fee prohibitions.

Financial Expert. The Act requires the SEC to adopt rules by January 26, 2003 to require issuers to disclose in their periodic reports whether at least one member of the audit committee is a "financial expert" and if not, why not. The SEC has recently proposed rules regarding audit committee financial experts. These rules define the phrase "financial expert." The proposed definition closely resembles the definition in Section 407 of the Act. Under the proposed rules, a financial expert is a person who has: (i) an understanding of GAAP and financial statements; (ii) experience in the preparation or auditing of financial statements, and the application of accounting principles in connection with the accounting for estimates, accruals and reserves; (iii) experience with internal accounting controls; and (iv) an understanding of audit committee functions. The proposed rules contemplate that this experience would be acquired through education and experience as a public accountant, auditor, or a principal financial officer, comptroller, or principal accounting officer of a public issuer, or the equivalent. The proposed rules have been heavily criticized as commentators have suggested that very few people among those willing to serve can be expected to meet the criteria established.

Financial Literacy. In view of the increased responsibility and potential liabilities of audit committees, a high level of financial knowledge will be required of committee members. Although not required specifically by the rules, managerial experience would also be useful in performing some of the committee's new functions such as resolving disputes between management and auditors.

Functions of the Audit Committee; Required Charter

The audit committee's role has traditionally been to assist and support the board in performing oversight responsibilities. The audit committee would make recommendations to the full board in the area of audit-related functions. The Act, however, has shifted the responsibility for the audit process and certain related matters from the board solely to the audit committee. The audit committee is now directly responsible for the appointment, compensation, and oversight of the work, for both audit and non-audit work, of the registered public accounting firm engaged by the issuer. The audit committee must provide advance approval of any permissible non-audit service, including tax services, to be performed for the issuer by the accounting firm. Further, the audit committee is now responsible for establishing procedures to receive and respond to employee and others' complaints and concerns regarding the issuer's accounting or auditing matters.

Arguably, the most important of the audit committee's new duties is the oversight of the work of the auditors. The committee will need to be engaged in most aspects of the audit process. Since auditors' opinions on financial statements are clear in providing that issuers and not independent auditors are primarily responsible for the accuracy of financial statements, in effect, the committee can now be considered as having primary responsibility for ensuring the integrity of the financial statements.

The audit committee is also specifically charged with resolving all audit disputes between management of the issuer and the auditor.

Additionally, Section 404 of the Act requires the SEC to adopt rules that require the inclusion, in the issuer's annual report, of an internal control report that (a) states the responsibility of management for establishing and maintaining adequate controls and procedures for financial reporting; (b) requires management to assess the effectiveness of the issuer's financial reporting, internal control structure and procedures for financial reporting; and (c) requires the auditor to attest to and report on management's assessment of the internal accounting procedures. No timeframe is specified in the Act for the adoption of these rules. Although the audit committee is not specifically charged with oversight responsibility for this function under the Act, the assessments and attestation will be included in annual reports. Hence, audit committee oversight is at least implied.

The Act undoubtedly will result in the audit committee having more regular contact with independent auditors. The requirement that the audit committee oversee the work of the independent auditors in most cases will result in the committee being involved during the conduct of an audit, instead of solely at the conclusion, as is often the practice today. In addition, the outside auditors will be required to regularly deliver certain reports to the audit committee, including a report on (a) critical accounting policies and practices; (b) alternative treatments under GAAP; (c) other material communications between the auditors and management; and (d) a report on the effectiveness of the issuer's internal controls.

Liabilities and Insurance

Historically, the audit committee's role as an advisor to the full board resulted in the board bearing the responsibility for final audit-related decisions. The Act has shifted this responsibility and the accompanying liability to the audit committee, although it is unclear whether the board members not serving on the audit committee are relieved of responsibility for activities specifically assigned to the audit committee.

Since passage of the Act, some companies have experienced difficulty in securing insurance coverage for directors in light of the uncertainty of potential liabilities. The cost of such policies will almost certainly be increasing. As a result, some issuers may choose to shift more towards self insurance through more expansive indemnities to attract and retain qualified board and audit committee members.

Independence of Committee

As noted above, the Act gives the audit committee the power to hire its own independent legal and other advisors (presumably including a second independent accounting firm). The issuer is also required to fund the retention of the advisors and experts selected by the committee. This statutory grant of resources should be a significant factor in enabling the audit committee to perform its required functions independent of undue management influence. Moreover, the use of and reliance upon advisors and experts independent of the issuer should help insulate the committee members from liabilities. Adherence to the advice of qualified independent legal and accounting advisors and experts should help demonstrate the exercise of proper business judgment and good faith of the audit committee members.

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Bulletin 03-09

Sarbanes-Oxley Act — Effective Dates of SEC Rules Required to be Issued in Final Form by January 26, 2003

The SEC is required to issue final rules implementing several sections of the Sarbanes-Oxley Act by January 26, 2003. While the final versions of these Rules are not yet available, based on statements at the SEC's recent open meetings and information in recent SEC press releases, the following is a list of the effective dates and, if relevant, transition periods, which will be applicable to the rules to be finalized by January 26. Public companies can use this information in prioritizing their compliance efforts.

Disclosure of non-GAAP financial information and 8-K disclosure regarding public information releases on completed fiscal periods

Effective 60 days after publication in the Federal Register.

Rules restricting insider trading during pension fund blackout periods

Effective January 26, 2003.

Disclosure concerning corporate codes of ethics and financial experts on audit committees

Effective 30 days after publication in the Federal Register. Disclosures are required in annual reports for fiscal years ended on and after July 15, 2003; financial expert disclosure for small business issuers is required in annual reports for fiscal years ended on and after December 15, 2003.

Disclosure of off-balance sheet arrangements and aggregate payments due under specified contractual obligations

Disclosure of off-balance sheet arrangements is required for Commission filings that are required to include financial statements for fiscal years ending on or after June 15, 2003. Disclosure of the table of contractual obligations is mandatory for Commission filings that are required to include financial statements for fiscal years ending on or after December 15, 2003.

Rules on retention of records relevant to audits and reviews

Effective October 31, 2003.

Rules relating to auditor independence, including restrictions, approvals and disclosure for non-audit services, audit partner rotation and other matters

Effective 90 days after publication in the Federal Register, with "appropriate transition" periods to be specified in the text of the final rules.

Rules relating to management certification of investment company shareholder reports, and to implement code of ethics and financial expert disclosure for investment companies

Effective 30 days after publication in the Federal Register.

Rules relating to standards of attorney conduct

Effective 180 days after publication in the Federal Register.

We assume that publication in the Federal Register will occur not later than January 27, since these rules are required to be issued by Sunday, January 26, 2003.

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Bulletin 03-11

The Sarbanes-Oxley Act of 2002 —
SEC Approves Final Rules Regarding
Non-GAAP Financial Measures

On January 15, 2003, the Securities and Exchange Commission (the "SEC") approved final rules relating to the disclosure of non-GAAP financial measures as required under Section 401(b) of The Sarbanes-Oxley Act of 2002. In addition, the SEC approved new Item 12 to Form 8-K requiring issuers to furnish, on Form 8-K, earnings releases or similar announcements. All rules will be effective with respect to disclosures or filings made after March 28, 2003.[31]

Non-GAAP Financial Measures

The SEC approved new Regulation G which requires issuers that publicly disclose or release non-GAAP financial measures to include, in that disclosure or release, a presentation of the most directly comparable GAAP financial measure and a reconciliation of the disclosed non-GAAP financial measure to the most directly comparable GAAP financial measure. The SEC also approved amendments to Item 10 of Regulation S-K and Item 10 of Regulation S-B, which require an issuer that includes a non-GAAP financial measure in a filing with the SEC to also include certain specified disclosures in such filing. The final rules included a number of modifications from the rules as initially proposed on November 4, 2002.[32]

What is a "non-GAAP financial measure"?

Non-GAAP financial measure has the same meaning under both Regulation G and amended Item 10. A "non-GAAP financial measure" is a numerical measure of an issuer's historical or future financial performance, financial position or cash flows that:

- excludes amounts that are included in the most directly comparable measure calculated and presented in accordance with GAAP in the statement of income, balance sheet or statement of cash flows (or equivalent statements) of the issuer; or

- includes amounts that are excluded from the most directly comparable measure so calculated and presented.

  Examples of non-GAAP financial measures: EBIT and EBITDA, measures of liquidity other than cash flow or cash flow from operations calculated pursuant to GAAP, and operating margin where any input is not calculated in accordance with GAAP.

Except as described below for foreign private issuers, GAAP refers to generally accepted accounting principles in the United States.

The following are not non-GAAP financial measures:

- operating and other financial measures;
- ratios or statistical measures calculated using exclusively one or both of:
  - financial measures calculated in accordance with GAAP
  - operating measures or other measures that are not non-GAAP financial measures;
- financial measures required to be disclosed by GAAP, SEC rules, or a system of regulation of a government or governmental authority or self-regulatory organization that is applicable to the issuer. For the purpose of amended Item 10, however, such financial measures generally should be presented outside of the financial statements.

  Examples of excluded measures: disclosure of expected indebtedness (including contracted and anticipated amounts), estimated revenues or expenses of a new product line (provided computed in accordance with GAAP), measures of profit or loss and total assets by segments (as required by GAAP), and sales per square feet or sales per store (assuming sales are calculated in accordance with GAAP).

What must be disclosed?

The disclosure requirements under Regulation G, which relates to public releases generally, and amended Item 10, which relates to disclosures in SEC filings, are similar but differ in a number of important respects.

Regulation G. Whenever an issuer, or person acting on its behalf, publicly discloses material information that includes a non-GAAP financial measure, the issuer must accompany that non-GAAP financial measure with:

- a presentation of the most directly comparable financial measure calculated and presented in accordance with GAAP; and
- a reconciliation (by schedule or other clearly understandable method) which shall be quantitative for historical non-GAAP measures presented, and quantitative, to the extent available without unreasonable efforts, for forward-looking information, of the differences between the non-GAAP financial measure disclosed or released with the most comparable financial measure or measures calculated and presented in accordance with GAAP.

An issuer, or a person acting on its behalf, may not make public a non-GAAP financial measure that, taken together with the information accompanying that measure, contains an untrue statement of a material fact or omits to state a material fact necessary in order to make the presentation of the non-GAAP financial measure, in light of the circumstances under which it is presented, not misleading.

Regulation G exempts two types of disclosures:

- non-GAAP financial measures included in disclosure relating to a proposed business combination, the entity resulting therefrom or an entity that is a party thereto, if the disclosure is contained in a communication that is subject to the SEC's communication rules applicable to business combinations; and
- certain disclosures by foreign private issuers as described below.

If a non-GAAP financial measure is made public orally, telephonically, by webcast, by broadcast, or by similar means, then the issuer's disclosure requirements are satisfied if:

- the required information is provided on the issuer's website at the time the non-GAAP financial measure is made public; and

- the location of the website is made public in the same presentation in which the non-GAAP financial measure is made public.

Regulation G does not indicate the length of time an issuer must maintain the required disclosure on its website. In the Approving Release, the SEC encourages “ongoing access” for at least a 12-month period.

The Approving Release notes that Regulation G works in tandem with Regulation FD such that if a communication of material, non-public information to an analyst or shareholder were to include a non-GAAP financial measure, then the issuer would need to comply with the requirements of both Regulation G and Regulation FD.

Compliance (and non-compliance) with the requirements of Regulation G will not affect any person’s liability under Section 10(b) (or Rule 10b-5 thereunder) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”).
Amended Item 10. Whenever a non-GAAP financial measure is included in an SEC filing, the following must also be included in the filing:

- the disclosures required under Regulation G;
- a statement disclosing the reasons why the issuer’s management believes that presentation of the non-GAAP financial measure provides useful information to investors regarding the issuer’s financial condition and results of operations; and
- to the extent material, a statement disclosing the additional purposes, if any, for which the issuer’s management uses the non-GAAP financial measure that are not otherwise disclosed pursuant to Item 10.

For Item 10 purposes, the disclosure of the most directly comparable financial measure calculated and presented in accordance with GAAP must be of equal or greater prominence than the disclosure of the non-GAAP financial measure.

If the filing is not an annual report on Form 10-K (or, for foreign private issuers, Form 20-F), the information required by the last two bullet points was included in the issuer’s most recent Form 10-K (or Form 20-F), and such disclosure remains current, then an issuer need not include the information required by last two bullet points.

The Approving Release relaxed the disclosure requirements initially proposed by conforming the forward-looking statements disclosure requirements to those set forth for Regulation G and by clarifying that the disclosure under the third bullet point above is required only to the extent necessary to supplement information otherwise disclosed.

Like Regulation G, amended Item 10 exempts non-GAAP financial measures included in disclosure relating to a proposed business combination, the entity resulting therefrom, or an entity that is a party thereto, if the disclosure is contained in a communication that is subject to the SEC's communication rules applicable to business combinations.

Under amended Item 10, the following are expressly prohibited in filings with the SEC:

- excluding charges or liabilities that required, or will require, cash settlement from non-GAAP liquidity measures (EBIT and EBITDA are excluded from this prohibition);
- adjusting a non-GAAP performance measure to eliminate or smooth items identified as non-recurring, infrequent or unusual, when the nature of the charge or gain is such that it is reasonably likely to recur within two years or there was a similar charge or gain within the prior two years;
- presenting non-GAAP financial measures on the face of the issuer's financial statements or in the accompanying notes;
- presenting non-GAAP financial measures on the face of any pro forma financial information required to be disclosed by Article 11 of Regulation S-X; or
- using titles or descriptions of non-GAAP financial measures that are the same as, or confusingly similar to, titles or descriptions used for GAAP financial measures.

Notably the SEC did not prohibit the use of "non-GAAP per share measures" as contemplated in the Proposing Release.

Special Rules for Foreign Private Issuers

While the requirements of Regulation G and amended Item 10 apply to foreign private issuers, the final rules included the following accommodations:

Definition of GAAP. For foreign private issuers whose primary financial statements are prepared in accordance with non-U.S. generally accepted accounting principles, "GAAP" refers to the principles under which those primary financial statements are prepared. For foreign private issuers that include a non-GAAP financial measure derived from a measure calculated in accordance with U.S. generally accepted accounting principles, "GAAP" refers to U.S. generally accepted accounting principles.

Exemption Under Regulation G. Regulation G does not apply to a disclosure of a non-GAAP financial measure made by or on behalf of a foreign private issuer if the following conditions are satisfied:

- the securities of the issuer are listed or quoted on a securities exchange or inter-dealer quotation system outside the United States;
- the non-GAAP financial measure is not derived from or based on a measure calculated and presented in accordance with U.S. GAAP; and
- the disclosure is made by or on behalf of the issuer outside the United States, or is included in a written communication that is released by or on behalf of the issuer outside the United States.

In light of the confusion over the last prong of the exemption in the Proposing Release, Regulation G as approved provides that the exemption applies if:

- a written communication is released in the United States as well as outside the United States, so long as the communication is released in the United States contemporaneously with or after the release outside the United States and is not otherwise targeted at persons located in the United States;

- foreign journalists, U.S. journalists or other third parties have access to the information;
- the information appears on one or more websites maintained by the issuer, as long as the websites, taken together, are not available exclusively to, or targeted at, persons located in the United States; or
- following the disclosure or release of the information outside the United States, the information is included in a submission by the issuer to the Commission made under cover of a Form 6-K.

Exemption Under Amended Item 10. Amended Item 10 does not apply to a non-GAAP financial measure included in a filing of a foreign private issuer if:

- the non-GAAP financial measure relates to the generally accepted accounting principles used in the issuer's primary financial statements included in its filing with the SEC;
- the non-GAAP financial measure is required or expressly permitted by the standard-setter that is responsible for establishing the generally accepted accounting principles used in such financial statements; and
- the non-GAAP financial measure is included in the annual report prepared by the issuer for use in the jurisdiction in which it is domiciled, incorporated or organized, or for distribution to its security holders.

The Approving Release indicates that this exception is intended to be available only where the appropriate standard-setter has acted affirmatively to require or expressly permit the non-GAAP measure and not where such non-GAAP measure merely has not been prohibited.

Because Form 6-K is not "filed" with the SEC, amended Item 10 does not apply to disclosures on Form 6-K unless incorporated by reference into a foreign private issuer's registration statement, prospectus or annual report.

Item 12 to Form 8-K

If an issuer, or any person acting on its behalf, makes any public announcement or release (including any update of an earlier announcement or release) disclosing material non-public information regarding the issuer's results of operations or financial condition for a completed quarterly or annual fiscal period, the issuer must furnish to the SEC a Form 8-K including the text of that announcement or release as an exhibit.

A Form 8-K is not required to be furnished to the SEC in the case of disclosure of material non-public information that is disclosed orally, telephonically, by webcast, by broadcast, or by similar means if:

- the information is provided as part of a presentation that is complementary to, and initially occurs within 48 hours after, a related, written announcement or release that has been furnished on Form 8-K pursuant to this Item 12 prior to the presentation;
- the presentation is broadly accessible to the public by dial-in conference call, by webcast, by broadcast, or by similar means;
- the financial and other statistical information contained in the presentation is provided on the issuer's website, together with any information that would be required under Regulation G; and
- the presentation was announced by a widely disseminated press release that included instructions as to when and how to access the presentation, and the location on the issuer's website where the information would be available.

Item 12 reports are required to be furnished, rather than filed, with the SEC within five (5) business days after the occurrence of the announcement or release. In the Proposing Release, the SEC contemplated a two (2) business day filing deadline. The SEC elected to defer action on the two (2) day requirement pending action with respect to Proposed Rule: Additional Form 8-K Disclosure Requirements and Acceleration of Filings Date, SEC Release No. 33-8106 (June 17, 2002), which the SEC intends to address in the near future Similarly, while the Proposing Release contemplated that Item 12 reports would be filed with the SEC, in response to comments received, the final rule requires that Item 12 reports be furnished with the SEC. Public commentators noted that if filed, rather than furnished, with the SEC, issuers would be subject to liability Section 18 of the Exchange Act and, consequently, may reduce or restrict the information included in, or simply not make, earnings releases. An issuer may, however, file an Item 12 report by expressly stating its intent to do so.

Earnings releases (and their related Item 12 Form 8-Ks) will be subject to Regulation G if they contain non-GAAP financial measures. In addition, the required Form 8-K must include the supplemental disclosures included in amended Item 10 discussed above (i.e., management's statement as to the usefulness of information to investors and the other purposes for which management uses such information).

The Approving Release discusses the relationship between new Item 12 on Form 8-K and Regulation FD, noting, among other things, that an issuer must be in compliance with both rules, if applicable.

Foreign private issuers are not required to make filings on Form 8-K.

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Bulletin 03-12

The Sarbanes-Oxley Act of 2002 —
SEC Adopts Final Rules Regarding Trading Prohibitions
During Pension Fund Blackout Periods

Section 306(a) of the Sarbanes-Oxley Act of 2002 (the "Act") prohibits insider trades during certain blackout periods. On January 15, 2003, the SEC adopted Regulation BTR to clarify Section 306(a) and to help prevent evasion of the provisions of Section 306(a).[33] Both Section 306(a) and Regulation BTR were effective January 26, 2003.

Specifically, Section 306(a) of the Act prohibits directors or executive officers of an issuer of any equity security, other than an exempted security, directly or indirectly, from purchasing, selling or otherwise acquiring or transferring any equity security of that issuer (other than an exempted security) during any blackout period with respect to such equity security if such director or executive officer acquires the equity security in connection with his or her service or employment as a director or officer. Those terms and phrases are discussed under separate headings below, all of which must apply before there is a violation of Section 306.

Issuers Covered by Section 306

Section 306(a) and Regulation BTR apply to the directors and executive officers (for purposes of this bulletin, "insiders") of issuers that (a) have a class of securities registered under Section 12 of the Exchange Act or (b) are required to file reports under Section 15(d) of the Exchange Act or (c) file or have filed a registration statement that has not yet become effective under the Securities Act of 1933 and that has not been withdrawn. The new rules apply to domestic as well as foreign private issuers, regardless of size. However, with respect to foreign private issuers, Regulation BTR limits the reach of Section 306(a) to blackout periods in which a threshold number of U.S. plan participants are affected (see below). The new rules do not apply to entities that do not issue equity securities (such as issuers of asset-backed securities).

Persons Subject to Trading Restrictions

Section 306(a) applies only to trades by directors and executive officers. For domestic issuers, those terms have the same meaning as under Section 16 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Thus, only those directors and executive officers who are currently subject to the insider reporting provisions of Section 16 of the Exchange Act are subject to the prohibitions of Section 306 and Regulation BTR.

For foreign private issuers, "director" means any person serving as a director of a corporation or performing similar functions with regard to any organization and who is a "management employee" of that entity. "Executive officer" includes only the principal executive officer or officers, the principal financial officer or officers, and the principal accounting officers or officers of the foreign private issuer.

Securities Covered by Section 306(a)

Section 306(a) applies to all equity securities of an issuer (other than exempt securities). As defined in Regulation BTR, "equity security" includes stock, stock futures and convertible securities as well as derivative securities relating to an issuer (whether or not issued by that issuer). The term "derivative security" has the same meaning as defined under Section 16 of the Exchange Act and includes options, warrants, phantom stock and other similar rights. With respect to foreign issuers, the term includes American Depositary Receipts ("ADRs").

Transactions Subject to and Exempt from Trading Prohibitions

> "Acquired in connection with Service or Employment" Test. Section 306(a) and Regulation BTR prohibit acquisitions, sales or other transfers of equity securities during a blackout period if those equity securities were acquired in connection with service or employment as a director or executive officer.

The phrase "acquired in connection with service or employment as a director or executive officer" includes securities acquired (either directly or indirectly) by an insider while a director or executive officer (a) under a compensatory plan or agreement (whether or not set forth in any formal plan document); (b) as a result of certain transactions or business relationships between the issuer and the insider, his or her family members or certain entities with which he or she is affiliated (or, in the case of a foreign private issuer, between the issuer and the insider or certain persons or entities associated with the insider) but only to the extent that the insider has a "pecuniary interest" in the equity securities; or (c) as "director's qualifying shares" or other securities that the insider must hold to satisfy minimum ownership requirements or guidelines for directors or executive officers.

That phrase also includes equity securities acquired prior to becoming, or while, a director or executive officer where (a) the equity security was acquired as a direct or indirect inducement to service or employment as a director or executive officer; or (b) the equity security was received as a result of a business combination (such as a merger) in respect of an equity security of an entity involved in the business combination that the insider otherwise acquired in connection with service or employment as a director or executive officer of that entity.

Securities acquired in connection with service as a director or employment as an executive officer of a company before it qualifies as an "issuer" will be considered to have met the "acquired in connection with" test, thus subjecting that director or executive officer to trading prohibitions if and when the company meets the definition of an "issuer."

Securities purchased in the open market or acquired under a compensatory plan or agreement by an individual before he or she becomes a director or executive officer are not covered by Section 306(a) unless the securities were purchased or acquired as an inducement to become a director or executive officer.

The new rules apply to equity securities regardless of whether acquired before or after the effective date of Section 306(a) and Regulation BTR.

Regulation BTR presumes that any equity securities sold or transferred during a blackout period were "acquired in connection with service or employment" unless the director or executive officer establishes that the securities were not so acquired. To rebut that presumption, the insider must specifically identify the origin of the securities at issue and show that his or her identification of the equity securities is consistent for all purposes related to the transaction (such as tax reporting and applicable disclosure and reporting requirements).

Direct or Indirect. Section 306(a) covers both direct and indirect transactions otherwise meeting Section 306(a). Regulation BTR clarifies that only transactions in which a director or executive officer has a "pecuniary interest" (which term includes indirect pecuniary interests) are covered by Section 306(a). Regulation BTR defines "pecuniary interest" and "indirect pecuniary interest" by reference to the definitions used in Section 16 of the Exchange Act. As a result, equity security transactions by certain family members, partnerships, corporations, trusts, limited liability companies or other entities may be attributed to an insider and expose him or her to a violation of Section 306 if he or she has a "pecuniary interest" in the equity securities traded.

Exempt transactions. The following transactions are expressly exempted from the Section 306(a) trading prohibitions:

- acquisitions of equity securities under dividend or interest reinvestment plans;
- purchases or sales of equity securities pursuant to trading plans, binding agreements or instructions meeting Rule 10b-5-1(c);
- purchases or sales of equity securities, other than "discretionary transactions" (as defined under the Section 16 rules), pursuant to certain employee benefit plans (or, in the case of foreign issuers, pursuant to plans approved by the taxing authority of a foreign jurisdiction or eligible for preferential treatment because of broad-based employee participation);
- grants and awards of equity securities pursuant to automatic or formula grant or award programs;
- exercises, conversions or terminations of certain derivative securities, which, by their terms, occur only on a fixed date, or are exercised, converted or terminated by a counter-party who is not subject to the influence of the director or executive officer;
- acquisitions or dispositions of equity securities by gift or a transfer by will or the laws of descent and distribution;
- acquisitions or dispositions of equity securities pursuant to a domestic relations order;

- sales or other dispositions of equity securities compelled by the laws or other requirements of an applicable jurisdiction;
- acquisitions or dispositions of equity securities in connection with a merger, acquisition, divestiture or similar transaction occurring by operation of law; and
- increases or decreases in equity securities holdings resulting from a stock split, stock dividend or pro rata rights distribution.

Exempt securities. Certain securities are exempt from Section 306(a) and Regulation BTR. Those include, among others, certain municipal and government securities, interests in certain trust funds, and pooled income funds.

Definition of Blackout Period

Section 306(a) provides that a transaction will only be subject to its terms if the transaction occurs during a "blackout period." Under Regulation BTR, a "blackout period" occurs when, with respect to a domestic issuer, 50 percent or more of the participants in the United States or its territories under all "individual account plans" maintained by the issuer are prohibited by the issuer or a plan fiduciary from trading for a period of more than three consecutive business days. The SEC has stated that it remains concerned that issuers may be motivated to structure blackout periods to last three business days or less to evade the new rules (and would view those efforts as a potential violation of Regulation BTR) and will continue to consider whether three days is the appropriate length of time.

In the case of a foreign private issuer, a blackout period will only be deemed to occur if the 50 percent test above is met and if the number of U.S. plan participants subject to the temporary trading suspension is either greater than 15 percent of the foreign private issuer's workforce worldwide or exceeds 50,000.

The term "individual account plan" encompasses a variety of pension plans, including 401(k) plans, profit-sharing and savings plans, stock bonus plans and money purchase pension plans, but does not include one-participant retirement plans as defined under ERISA or pension plans, including deferred compensation plans, in which only directors participate. Individual plan accounts maintained outside the United

States primarily for the benefit of non-resident aliens are not considered in determining the plans maintained by an issuer.

Regularly scheduled blackout periods will not be considered "blackout periods" for Section 306(a) purposes if a description of those periods either (a) is incorporated into individual account plans or included in plan documents or (b) is disclosed to an employee before enrollment or within 30 days following enrollment in a plan. Likewise, trading suspensions imposed in connection with certain mergers, acquisitions or other similar transactions in order to permit employees of acquired or divested entities to become, or cease to be, plan participants will not subject insiders to the Section 306(a) trading prohibitions.

Required Notices

An issuer must notify its insiders and the SEC if there will be a blackout period during which any director or executive officer would be subject to the Section 306 trading prohibitions. The notice must include the reasons for the blackout period, a description of the transactions to be suspended or affected during the blackout period, the equity securities subject to the blackout period, the length of the blackout period, and the name, address and telephone number of the person designated by the issuer to respond to questions or, if no one is so designated, the issuer's Human Resources director (or person performing equivalent functions). The notice must be given to insiders no later than five business days after the issuer's receipt of a notice from the plan administrator or, if no such notice is received, at least 15 calendar days before the actual or expected beginning date of the blackout period. If, due to circumstances beyond the control of, or unforeseeable to, the issuer, the issuer cannot give notice within those time frames, Regulation BTR offers the issuer some relief. If the beginning or ending date of the blackout period changes, the issuer must give an updated notice to its insiders as soon as reasonably practicable unless notice in advance of termination is impracticable.

Domestic issuers must file with the SEC a Form 8-K, containing the same information as is required to be given to insiders, by no later than the date the notice is required to be given to insiders. If there are changes in the beginning or ending dates of a blackout period, the issuer must file, as soon as reasonably practicable, a Form 8-K to report those changes. Foreign private issuers must file as an exhibit to their annual report on Form 20-F or 40-F a copy of each notice provided to insiders under Section 306(a) during the most recently completed fiscal year unless previously filed on Form 6-K. Registered investment companies that are subject to Section 306(a) will be required to file a Form 8-K even if they are not otherwise subject to those filing requirements.

Transition Provisions

Except as described, both Section 306(a) and Regulation BTR are effective January 26, 2003. Although the notice requirements are applicable to blackout periods commencing on or after January 26, 2003, issuers are required only to furnish the notice to insiders as soon as reasonably practicable with respect to blackout periods beginning between January 26, 2003 and February 25, 2003. The requirements under Regulation BTR to file notices with the SEC under new item 11 of Form 8-K will not be effective until 60 days after publication in the Federal Register to allow time for EDGAR updates. In the meantime, issuers should provide the required notice to the SEC under Item 5 of Form 10-Q or Form 10-QSB in the first such report filed after commencement of a blackout period.

Remedies for Violations of Section 306(a)

Section 306(a) permits the recovery by the issuer of any profit realized by an insider, regardless of his or her intent, in the event of a violation of Section 306(a). Either the issuer or a stockholder (if the issuer fails or refuses to bring an action) may bring an action to recover those profits. For issuers whose securities trade on a national securities exchange or are listed in an automated inter-dealer quotations system, profit (including loss avoided) is measured by the difference between the amount paid or received for the equity security on the date of the transaction and the average market price of the equity security for the first three trading days after the ending date of the blackout period. For all other issuers, profit (including loss avoided) is measured in a manner consistent with the objective of identifying the amount of the gain realized or loss avoided as a result of a transaction taking place during a blackout period as opposed to outside that blackout period. Because a violation of Section 306(a) would be a violation of the Exchange Act, an insider may also be subject to an SEC enforcement action.

Pension Plan Notice Requirement

In addition to the Section 306(a) insider trading prohibition, the Sarbanes-Oxley Act included a separate provision, Section 306(b), amending ERISA to require administrators of individual account pension plans to provide notice to affected plan participants in advance of a "blackout" period. Section 306(b) defines a blackout period more broadly than Section 306(a). The U.S. Department of Labor has published a final regulation[34] that provides a model notice form for plan administrators, specifies timing requirements for issuing the notices, clarifies issues regarding what is a blackout period under Section 306(b), and also establishes rules and procedures for determining the penalties imposed for violation of the notice requirement. Among other things, the Department of Labor rule requires that the plan administrator provide notice of a blackout period to the issuer, to facilitate compliance with Section 306(a).

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Bulletin 03-13

Audit Committee Financial Experts

On January 23, 2003, the Securities and Exchange Commission published final rules[35] requiring each public company board of directors to make a determination as to whether the company has an "audit committee financial expert" serving on its audit committee. If the board determines that the company has such an audit committee financial expert, the company must disclose that determination, the name of the expert and whether the expert is independent of management. If the board determines that the company has no such audit committee financial expert, the company must disclose that determination and explain why it has no such expert.

The SEC initially proposed rules on this subject on October 22, 2002,[36] prompting more than 200 comment letters. Many commenters voiced a concern about the proposal's narrow definition of financial expert and the potential liabilities to which a financial expert could be exposed. In response to the comments, the final rules incorporate a substantially broader definition of financial expert.[37] The final rules also incorporate a provision stating that the designation of a person as an audit committee financial expert does not impose upon him any increased duties, obligations or liability.

The disclosure called for by the new rules is generally required to be included in Form 10-Ks or similar annual reports[38] filed for fiscal years ending on or after July 15, 2003. Small business issuers are required to make the disclosure in annual reports for fiscal years ending on or after December 15, 2003. The information may be incorporated by reference from the company's definitive proxy or information statement that involves an election of directors, if the company files such statement with the Commission no later than 120 days after the end of the fiscal year.

Statutory Background

The Commission's rulemaking was mandated by Section 407 of the Sarbanes-Oxley Act of 2002,[39] which directed the Commission to adopt rules to require disclosure about the presence or absence (and reasons for absence) of a financial expert on the audit committee.

Section 407 left the definition of the term "financial expert" to Commission rulemaking, but specified that in defining the term "financial expert," the Commission must "consider" whether a person:

> has, 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 –
>
> (1) an understanding of generally accepted accounting principles and financial statements;
>
> (2) experience in—
>
> (A) the preparation or auditing of financial statements of generally comparable issuers; and
>
> (B) the application of such principles in connection with the accounting for estimates, accruals and reserves;
>
> (3) experience with internal accounting controls; and
>
> (4) an understanding of audit committee functions.

Required Disclosure

Under the final rules, a company must disclose either that its board of directors has determined that the company has at least one audit committee financial expert serving on its audit committee, or that the board has determined that it does not have an audit committee financial expert serving on its audit committee.[40]

Every company subject to the disclosure requirements must secure a board determination that it either has, or does not have, at least one audit committee financial expert. A disclosure that the board considered the question, but was unable to make a determination, would not satisfy the requirement, nor would disclosure that the board had not considered the issue. The board's determination must be accurately disclosed. Thus, if the board determines that it has an audit committee financial expert, the company may not (because of individual liability concerns or otherwise) omit disclosure of this determination.

The rule requires that the audit committee financial expert be named.[41] Once a company's board determines that a particular audit committee member qualifies as an audit committee financial expert, it may, but is not required to, determine whether additional audit committee members also qualify as experts and the company may, but is not required to, disclose their names.

The final rules require, as did the proposed rules, that a company must disclose whether its audit committee financial expert is independent of management.[42] Independence is defined by reference to Item 7(d)(3)(iv) of Schedule 14A, which incorporates the applicable independence standard of the New York Stock Exchange,[43] AMEX[44] or NASDAQ,[45] as the case may be.

If the board determines that the company has no audit committee financial expert serving on its audit committee, it must disclose that fact.[46] And, it must explain why it does not have an audit committee financial expert.[47] The nature of such an explanation would presumably vary with the circumstances of the particular company, but conceivably could include a description of the basis for the board's determination that the existing audit committee did not include an audit committee financial expert, together with a description of the qualifications which the audit committee members do possess and, perhaps, a description of the company's efforts to locate and recruit for audit committee service a person having the requisite qualifications to serve as an audit committee financial expert, against the backdrop of other qualifications the company seeks from all board members.

Definition of Audit Committee Financial Expert

The final rules define an audit committee financial expert as a person who has five specified attributes, acquired through one or more of four types of experience. The provisions relating to both the attributes and the experience were significantly expanded from the rules as initially proposed.

The first required attribute is an "understanding of generally accepted accounting principles and financial statements." This attribute, which is also contained in the Sarbanes-Oxley Act, was carried forward unchanged from the proposed rule.[48] Consistent with the statutory purpose and the other features of the final rules, the word "understanding" here should not be interpreted as requiring a detailed knowledge of the myriad specialized rules which make up the body of generally accepted accounting principles. The adopting release stressed the

Commission's view that the definition of audit committee financial expert should not focus so strictly upon highly specialized technical knowledge as to result in a very limited pool of candidates. Instead, what is necessary is the ability to understand the general application of accepted accounting principles to the company's financial statements.[49] This direction is clarified in the second attribute.

The second required attribute is the ability to assess the general application of generally accepted accounting principles in connection with the accounting for estimates, accruals and reserves.[50] The rules as originally proposed would have required such experience with specific reference to estimates, accruals and reserves "generally comparable" to those confronted by the company. Many commenters argued that this comparability requirement would require particular experience with the same specialized issues faced by the company and could substantially narrow the pool of candidates, especially if a company wished to exclude persons having connections with competitors. As a result, the comparability requirement was deleted, and the words "general application" of accounting principles were used to describe the necessary ability. Consequently, companies will have the flexibility to choose persons having general, not industry-specific or issue-specific, expertise.

The third required attribute is experience in 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 company's financial statements, or experience actively supervising one or more persons engaged in such activities.[51] This attribute in the final rules represents an expansion from the initial proposal in three ways.

First, the attribute may be satisfied by experience in analyzing or evaluating financial statements; under the proposed rule only experience in preparing and auditing financial statements would suffice. In this way the Commission sought to broaden the pool of candidates beyond persons who are simply accounting experts. The Commission recognized that persons engaged in financial statement analysis and evaluation, such as in investment banking and venture capital investment, could well possess the necessary expertise and skeptical mindset to diligently and zealously discharge their audit committee responsibilities.

Second, the attribute may be satisfied by experience with financial statements presenting issues of comparable "breadth and complexity"; the proposed rule would have required experience with financial statements presenting issues "generally comparable" to those faced by the company. This drafting change was intended to negate the implication that the audit committee financial expert must have prior familiarity with the particular issues which the company is facing.

Third, the attribute may be satisfied by the experience of actively supervising a person who prepares, audits, analyzes or evaluates financial statements; the proposed rule contained no active supervision concept. Active supervision here means more than the existence of a structural reporting relationship between the supervisor and the person being supervised. The supervisor here must have participated in and contributed to the process of addressing issues presented in the preparation, auditing, analysis or evaluation of financial statements. The adopting release states that a principle executive officer "should not be presumed to qualify." However, a principal executive officer with active financial and accounting involvement would qualify.

The fourth required attribute is an "understanding of internal controls and procedures for financial reporting."[52] The proposed rule required experience with internal controls and procedures; the final rule focuses on the requirement that the audit committee financial expert understand why internal controls and procedures exist, how they were developed, and how they operate, without requiring specific experience.

The fifth required attribute, unchanged from the proposed rule, is an "understanding of audit committee functions." [53]

Under the final rule, the audit committee financial expert must have acquired the five required attributes through one of four specified ways:

- 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; or
- Experience actively supervising one of such persons; or
- 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.[54]

These provisions broaden the proposed rule in a number of respects. First, the proposed rule specified that the financial expert must have obtained his experience with a public reporting company. This requirement was deleted. Second, the final rule adds a provision that experience overseeing or assessing the performance of companies or public accountants can meet the requirement. The adopting release notes that, for example, certain individuals serving in governmental, self-regulatory and private sector oversight bodies may qualify. Third, the proposed rule, in the final catch-all category, had required experience in a position resulting, in the judgment of the board, in the person's having expertise and experience similar to a principal financial officer, principal accounting officer, controller, public accountant or auditor. The final rule changes this to require simply "other relevant experience." No disclosure is required, contrary to the proposed rule, of the basis for the board's determination that the person has "similar expertise and experience" to the enumerated positions; instead, disclosure is simply required of the nature of the person's experience.[55]

The expansion of the definition of audit committee financial expert effected by the final rules will afford companies a more realistic opportunity to obtain a person meeting the requirements for service on the audit committee. A board will wish to document the basis for its decision that a particular individual qualifies. This documentation should focus on the basis for a determination that each of the required attributes has been met, and that such attributes have been acquired in one or more of the required ways. The documentation could take the form of a director questionnaire, or a memorandum of an interview with the director, but should in any event evidence direct inquiry of the director on the relevant criteria. A board may also find it helpful to secure an opinion of counsel as to whether the designated individual meets the Regulation S-K, Item 401 requirements to qualify as an audit committee financial expert.

Liability Safe Harbor

In response to commenter concerns, the Commission included in the final rules a codification of the Commission's position that it would be adverse to the interests of investors and to the operation of markets if the designation and identification of an audit committee financial expert affected such person's, or any other director's, duties, obligations or liability exposure. As a result, the rules provide that such designation will not have such effect.[56] The rules make such provision under federal law, by stating that 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, by virtue of such designation. The rules also make such provision more generally, without specific limitation to federal law, by simply stating that such designation does not affect such person's or any director's duties, obligations or liability. However, to the extent such matters are governed by state law, a question may be raised as to the Commission's power to alter otherwise applicable legal standards.

Substantive Membership Requirements

As noted, the Commission's rulemaking does not mandate membership of an audit committee financial expert on a public corporation's audit committee—it simply provides for disclosure.

Substantive requirements for audit committee membership are currently set forth in exchange listing standards. The New York Stock Exchange provides that at least one member of a listed company audit committee must have "accounting or related financial management expertise, as the Board of Directors interprets such qualification in its business judgment."[57] NASDAQ and the AMEX require each listed company to certify that it has at least one member of the audit committee that has former employment experience in finance or accounting, a professional certification in accounting, or comparable experience or background that demonstrates the individual's financial sophistication. These rules provide, for example, that a chief executive officer, chief financial officer or other senior corporate officer with financial oversight responsibilities would satisfy the requirement.[58] Currently, these rules permit significantly more leeway in determining whether an individual has the requisite expertise than the Commission rules.

However, the self-regulatory organizations are considering new substantive requirements relating to the makeup of audit committees. On August 16, 2002, the NYSE filed with the Commission proposed rule changes including proposals relating to audit committee composition. With regard to a requirement of financial expertise for at least one audit committee member, the NYSE filing indicated that the NYSE has determined to await the Commission's interpretation of "financial expert" before making a recommendation on this point. No recommendation has yet been forthcoming.

On October 9, 2002, NASDAQ filed with the Commission proposed rule changes including a proposal relating to audit committee composition. The proposal included the following:

> [E]ach issuer must certify that it has, and will continue to have, at least one member of the audit committee who is a financial expert. In determining whether an audit committee member is a financial expert, the board must consider whether a person has, through education and experience as a public accountant or auditor or principal financial officer, comptroller or principal accounting officer of an issuer or from a position involving the performance of similar functions, sufficient financial expertise in the accounting and auditing areas, as specified in Section 407(b) of the Sarbanes-Oxley Act, and as may be established by the SEC in rulemaking under the Sarbanes-Oxley Act.[59]

The AMEX Board of Governors approved proposed changes to the AMEX audit committee membership requirements on November 25, 2002. The text of these changes is not yet available; however, the description of the changes on the AMEX website indicates that audit committee requirements will be conformed to the requirements of the Sarbanes-Oxley Act.

The Commission has indicated that it will continue to work with the self-regulatory organizations "to reconcile to the extent possible the various definitions of expert."[60] The situation is currently very much in flux. The Commission has not yet published a formal notice of filing of the proposed audit committee rule changes by any of the self-regulatory organizations, which will trigger a comment period on the proposals. At a recent webcast conducted by the NYSE, an Exchange official speculated that any new substantive rules will not become effective before the second quarter of 2003.

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Bulletin 03-16

The Sarbanes-Oxley Act of 2002 —
SEC Approves Final Rules Regarding Disclosure of
Off-Balance Sheet Arrangements and
Aggregate Contractual Obligations

On January 22, 2003, the Securities and Exchange Commission (the "SEC") approved final rules[61] under Section 401(a) of The Sarbanes-Oxley Act of 2002 (the "Act"), which directed the SEC to adopt rules mandating that each annual and quarterly financial report required to be filed with the SEC disclose "all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities or other persons, that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses."

Under the amendments to Item 303 of Regulation S-K[62] constituting the final rules, issuers must make specified disclosures regarding off-balance sheet arrangements and include a tabular disclosure of specified contractual commitments in management's discussion and analysis ("MD&A"). Small business issuers are not subject to the tabular disclosure of specified contractual commitments requirement. The final rules generally apply, however, to foreign private issuers and to Canadian participants in the multi-jurisdictional disclosure system ("MJDS filers").

The final rules do not require that issuers include a textual or tabular disclosure of contingent liabilities and commitments in MD&A as initially proposed. The SEC indicated, however, that it would continue to monitor the costs and benefits of additional disclosures regarding contingent liabilities and commitments.

Issuers must comply with the new off-balance sheet arrangement disclosure requirements in registration statements, annual and quarterly reports and proxy or information statements that are required to include financial statements for fiscal years ending on or after June 15, 2003. Issuers must include the table of contractual obligations in registration statements, annual and quarterly reports, and proxy or information statements that are required to include financial statements for the fiscal years ending on or after December 15, 2003. The new disclosure rules do not apply to filings on Form 6-K by foreign private issuers or to registration statements filed by MJDS filers.

The final rules contain a number of important changes from the proposals of November 4, 2002[63], and expand upon the stated requirements of the Act.

Off-Balance Sheet Arrangements

Required Disclosure

In a separately captioned section of MD&A, an issuer must discuss its off-balance sheet arrangements that have or are reasonably likely to have a material current or future effect on its financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources. As initially proposed, an issuer would have been required to disclose off-balance sheet arrangements that may have a material current or future effect. The Proposing Release indicated that under the "may have" standard, an issuer would be required to disclose all off-balance sheet arrangements excluding only those arrangements where the likely impact of the arrangement was remote. In moving to the "reasonably likely" standard, the off-balance sheet arrangement disclosure standard is consistent with the threshold currently applied to other portions of MD&A. In the event of confusion, however, the Approving Release explains how to apply the threshold analysis.

To the extent necessary for an understanding of off-balance sheet arrangements and the effects of such arrangements, MD&A shall address:

- the nature and business purpose of such arrangements;
- the importance of such arrangements in respect of the issuer's liquidity, capital resources, market risk support, credit risk support or other benefits;
- the amounts of revenues, expenses and cash flows of the issuer arising from such arrangements;
- the nature and amounts of any interests retained, securities issued and other indebtedness incurred by the issuer in connection with such arrangements;

- the nature and amounts of any other obligations or liabilities (including contingent obligations or liabilities) of the issuer arising from such arrangements that are or are reasonably likely to become material and the triggering events or circumstances that could cause them to arise; and
- any known event, demand, commitment, trend or uncertainty that will result in or is reasonably likely to result in the termination, or material reduction in availability to the issuer, of such arrangements that provide material benefits to it, and the course of action that the issuer has taken or proposes to take in response to any such circumstances.

In addition, consistent with the principles-based disclosure found in existing parts of MD&A, the issuer must disclose any other information that it believes necessary to understand its off-balance sheet arrangements and the effects of such arrangements.

A disclosure obligation does not arise with respect to an off-balance sheet arrangement until a definitive agreement that is unconditionally binding or subject only to customary closing conditions exists or, if there is no such agreement, when settlement of the transaction occurs.

The disclosure should cover the most recent fiscal year. However, the discussion should address changes from the previous year where necessary to an understanding of the disclosure.

An issuer's disclosure should be understandable, and with that principle in mind an issuer:

- should aggregate its off-balance sheet arrangements in groups or categories that provide material information in an efficient and understandable manner;
- should aggregate effects that are common or similar with respect to a number of arrangements to the extent the aggregation increases understanding;
- should discuss distinctions in arrangements and their effects to the extent the information is material;
- should avoid repetition and disclosure of immaterial information;

- need not repeat information provided in the footnotes to the financial statements, provided that clear and appropriate cross-references are included in MD&A and the substance of the footnotes is integrated into such discussion in a manner designed to inform readers of the significance of the information omitted.

The disclosure requirements are identical for foreign private issuers and MJDS filers.

What is an "off-balance sheet arrangement"?

The SEC significantly revised the definition of "off-balance sheet arrangement" contained in the Proposing Release by reducing the subject categories and by defining each category in the context of U.S. GAAP.

"Off-balance sheet arrangement" means any transaction, agreement or other contractual arrangement to which an entity unconsolidated with the issuer is a party, under which the issuer has:

- any obligation under a guarantee contract that has any of the characteristics identified in paragraph 3 of FASB Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others (November 2002) ("FIN 45"), and that is not excluded from the initial recognition and measurement provisions of FIN 45 pursuant to paragraphs 6 or 7 of that Interpretation;
- a retained interest (including a contingent interest) in assets transferred to an unconsolidated entity or similar arrangement that serves as credit, liquidity or market risk support to such entity for such assets;
- any obligation (including a contingent obligation) under a contract that would be accounted for as a derivative instrument, except that it is both indexed to the issuer's stock and classified in stockholders' equity in the issuer's statement of financial position, and therefore excluded from the scope of FASB Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities (June 1998) ("FAS 133"), pursuant to paragraph 11(a) of that Statement[64]; or

- any obligation (including a contingent obligation) arising out of a variable interest (as referenced in FASB Interpretation No. 46, Consolidation of Variable Interest Entities (January 2003)) in an unconsolidated entity that is held by, and material to, the issuer, where such entity provides financing, liquidity, market risk or credit risk support to, or engages in leasing, hedging, or research and development services with, the issuer.

Contingent liabilities arising out of litigation, arbitration or regulatory actions are not considered to be off-balance sheet arrangements.

The foregoing is highly technical in nature, and issuers, particularly foreign private issuers, will likely require significant assistance from their public accountants and counsel to ensure a compliant disclosure.

Although based on U.S. GAAP, the definition of off-balance sheet arrangements applies equally to all issuers, regardless of the GAAP utilized in their primary financial statements.

Contractual Obligations

Required Disclosure

Issuers must disclose in a tabular format, as of the latest fiscal year end, the amounts, aggregated by type, of specified categories of contractual obligations. The specified categories are identified in the sample table below. The issuer may disaggregate the specified categories of contractual obligations using other categories suitable to its business, but the presentation must include all of the obligations of the issuer that fall within the specified categories. A presentation covering at least the periods specified must be included. The tabular presentation may be accompanied by footnotes to describe provisions that create, increase or accelerate obligations, or other pertinent data to the extent necessary for an understanding of the timing and amount of the issuer's specified contractual obligations.

		Payments due by period			
Contractual Obligations	**Total**	**Less than 1 year**	**1–3 years**	**3–5 years**	**More than 5 years**
[Long-Term Debt Obligations]					
[Capital Lease Obligations]					
[Operating Lease Obligations]					
[Purchase Obligations]					
[Other Long-Term Liabilities Reflected on the Issuer's Balance Sheet under GAAP]					
Total					

The specified categories of contractual obligations have been defined in the context of U.S. GAAP and, with the exception of purchase obligations, issuers subject to U.S. GAAP have been historically required under U.S. GAAP to aggregate the specified categories:

- Long-Term Debt Obligation means a payment obligation under long-term borrowings referenced in FASB Statement of Financial Accounting Standards No. 47 Disclosure of Long-Term Obligations (March 1981);
- Capital Lease Obligation means a payment obligation under a lease classified as a capital lease pursuant to FASB Statement of Financial Accounting Standards No. 13 Accounting for Leases (November 1976);
- Operating Lease Obligation means a payment obligation under a lease classified as an operating lease and disclosed pursuant to FASB Statement of Financial Accounting Standards No. 13 Accounting for Leases (November 1976);
- Purchase Obligation means an agreement to purchase goods or services that is enforceable and legally binding on the issuer that specifies all significant terms, including: fixed or minimum quantities to be purchased; fixed, minimum or variable

price provisions; and the approximate timing of the transaction;

- Other Long-Term Liabilities Reflected on the Issuer's Balance Sheet under GAAP, aggregates all other contractual obligations without requiring specific categorization. "GAAP" for this purpose refers to U.S. GAAP for U.S. issuers and to the GAAP used in the issuer's primary financial statements in the case of foreign private issuers and MJDS filers. The disclosure by some foreign private issuers and MJDS filers thereby being a mix of U.S. GAAP and non-U.S. GAAP.

Issuers are not required to include the table of contractual obligations in reports for interim periods. Instead, the issuer should disclose material changes outside the ordinary course of the issuer's business in the specified contractual obligations during the interim period.

Safe Harbor

The final rules extend the general forward-looking statement safe harbors provided in the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended, to the new disclosures regarding off-balance sheet arrangements and tabular disclosure of contractual arrangements.

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Bulletin 03-17

The Sarbanes-Oxley Act of 2002 —
SEC Issues Final Rule on Attorney Conduct;
Delays Final Rule on "Noisy Withdrawal"

On January 29, 2003, the Securities and Exchange Commission ("SEC") issued its final rule ("Attorney Conduct Rule" or "Rule") establishing standards of professional conduct for attorneys who practice before the SEC on behalf of public companies, as required by Section 307 of the Sarbanes-Oxley Act of 2002 ("Act").[65] The Rule will be effective on August 5, 2003. All public companies, including foreign private issuers, must put in place procedures to comply with the requirements of the Rule by that date.

At the same time, the SEC approved an extension of the comment period for the controversial "noisy withdrawal" provisions contained in the original proposed rule.[66] On January 30, 2003, the SEC issued a new proposed rule for "noisy withdrawal," setting forth alternative provisions which prescribe attorney withdrawal in a narrower set of circumstances and would require the issuer, rather than the attorney, to report to the SEC the attorney's withdrawal or written notice of failure to receive an appropriate response to a report of a material violation.[67] The comment period for the Revised Noisy Withdrawal Release is 60 days from publication in the Federal Register.

Summary of Attorney Conduct Rule—Up-the-Ladder Reporting

Section 307 of the Act requires the SEC to establish minimum standards of conduct for attorneys appearing and practicing before the SEC, including a rule requiring up-the-ladder reporting of any evidence of a material violation of securities law, breach of fiduciary duty or similar violations. The following is a summary of the steps that must be taken under the Attorney Conduct Rule. Some of the key terms used in the Rule are highlighted in italics and are discussed in more detail below.

- An attorney appearing and practicing before the Commission in the representation of an *issuer* who becomes aware of evidence of a material violation of a U.S. federal or state securities law, a material breach of fiduciary duty under a U.S. federal or state law, or a similar material violation of any U.S. federal or state law by the issuer or an officer, director, employee or agent of the issuer, must report the evidence to the issuer's chief legal officer ("CLO") or to both the CLO and chief executive officer ("CEO") forthwith.[68]

- The CLO must cause an inquiry to be made into the evidence of material violation as he or she reasonably believes is appropriate, to determine whether the alleged material violation has occurred, is ongoing or about to occur.
- If the CLO determines no material violation has occurred, is ongoing or is about to occur, he or she must notify the reporting attorney, including advising the attorney of the basis for such determination.
- If the CLO determines that a material violation has occurred, is ongoing or is about to occur, he or she must take all reasonable steps to cause the issuer to adopt an appropriate response and advise the reporting attorney.
- If the reporting attorney does not reasonably believe that the CLO or CEO has provided an appropriate response within a reasonable time, the attorney must report the evidence of material violation to the audit committee (and, if there is no audit committee, to another committee consisting solely of non-employee directors) or the full board (if there is no audit committee or other committee of non-employee directors).
- If the reporting attorney reasonably believes that it would be futile to report the evidence of material violation to the CLO or CEO, he or she may report directly to the audit committee (or another non-employee committee or the full board, as applicable).
- If the reporting attorney receives what he or she reasonably believes is an appropriate and timely response to a report of material violation, he or she is not required to do anything further with respect to the report.
- If the reporting attorney does not reasonably believe that the issuer has made an appropriate response within a reasonable time, the attorney must report his or her reasons to the CLO or the directors to whom he or she reported the evidence of material violation.

- In lieu of conducting an inquiry, the CLO may refer the report of a material violation to the issuer's Qualified Legal Compliance Committee ("QLCC") if the issuer has established a QLCC prior to the report. (The QLCC is discussed in more detail below.)

Key Definitions and Terms

Much of the content of the Rule is set forth in detailed definitions of key terms and phrases. These definitions, and certain implications to be drawn from them, are outlined below:

"Appearing and practicing before the Commission" is one of the most far-reaching and important definitions, because it defines the range of circumstances under which a duty to report may arise. As widely noted in connection with the Original Rule Release, "appearing and practicing before the Commission" is broadly defined to include the following:

- Transacting any business with the SEC, including any communication;
- Representing an issuer in an administrative proceeding or in connection with an SEC investigation, inquiry, information request or subpoena;
- Providing advice with respect to U.S. securities laws or SEC rules or regulations regarding any document the attorney has notice will be filed with or submitted to the SEC, or incorporated in a document that will be filed with the SEC, including advice in connection with the preparation of the document; or
- Advising an issuer as to whether information or a document is required under U.S. law or SEC rule or regulation to be filed with or submitted to the SEC.

Under this definition, a wide range of attorneys performing legal services for an issuer will be appearing or practicing before the SEC and therefore subject to the Rule. For example, non-securities lawyers who contribute to, edit or prepare portions of a prospectus or periodic reports filed under the '34 Act will be subject to the Rule. On the other hand, with respect to documents, the attorney must have notice that the document he or she is preparing will be submitted to the SEC, such that an attorney who drafted a contract but had no notice that it would be filed with the SEC will not fall within the Rule, even if the contract is later filed.

In addition, to fall under the Rule, the attorney must have an "attorney-client" relationship with the issuer; thus, lawyers who are not providing legal services are not covered by the Rule (which reflects a narrowing of the scope of the rule compared to the Original Rule Release). An in-house lawyer need not serve in the legal department to be subject to the Rule, but he or she must be providing legal services to the issuer in the context of an attorney-client relationship. A formal retainer or agreement need not be in place to create an attorney-client relationship.

"Appropriate response" is defined as a response which enables the reporting attorney to reasonably believe:

- that no material violation has occurred, is ongoing or is about to occur;
- that the issuer has adopted appropriate remedial measures to stop, prevent or remedy the material violation and minimize the likelihood of recurrence; or
- that the issuer, with the consent of the board or a non-employee committee or the QLCC, has retained counsel to review the report and either (i) substantially implemented remedial recommendations by such counsel or (ii) been advised that such counsel may assert a colorable defense on behalf of the issuer in any judicial or administrative proceeding relating to the reported evidence of material violation.

"Reasonably believe" and "reasonable" are also defined, although in a somewhat circuitous fashion. In evaluating the appropriateness of the response to a report of evidence of a material violation, the attorney must "reasonably believe" in its appropriateness, which is defined as a belief that is "not unreasonable." To be "reasonable," the actions of the attorney must not be "unreasonable for a prudent or competent attorney." The Final Rule Release indicates that these standards enable the attorney to take into account and weigh "all attendant circumstances," including the amount and weight of evidence, the severity of the apparent violation and the scope of investigation. In addition, while the reporting attorney cannot rely completely on assurances by the issuer that no material violation occurred or that the issuer is undertaking an appropriate response, the attorney, in determining whether a response is appropriate, may rely on “reasonable and appropriate factual representations and legal determinations.”

“Evidence of a material violation” is intended to create an “objective standard” for determining whether a material violation exists. In support of this, the evidence must first be “credible evidence” and then it must be “unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely [which the Final Rule Release describes as “more than a mere possibility,” but which need not be “more likely than not”] that a material violation has occurred, is ongoing or is about to occur.” So that while the Final Rule Release acknowledges that an attorney is not required or expected to report gossip, hearsay or innuendo, the so-called objective standard recognizes that there is a range of conduct in which an attorney may engage without being unreasonable.

“Issuer” includes any company, whether domestic or foreign, that has securities registered under Section 12 of the ’34 Act or that is required to file reports under Section 15(d) of the ’34 Act or has filed a registration statement under the ’33 Act which has not yet become effective. In addition, the Rule also provides that “issuer” includes any entity controlled by an issuer, where an attorney provides legal services to that entity for the benefit or on behalf of the issuer. Thus, an attorney employed or retained by a non-public subsidiary of a public parent company will be covered by the Rule, such as when the attorney prepares a portion of a disclosure document or discovers evidence of misconduct at the non-public subsidiary that is material to the parent.

“Material violation” is a shorthand term meaning material violation of an applicable U.S. federal or state securities law, a material breach of fiduciary duty arising under U.S. federal or state law, or similar material violation of U.S. federal or state law. While the Final Rule Release makes it clear that the definition is limited to U.S. federal and state laws and does not include violations of foreign laws, it leaves many open questions. For example, consistent with long-standing SEC practice, “material” is not defined. “Breach of fiduciary duty” is defined very broadly to cover any breach of fiduciary or similar duty to the issuer under federal, state or common law, including misfeasance, nonfeasance, abdication of duty, abuse of trust and approval of unlawful transactions. “Similar material violation” is not defined and no guidance is provided with respect to its meaning or usage.

Elimination of Documentation Requirement

The Final Rule Release eliminates all requirements that reports and responses be documented or retained for a reasonable period (as set forth in the Original Rule Release), although the SEC cautions that "prudent counsel" will consider whether to advise a client that it may be violating the law and that corporate officials may direct that such matters be documented.

Qualified Legal Compliance Committee (QLCC)

The QLCC provides an alternative procedure for reporting evidence of a material violation. If the issuer has formed a QLCC, then an attorney can report evidence of a material violation to the QLCC in lieu of making a report to the CLO. Moreover, if the attorney reports to the QLCC, he or she has satisfied his or her obligation under the Rule and is not required to assess the issuer's response.

In addition, a CLO may refer a report he or she receives to the QLCC (if the QLCC was formed before the report was received by the CLO), and the QLCC will thereafter be responsible for responding to the report. The CLO is required to notify the reporting attorney that he or she has referred the matter to the QLCC. As noted above, the QLCC must have been "previously established," and cannot be formed after-the-fact to respond to an existing report.

The QLCC must consist of at least one member of the audit committee and two or more other non-employee directors.[69] The QLCC must have written procedures for the confidential receipt, retention and consideration of a report of evidence of a material violation. The QLCC must be established by the board with authority to notify the CLO and CEO of any report; determine whether an investigation is necessary and, if so, to notify the audit committee or full board; initiate an investigation; and retain outside counsel and other experts. At the conclusion of the investigation, the QLCC has the authority to recommend, by majority vote, that the issuer implement on appropriate response and inform the CLO, CEO and full board of the results of the investigation and remedial measures adopted.

The Final Rule Release clarifies that the QLCC may be the audit committee or another existing committee that meets the requirements described above. It also indicates that the QLCC may, but is not required to, have the authority to direct the issuer to take remedial action, since such steps might require action by the full board. The SEC "encourages" the use of a QLCC as a means of effective corporate governance, but it is not required.[70]

The appropriateness of a QLCC will vary from company to company. Clearly, the size and complexity of the issuer, as well as the size and organization of its legal department (if any), will impact the decision as to whether a QLCC is desirable. Other factors may include whether the members of the audit committee or other non-employee directors have the time to perform these additional duties, particularly those on the audit committee who must cope with the additional duties expressly imposed by the Act. Other uncertain areas to be considered include:

- Will the QLCC provide disgruntled attorneys with direct access to board members under cover of alleged evidence of a material violation?
- Will direct reporting by an attorney to the QLCC, rather than through the CLO, enhance the risk of waiver of the attorney-client privilege?[71]

Use of Counsel to Investigate Report

The Final Rule Release contains several important additions and clarifications concerning the use of counsel to investigate a report of evidence of a material violation:

- As noted above, an issuer can assert as an appropriate response that it has directed its attorney (which can be an in-house attorney employed by the issuer or outside counsel retained by the issuer with the consent of the issuer's board, a non-employee board committee or the QLCC) to undertake an internal review of a report and has substantially implemented the recommendations made by the attorney after reasonable investigation and evaluation.
- The Rule permits an issuer to respond to a report that it has been advised by its attorney (retained with consent as described above) that he or she may assert a colorable defense on behalf of the issuer, as long as the attorney can assert such position consistent with his or her professional obligation.

- If an attorney is retained to investigate the report, the Rule relieves that attorney from reporting up-the-ladder in a number of instances:
    - If the attorney is retained by the CLO (with consent as described above) to investigate the reported violation, the attorney has no duty to report up-the-ladder where the results of the investigation are provided to the CLO, and the attorney and CLO agree no violation has occurred and the results are reported to the full board or a non-employee committee or the QLCC.
    - If the attorney is retained by the CLO (with consent as described above) to litigate the reported violation, the attorney has no duty to report up-the-ladder if he or she is able to assert a colorable defense on behalf of the issuer, and reports on the litigation to the board.
    - If the attorney is retained by the QLCC to investigate a reported violation, he or she has no up-the-ladder reporting obligations.
    - If the attorney is retained by the QLCC to litigate a reported violation, he or she has no reporting obligation as long as he or she can assert a colorable defense on behalf of the issuer.

Non-Appearing Foreign Attorneys Excluded

One important change made in the Final Rule Release compared to the Original Rule Release relates to when and whether foreign counsel are subject to the Rule. The SEC added a definition of "non-appearing foreign attorney" and provided that an attorney who meets this definition is not "appearing and practicing" before the SEC and therefore is not subject to the Rule. A non-appearing foreign attorney is an attorney who:

- Is admitted to practice law outside the U.S.;
- Does not hold himself or herself out as practicing, and does not give legal advice regarding U.S. federal or state securities or other laws; and

- Conducts activities that would constitute appearing and practicing before the SEC only incidental to, and in the ordinary course of, practice outside the United States or is appearing and practicing only in consultation with counsel admitted to practice in the United States.

Sanctions and Disciplinary Provisions

Violations of the Rule by an attorney appearing and practicing before the SEC are subject to applicable civil penalties and remedies under federal securities laws. In addition, an attorney who violates the Rule is subject to disciplinary action by the SEC, including censure or temporary or permanent denial of the privilege to appear and practice before the SEC, regardless of whether the attorney is subject to disciplinary action in his or her licensing jurisdiction.

The Rule also provides that an attorney who complies in good faith with the Rule will not be subject to discipline or liability under inconsistent state standards (i.e., the rule pre-empts inconsistent state law or standards), although the state can impose more stringent standards. In addition, the Rule does not give rise to a private cause of action.

Subordinate and Supervisory Attorneys

Subordinate attorneys, who are defined as attorneys who appear and practice before the SEC under the supervision or direction of another attorney (other than under direct supervision by the CLO), must comply with the Rule. However, a subordinate attorney is deemed to have complied if he or she reports evidence of a material violation to his or her supervisory attorney. If the subordinate attorney reasonably believes that the supervisory attorney has failed to comply with the Rule, then the subordinate attorney may, but is not required to, report the evidence to the issuer's CLO (or CLO and CEO) or to the QLCC (if one exists).

If an in-house attorney is under the supervision or direction of the CLO on a matter covered by the Rule, then he or she is deemed not to be a subordinate attorney and must comply with the entire Rule (i.e., reporting evidence of a material violation and unless reporting to the QLCC, assessing response).

Supervisory attorneys, who are defined as supervising or directing another attorney who is appearing and practicing before the SEC, are subject to the following rules:

- Supervisory attorneys must make reasonable efforts to ensure that subordinate attorneys that he or she supervises comply with the Rule.
- Supervisory attorneys are responsible for complying with the reporting requirements of the Rule when a subordinate attorney reports evidence of a material violation.

To be subject to the Rule, the supervisory attorney must supervise the subordinate attorney with respect to matters related to appearing and practicing before the SEC.

Practical Implications and Questions

Issuers must address the following:

- Adopt a policy on the Attorney Conduct Rule by August 5, 2003 and disseminate it to all practicing attorneys employed by the issuer, even if not in the legal department and even if they do not handle securities matters.
- Advise the CLO and all subordinate and supervisory attorneys of their duties under the Rule and the issuer's policy.
- Advise the CEO that he or she may receive reports of evidence of material violations at the same time they are reported to the CLO and ensure that the CEO is aware of his or her duties and obligations under the Rule and the issuer's policy.
- Decide whether to utilize a QLCC and, if so, appoint the QLCC and adopt a written policy for the QLCC.
- Notify outside law firms which perform services for the issuer of the issuer's policy, including whether it has a QLCC.

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Bulletin 03-19

The Sarbanes-Oxley Act of 2002 —
SEC Approves Final Rules Regarding Codes of Ethics
for Principal Executive Officer and Senior Financial Officers

The Sarbanes-Oxley Act of 2002 (the "Act") required the Securities and Exchange Commission (the "SEC") to adopt rules mandating that each company subject to the reporting requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act") disclose in its annual report whether it has adopted a code of ethics for its principal financial officer and comptroller or principal accounting officer, or persons performing similar functions (and if not, why not). The Act also required a company to report, on Form 8-K, by dissemination by the Internet or by other electronic means, any change in or waiver of the code of ethics for senior financial officers. On January 15, 2003, the SEC approved its final rules, extending the coverage of the code to the company's principal executive officer ("CEO") and going beyond the mandate of the Act in a number of other respects, as described more fully below.

A company must comply with the code of ethics disclosure requirements in its annual report on Form 10-K, 10-KSB, 20-F or 40-F for fiscal years ending on or after July 15, 2003. The disclosure requirements relating to amendments to or waivers of such code go into effect when the company files its first annual report in which the code of ethics disclosure is required.

What is a Code of Ethics?

The SEC defines a "code of ethics" to mean a codification of 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;
- 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

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.

As proposed[72] and as adopted,[73] the SEC expanded the required components of the code from those specified in the Act. The SEC views the code as an opportunity to "deter wrongdoing," so the second bullet above covers all public communications, not simply SEC filings, and the fourth and fifth bullets, not contemplated by the Act, were added.[74] The other components of the SEC's definition are consistent with the Act.

In its approving release,[75] the SEC indicated that codes of ethics will vary from company to company and that the specific provisions, compliance procedures and disciplinary measures for ethical breaches are best left to each company to determine in light of its own unique situation. Furthermore, the SEC clarified that a company may have separate codes of ethics for different types of officers and that the provisions of the company's code of ethics that address the elements listed in the definition and apply to the CEO and to the other senior officers who are subject to the Act may be part of a broader code that addresses additional issues and applies to additional persons, such as all executive officers and directors of the company.

Required Disclosure of the Code of Ethics

A company must disclose in its annual report (on Form 10-K, 10-KSB, 20-F or 40-F) whether it has a code of ethics meeting the specified standards that is applicable to its CEO and its principal financial officer and comptroller or principal accounting officer, or persons performing similar functions ("Senior Financial Officers"). If the company has not adopted such a code of ethics, the company would be required to explain in its annual report why it has not done so.[76]

Additionally, a company must make its code of ethics publicly available by:

- Filing its code of ethics as an exhibit to its annual report;
- Posting its code of ethics, or relevant portion thereof, on its Internet website, provided that the company's annual report contains the website's Internet address[77] and a statement that the code of ethics has been posted to the website; or
- Including in its annual report an undertaking to provide a copy of its code of ethics to any person without charge upon request and explaining the manner in which such request may be made.

The revisions to Forms 20-F and 40-F make foreign private issuers subject to the foregoing disclosure rule to the same extent as domestic issuers.

Prompt Disclosure of Changes or Waivers

A company reporting that it has a qualifying code of ethics for its CEO and Senior Financial Officers would be required to disclose, within five business days, the nature of any amendment[78] to, or any waiver or implicit waiver of, the code. The disclosure would consist of the nature of the amendment or waiver and, in the case of a waiver, the name of the person to whom the waiver was granted and the date of the waiver. The final rules define "waiver" as the company's approval of a material departure from a provision of the code, and "implicit waiver" as the company's failure to take action within a reasonable period of time regarding a material departure from the code that has been made known to an executive officer. This disclosure requirement relates only to amendments or waivers of the specified elements of the code, and, in the case of waivers, only to the extent they apply or are granted to the specified officers. This is intended to encourage companies to develop wide-ranging and broadly applicable codes of ethics without incurring additional disclosure responsibility.

A company other than a foreign private issuer is required to disclose amendments and waivers by:

- Reporting them on Form 8-K under new Item 10; or
- Posting the disclosure on its Internet website, provided that the company's annual report contains the website's Internet address and a statement of the company's intention to disclose amendments to, and waivers or implicit waivers of, the code of ethics in this manner, and provided further that such information remains available on the website for at least 12 months and is retained by the company for at least five years.[79]

A foreign private issuer is not required to disclose amendments or waivers within five business days, but must make disclosures of amendments or waivers that have occurred during the past fiscal year in its annual report. However, if the foreign private issuer elects to disclose the required information on its Internet website within five business days following the date of the amendment or waiver and has disclosed in its most recently filed annual report its Internet address and intention to provide disclosure in this manner, it need not report the same information again in its annual report.[80]

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Bulletin 03-23

Sarbanes-Oxley Regulation —
Non-Audit Services by Independent Accountants

On January 22, 2003, the Securities and Exchange Commission adopted final rules[81] to carry out the provisions of the Sarbanes-Oxley Act of 2002, restricting the types of non-audit services which auditing firms may provide to their audit clients, and imposing audit committee approval requirements and corporate disclosure obligations with respect to audit and non-audit services.

Title II of the Sarbanes-Oxley Act, entitled "Auditor Independence," added new Subsections (g) through (l) to Section 10A of the Securities Exchange Act of 1934.[82] Subsection (g) specifies that it is unlawful for a "registered public accounting firm" that performs for an issuer[83] any audit required under the 1934 Act or regulations promulgated thereunder to provide certain designated non-audit services.[84]

Subsection (h) provides that a registered public accounting firm may engage in any permitted non-audit service, including tax services, only if the activity is approved in advance by the issuer's audit committee.

Subsection (i) provides that all auditing services, including comfort letters in connection with securities underwritings or statutory audits required for insurance companies, and all non-audit services (other than certain de minimis services) must be preapproved by the audit committee. Subsection (i) also states that approval by an audit committee of an issuer under Subsection (i) of a non-audit service to be performed by the auditor of the issuer must be disclosed to investors in periodic reports required by Section 13(a) of the 1934 Act.

These statutory provisions are applicable to non-audit services provided by "registered public accounting firms." Section 2(a)(12) of the Sarbanes-Oxley Act defines "registered public accounting firm" as a public accounting firm registered with the Public Accounting Oversight Board established under Section 101 of the Act. Under Section 101, the SEC must determine, not later than 270 days after enactment of the Act, that the Board has been duly organized and has the capacity to carry out the requirements of the statute. Public accounting firms must register with the Board within 180 days after the SEC determination. There has yet been no SEC determination and no registration by public accounting firms. Since there are no "registered" public accounting firms, the statutory provisions restricting non-audit services of registered public accounting firms are not yet operational.[85]

However, unlike the statutory provisions, the final rules adopted by the SEC on January 22, 2003 are not limited to registered public accounting firms. Subject to transitional provisions included in the final rules, which are discussed below, these requirements are effective on May 6, 2003.

Overview

The new requirements relating to non-audit services have three parts. First, a variety of revisions have been made in Rule 2-01 of Regulation S-X[86], which sets forth the criteria for "independence" of public accountants.[87] An accountant will not be considered independent if, at any point during the audit and professional engagement period,[88] the accountant provides non-audit services to the audit client in any of 10 specified categories.

Second, the SEC has adopted a new Rule 10A-2, under which it is unlawful for an auditor not to be independent under the Regulation S-X requirements. This enables the direct imposition of sanctions against the auditor for violation of the independence requirements.

Third, Item 9 of Schedule 14A (and other comparable disclosure requirements)[89] have been revised to add certain registrant disclosure requirements concerning audit and non-audit services performed by the registrant's auditor.

Revisions to Regulation S-X Regarding Non-Audit Services

Regulation S-X provides that the Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. In determining whether an accountant is independent, the Commission will consider all relevant circumstances, including evidence bearing on all relationships between the accountant and the audit client.[90]

Regulation S-X then enumerates a "non-exclusive" specification of circumstances inconsistent with the above standard. These include a list of prohibited non-audit services.

The new rules do not change the general standard of independence, and do not modify the "non-exclusivity" of the list of prohibited non-audit services. As a result, under the new rules as under existing law, performance of a non-audit service not specifically enumerated as a prohibited service could result in an accountant being deemed to be not independent if the service results in the fact or reasonable appearance of compromised objectivity.

Prior to the new rules, the non-exclusive list of prohibited non-audit services in Regulation S-X described non-audit services in nine enumerated categories. The new rules generally track the current S-X language relating to these categories, with the exceptions noted below, and add one additional category, discussed below.

Bookkeeping or other services related to the accounting records or financial statements. The new rule differs from the previous S-X requirement by providing that any service of this nature is prohibited, unless it is reasonable to conclude that the results of the services will not be subject to audit procedures during an audit of the audit client's financial statements. This "reasonable to conclude" language (which is also used in the paragraphs of the new rule dealing with financial information systems design and implementation, appraisal or valuation services, actuarial services and internal audit outsourcing services) is intended to invoke a presumption that these types of services are prohibited, which presumption can only be overcome by a demonstration that it is reasonable to conclude that the services will not be the subject of audit procedures. The prior S-X prohibitions on maintenance of accounting records and preparation of financial statements or source data are utilized only as examples of the general prohibition on bookkeeping services. The new rule also eliminates the previous exceptions for emergency and foreign situations.[91] The preparation of statutory financial statements for foreign companies which are not filed with the SEC would impair an accountant's independence if the statutory financial statements form the basis of financial statements that are filed with the SEC.[92]

Financial information systems design and implementation. Previously, the S-X prohibition contained an exception permitting services of this type in circumstances where it is clear that the audit client and its management retain ultimate responsibility. The new rule eliminates this exception, and prohibits all services of this nature 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.[93] The prohibition does not preclude the accountant from evaluating internal controls or from making recommendations on internal controls in conjunction with the design and installation of a system by another service provider.[94]

Appraisal or valuation services, fairness opinions or contribution-in-kind reports. Previously, the S-X prohibition on these types of services contained an exception permitting valuation services where the client provides the primary support for the recorded amounts, valuation of pension or similar liabilities where the client takes responsibility for significant assumptions and data, tax-related valuations, and valuations which do not affect the financial statements. The new rule eliminates these exceptions and prohibits all such services 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.[95] The new rule also explicitly applies to "contribution-in-kind reports."[96]

Actuarial Services. The previous prohibition of these types of services related only to insurance company policy reserves, and contained exceptions where the accountant's role is limited. The new rule eliminates these exceptions, and extends the prohibition to any actuarially oriented advisory service involving the determination of amounts recorded in financial statements, other than assisting a client in understanding the methods, models, assumptions and inputs used in computing an amount, 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.[97]

Internal Audit Outsourcing Services. The previous S-X provision prohibited the performance of internal audit services generating fees in excess of specified amounts, and such services generating fees less than such amounts unless management acknowledged its own ultimate responsibility. The new rule eliminates these qualifications and generally prohibits all internal audit services outsourced by the audit client relating to the internal accounting controls, financial systems or financial statements of an 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.[98] The prohibition on "outsourcing" does not preclude engaging an accountant to perform nonrecurring evaluations of discrete items that do not amount to an outsourcing of the internal audit function.[99]

Management Functions/Human Resources/Broker-Dealer Services. These categories of prohibited services are left unchanged by the new rule, except for minor language clarifications.[100]

Legal Services. The language of this prohibition is clarified in the new rule so as to prohibit services that, under circumstances in which the service is provided, could be provided only by someone licensed, admitted, or otherwise qualified to practice law in the jurisdiction in which the service is provided.[101]

Expert Services. The proposed rule adds a new category of prohibited services. Under this category, an accountant is prohibited from providing expert opinions or other expert service to an audit client or an audit client's legal representative for the purpose of advocating an audit client's interests in litigation or in regulatory or administrative proceedings or investigations. The rule provides that the accountant's independence is not deemed to be impaired if the accountant provides factual accounts, including in testimony, of work performed or explains the positions taken or conclusions reached during the performance of any service provided by the accountant for the audit client.[102] The intent of the rule is to prohibit the accountant from lending its expertise to provide authority to the client's advocacy position in the specified proceedings.[103]

Tax Services. New Section 10A(h) of the 1934 Act, added by Section 201 of the Sarbanes-Oxley Act, states that an auditor may provide, after audit committee approval, non-audit services "including tax services" that are not identified as prohibited in the statute. The new Regulation S-X prohibitions on non-audit services make no reference to tax services, and the new rules do not define tax services. The adopting release states that accountants may continue to provide tax services such as tax compliance, tax planning and tax advice to audit clients, subject to the normal audit committee pre-approval requirements.[104]

However, simply classifying a service as a "tax service" does not mean that the service does not compromise the auditor's independence. Independence may be compromised, according to the language in the adopting release, if accountants represent an audit client before a tax court, district court, or federal court of claims. In addition, the release notes 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 in the Internal Revenue Code and related regulations.[105]

New Audit Committee Approval Requirements

The new rules also create additional independence requirements, separate from the new prohibitions on non-audit services.[106] These include a new requirement concerning administration of the engagement by the audit committee.[107] Under new S-X Rule 2-01(c)(7), the auditor will not be deemed to be independent unless either (1) prior to the accountant's engagement to render audit or non-audit services, the engagement is approved by the audit committee; or (2) the engagement to render the service is entered into pursuant to pre-approval policies and procedures established by the audit committee; provided the policies and procedures are detailed as to the particular service and the audit committee is informed of each service and such policies and procedures do not include delegation of the audit committee's responsibilities under the 1934 Act to management.

The new rule indicates that the approval must be made in accordance with Section 10A(i) of the 1934 Act.[108] Under this section, the audit committee may delegate to one or more designated members of the committee who are independent directors of the board of directors, the authority to grant preapprovals. The decisions of any such member are required to be presented to the full audit committee at its scheduled meeting.[109]

The preapproval requirement for non-audit services is inapplicable where the issuer does not recognize at the time of the engagement that the services were to be non-audit services, and where the amount paid for such services is not more than 5 percent of the total amount of revenues paid by the audit client to its accountant during the fiscal year in which the services are provided.[110] The "non-recognition" requirement would cover a situation where the issuer did not understand at the time of an audit engagement that particular non-audit services were to be rendered as part of the approved audit engagement.

Disclosure

Currently, Item 9 of Schedule 14A and comparable provisions of other disclosure forms require certain disclosures concerning the issuer's auditor. The new rules change some of these requirements.

Under the previous version of Item 9, issuers were required to disclose the amount of fees paid to the auditor during the most recent fiscal year for services in each of three categories: audit fees; financial information systems design and implementation fees; and other fees. Under the new rules, fees for each of the two most recent years are required to be disclosed, in each of four categories: audit fees, audit-related fees, tax fees, and other fees.[111]

The audit fee category includes fees paid for the audit of the registrant's annual financial statements, review of the quarterly financial statements, and services normally provided by the accountant in connection with statutory and regulatory filings or engagements.[112] The adopting release indicates that audit fees also include fees which generally only the independent accountant can reasonably provide, such as comfort letters, statutory audits, attest services, consents, and assistance with and review of documents filed with the SEC.[113]

The category of "audit-related fees" includes fees for services reasonably related to the performance of the audit.[114] The adopting release indicates that these could include employee benefit plan audits, due diligence related to mergers and acquisitions, accounting assistance and audits in connection with acquisitions, internal control reviews, attest services that are not required by statute or regulation, and consultation concerning financial accounting and reporting standards.[115] Disclosure is required as to the nature of the services comprising the fees disclosed in this category.

The category of "tax fees" added by the new rules includes fees for services rendered for tax compliance, tax consulting and tax planning.[116] The adopting release clarifies that tax compliance involves preparation of tax returns and related matters.[117] The release states that reviewing tax accruals, where necessary to comply with generally accepted auditing standards, is part of the audit services and is not itself a tax compliance service.[118] Tax consulting and tax planning includes services in connection with tax audits and appeals, tax advice related to mergers and acquisitions and employee benefit plans, and requests for rulings or technical advice from taxing authorities.[119] Disclosure is required as to the nature of the services comprising the fees disclosed in this category.

The category of "other fees" includes all other fees billed for products and services provided by the principal accountant. Disclosure is required as to the nature of the services comprising the fees disclosed in this category.

In addition to fee disclosure, the proposal requires certain disclosures concerning audit committee approvals of audit and non-audit services.

First, disclosure is required of the audit committee's preapproval policies and procedures, if any, as described above.[120] This disclosure may be accomplished by providing a description of the policies and procedures or supplying a copy of the policies and procedures themselves.[121]

Second, disclosure is required of the percentage of fees in each of the "audit-related," "tax" and "other" categories described above which were approved by the audit committee pursuant to the de minimis exception described above.

In addition, disclosure is required if more than 50 percent of the hours expended on the audit engagement were worked by persons other than the accountant's full-time permanent employees.

Finally, certain particular disclosures are required for investment companies. First, disclosure is required of the aggregate non-audit fees billed for the last two fiscal years by the investment company's accountant for services rendered to the investment company, and to its investment adviser (excluding certain subadvisers) and any entity controlling, controlled by or under common control with the adviser that provides ongoing services to the investment company. Secondly, disclosure is required as to whether the investment company's audit committee considered whether the provision of non-audit services to such investment adviser and related entities is compatible with maintaining the principal accountant's independence.

Effective Date and Transition Rules

The new rules become effective on May 6, 2003. However, transition periods are provided with regard to certain of the rules. Non-audit services which were previously permissible may continue to be performed under contracts in existence on May 6, 2003, until May 6, 2004. Previously permissible non-audit services may continue to be performed under contracts in existence on May 6, 2003 without audit committee pre-approval. The rules requiring additional disclosures will be effective for periodic annual filings (including proxy statement information incorporated therein) for the first fiscal year ending after December 15, 2003.

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Bulletin 03-31

The Sarbanes-Oxley Act of 2002 —
SEC Approves Standards Relating to
Listed Company Audit Committees

The Securities and Exchange Commission recently adopted new Rule 10A-3 under Section 10A(m) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), which was added by Section 301 of The Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act").[1] New Rule 10A-3 mandates that all national securities exchanges and national securities associations (individually, an "SRO" and collectively, the "SROs") implement new listing standards applicable to all listed companies. Companies not complying with the new standards would not be entitled to be listed. The new rules require that all members of an issuer's audit committee be independent under specified criteria, and that the audit committee of a listed issuer be directly responsible for the issuer-auditor relationship, have the authority to hire independent counsel and other advisors, and be provided appropriate funding. In addition, the Final Release added disclosure requirements relative to exemptions from listing standards and changed certain of the existing disclosure requirements relative to audit committees.

Under Rule 10A-3, the new listing standards of each SRO must be operative, and listed issuers must be in compliance with those rules, by the earlier of the listed issuer's first annual shareholders meeting after January 15, 2004, or October 31, 2004, except that listed foreign private issuers and listed small business issuers have until July 31, 2005 to comply. The new disclosure requirements, which apply to listed and non-listed issuers, are applicable beginning with reports covering the period ending on or after the compliance date of the listing standards (or for a non-listed issuer, on or after the date compliance would have been required had the issuer been listed).

Heightened Independence Standards for Audit Committee Members

Under Rule 10A-3, SRO listing standards must require each member of the audit committee[2] of a listed issuer to be an independent member of the board of directors. In order to be considered to be independent for these purposes, the individual may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee:

- accept directly or indirectly any consulting, advisory, or other compensatory fee from the issuer or any subsidiary (the "Compensation Prohibition"); or
- be an affiliated person of the issuer or any subsidiary (the "Affiliation Prohibition").

Compensation Prohibition

Because Section 10A(m)(3) of the Exchange Act does not contain a de minimis exemption, and notwithstanding the current proposals by certain of the SROs, the SEC determined not to provide for a de minimis exemption with respect to the receipt of compensation.

The Final Release indicates that the receipt of dividends, and other payments made to all shareholders of a class generally, are not prohibited by the Compensation Prohibition.[3]

For the purposes of the Compensation Prohibition, unless the rules of the SRO provide otherwise, compensatory fees do not include the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the issuer provided that such compensation is not contingent in any way on continued service.

Rule 10A-3 provides that "indirect" acceptance of compensation includes acceptance by:

- a spouse, a minor child or stepchild or a child or stepchild sharing a home with the member; or
- an entity in which the member is a partner, member, an officer such as a managing director occupying a comparable position or executive officer, or occupies a similar position (except limited partners, non-managing members and those occupying similar positions who, in each case, have no active role in providing services to the entity) and which provides accounting, consulting, legal, investment banking or financial advisory services to the issuer or any subsidiary of the issuer.

The Final Release notes that compensation received in commercial relationships other than accounting, consulting, legal, investment banking and financial advisory services would not negatively impact an independence determination under Rule 10A-3, although such compensation may impact an independence determination under the rules of the SROs. Likewise, unlike the proposed SRO rules, Rule 10A-3 does not contain a "look back" provision; accordingly, compensation received prior to appointment/election to an audit committee will not negatively impact independence for Rule 10A-3 purposes.

Affiliation Prohibition

For the purposes of the Affiliation Prohibition, the SEC defined "affiliate" and "control" consistently with other Exchange Act uses of the words. The term affiliate of a specified person, means a person who directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified. And, the term control means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.

Rule 10A-3 establishes a safe harbor from the Affiliation Prohibition whereby a person will be deemed not to be in control of a specified person if the person:

- is not the beneficial owner, directly or indirectly, of more than 10 percent of any class of voting equity securities of the specified person[4]; and
- is not an executive officer[5] of the specified person.

The safe harbor only establishes a baseline for who does not control a specified person. The safe harbor does not create a presumption in any way that a person exceeding the ownership requirement controls or is otherwise an affiliate of a specified person. A determination under the Affiliation Prohibition with respect to anyone who does not meet the safe harbor will be based on the facts and circumstances of the individual's relationship with the issuer.

An audit committee member who sits on the board of directors of a listed issuer and an affiliate of the listed issuer is exempt from the Affiliation Prohibition if the member, except for being a director on each such board of directors, otherwise meets the independence requirements for each such entity.

General Application

In the Final Release, the SEC acknowledged that many SROs are in the process of tightening their respective definitions of independence, and that the Rule 10A-3 definition would be supplemental to any definition adopted by an SRO and applicable only with respect to audit committee membership.

The SRO rules may provide that if a member of an audit committee ceases to be independent in accordance with the requirements of Rule 10A-3 for reasons outside the member's reasonable control, that person, with notice by the issuer to the applicable SRO, may remain an audit committee member of the listed issuer until the earlier of the next annual shareholders meeting of the listed issuer or one year from the occurrence of the event that caused the member to be no longer independent.

In the case of a listed issuer that is a limited partnership or limited liability company where such entity does not have a board of directors or equivalent body, "board of directors" means the board of directors of the managing general partner, managing member or equivalent body.

Exemptions from the Independence Requirements

Rule 10A-3 contains a number of exemptions from the independence requirements (or from one of the two prongs of the requirement), including:

- a temporal exemption for issuers engaging in an initial public offering; and
- numerous exemptions specific to foreign private issuers.

In addition, although the SEC may exempt from the independence requirement a particular relationship with respect to audit committee members, the SEC does not expect to grant such relief.

Responsibilities Relating to Auditors

The audit committee of each listed issuer must be directly responsible for the appointment, compensation, retention and oversight of the work of any auditor engaged for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the listed issuer, and each auditor must report directly to the audit committee. The responsibility of the audit committee includes resolution of disagreements between management and the auditor regarding financial reporting. The Final Release makes it clear that these rules establish the relationship between the audit committee and management with respect to the identified obligations, and do not conflict with, or affect the application of, applicable requirements of law or an issuer's organizing documents granting rights to shareholders.

Complaints

Each audit committee must establish procedures for:

- the receipt, retention, and treatment of complaints received by the listed issuer regarding accounting, internal accounting controls, or auditing matters; and
- the confidential, anonymous submission by employees of the listed issuer of concerns regarding questionable accounting or auditing matters.

None of Rule 10A-3, the Final Release or the Proposing Release provides guidance as to the necessary elements of complying procedures. The SEC indicates that flexibility is important in adopting and implementing procedures, as procedures appropriate for a small issuer may not be satisfactory for a large multinational firm.

Authority to Engage Advisers

Each audit committee must have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties.

Funding

Each listed issuer must provide for appropriate funding, as determined by the audit committee, for payment of:

- compensation to any auditor engaged for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the listed issuer;
- compensation to any advisers employed by the audit committee; and
- ordinary administrative expenses of the audit committee that are necessary or appropriate in carrying out its duties.

General Exemptions

Rule 10A-3 contains a number of general exemptions from its provisions, including exemptions for certain qualifying domestic and foreign private issuers, and exemptions for specified securities.

Any listed issuer availing itself of one of the exemptions from Rule 10A-3 (including exemptions from the independence requirement) must disclose its reliance on the exemption and its assessment of whether, and if so, how, such reliance would materially adversely affect the ability of the audit committee to act independently and to satisfy the other requirements of Rule 10A-3. The disclosure must appear in any proxy or information statement for a meeting of shareholders at which directors are elected, and in its annual report.[6]

Listing Standards of the SROs

In order to assure time for listed issuers to comply with the new listing standards, each SRO must provide to the SEC, no later than July 15, 2003, proposed rules or rule amendments that comply with Rule 10A-3. The SRO listing standards must be in final form and approved by the SEC not later than December 1, 2003.

The SRO rules must provide appropriate procedures for a listed issuer to have an opportunity to cure any defects that would be the basis for delisting. The SRO rules must also include a requirement that a listed issuer notify the applicable SRO promptly after an executive officer of the listed issuer becomes aware of any material noncompliance by the listed issuer with the requirements of Rule 10A-3.

Amended Disclosure Requirements

In addition to Rule 10A-3, the Final Release also amended existing disclosure requirements under Regulation S-K, Schedule 14A, Form 20-F and Form 40-F. The new disclosure requirements apply to listed and non-listed issuers as follows:

- A listed issuer must disclose whether the members of the audit committee are independent, as independence for audit committee members is defined in the listing standards applicable to the listed issuer. If the issuer does not have a separately designated audit committee, or committee performing similar functions, the issuer must provide the required disclosure with respect to all members of its board of directors;

- If a listed issuer's board of directors determines, in accordance with the listing standards applicable to the listed issuer, to appoint a director to the audit committee who is not independent under the applicable listing standards because of exceptional or limited or similar circumstances, the listed issuer must disclose the nature of the relationship that makes that individual not independent and the reasons for the board of directors' determination; and
- If the issuer is not listed, the issuer must disclose whether the issuer has an audit committee and, if so, whether the members of the committee are independent. A nonlisted issuer may elect a definition of independent from among those approved by the SEC for SROs. The nonlisted issuer must disclose the standard selected and apply the standard consistently among its directors.

* * * * * * *

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1 Final Rule: Standards Relating to Listed Company Audit Committees, SEC Release Nos.: 33-8220, 34-47654, IC-26001 (April 9, 2003), 68 Fed. Reg. 18788 (April 16, 2003) (the "Final Release"). See also Proposed Rule: Standards Relating to Listed Company Audit Committees, SEC Release Nos.: 33-8173, 34-47137 (January 8, 2003), 68 Fed. Reg. 2638 (January 17, 2003) (the "Proposing Release"). The Final Release and the Proposing Release are available at www.sec.gov.

2 Section 3(a)(58) of the Exchange Act, as added by Section 205 of the Sarbanes-Oxley Act, defines "audit committee" as:

"(A) a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and (B) if no such committee exists with respect to an issuer, the entire board of directors of the issuer."

3 Final Release, ftnt. 45.

4 For purposes of Rule 10A-3, the determination of a person's beneficial ownership must be made in accordance with Exchange Act Rule 13d-3.

5 The term executive officer has the meaning in Exchange Act Rule 3b-7 (an issuer's president, any vice president in charge of a principal business unit, division or function, any other officer who performs a policy-making function or any other person who performs similar policy-making functions).

6 Incorporation by reference from a proxy or information statement is permitted.

Bulletin 03-36

The Sarbanes-Oxley Act of 2002 —
Final Rules Impacting Filing Procedures
For Section 16(a) Ownership Reports

The Securities and Exchange Commission has adopted final rules related to the electronic filing of beneficial ownership reports required by Section 16(a) of the Securities Exchange Act of 1934. The rules will update the EDGAR Filer Manual and will implement certain changes required by Section 403 of the Sarbanes-Oxley Act of 2002.

Recent rulemaking mandating electronic filing and web posting of ownership reports has led the Commission to create a new website that will allow filers to create and submit Forms 3, 4 and 5, and amendments to these forms, directly online (https://www.onlineforms.edgarfiling.sec.gov). This will facilitate compliance with the requirement that such forms may only be submitted electronically after June 30, 2003. Filers will no longer be able to submit these ownership forms on paper, through the EDGARLink submission template, or on magnetic tape cartridges after June 30.

A third Volume of the Filer Manual entitled "EDGAR Release 8.5 OnlineForms Filer Manual Volume III" has been adopted to reflect these changes, and was implemented on May 5, 2003. Filers must comply with the new requirements contained in the revised Filer Manual in order for documents to be timely received and accepted by the SEC. Volumes I and II of the Filer Manual, EDGARLink and the N-SAR Supplement respectively, have been modified primarily to reference the new Online Forms website and the removal of magnetic tape cartridges as a filing medium. Paper copies of the Filer Manual are available from the SEC Public Reference Room, or by calling Thompson Financial, Inc. at (800) 638-8241, and electronic copies are available at the SEC's website: http://www.sec.gov/info/edgar.shtml.

Release No. 33-8224, which adopted the final rules described above, makes final only a portion of the rules proposed by Release No. 33-8170 in December 2002. We expect additional final rules to be adopted in the near future covering the remainder of these proposals, which include changes to the ownership report forms and rules related to the posting of reports on issuer websites. Future Bulletins will be issued detailing the additional final rules when they become available.

Endnotes

1 Executive officers are required to be identified in Item 10 of the issuer's Form 10-K.

2 We believe that it is difficult to construct an argument that this procedure involves an extension of credit directly by the company, where the stock is not issued by the company until the company receives payment for it. Often, stock option plans contain provisions stating that the date of exercise of the stock option is deemed to be the date the company receives the notice of exercise from the optionee. These are included for the purposes of fixing the optionee's tax liability on such date. If the actual procedures followed in the issuance of stock do not involve the issuance prior to payment, these types of provisions, standing alone, should not cause the cashless option exercise to be considered an extension of credit by the company.

3 There is no mention of stock option exercises in the legislative history of the loan prohibition. However, the absence of such mention probably cannot be relied upon as an indication of an affirmative legislative intent that cashless option exercises be excluded from the prohibition's coverage. The use of the broad term "extension of credit in the form of a personal loan" was probably intended to cover more types of arrangements than those Congress specifically considered in the rapid deliberation of the statute.

4 The fact that the source of repayment is a source designated by the optionee rather than the optionee itself probably does not provide support for the conclusion that there is no loan to the optionee. Many loan arrangements are structured contemplating repayment by a designee of the obligor rather than the obligor itself.

5 Regulation T was adopted pursuant to the Section 7 of the Securities Exchange Act of 1934, which makes it unlawful for any broker or dealer to directly or indirectly "extend or maintain credit" in violation of rules promulgated by the Federal Reserve Board.

6 See discussion of the policy basis of Regulation T and Section 402 in connection with the term "arranging" below.

7 See generally cases cited in Rechlin, *Securities Credit Regulation* (West Group 2002), §7:2 ("Arranging of credit"); §7:6 ("Introduction of customer to lender"); §7:9 ("Delivery of collateral and receipt of funds from lender").

8 The House Report accompanying the Exchange Act stated:

> "[T]he main purpose of these margin provisions … is not to increase the safety of security loans for lenders. Banks and brokers normally require sufficient collateral to make themselves safe without the help of the law."

9 Neither this bill nor House bill 3763 contained a prohibition on loans to executives. The Senate bill required enhanced disclosure of such loans, while the House bill required the SEC to adopt regulations on enhanced disclosure of insider transactions generally. The loan prohibition appeared after deliberations of the conference committee on the House and Senate bills.

10 The AES loan was made to executives to prevent them from being forced to sell company shares due to margin calls.

11 The Oxford English Dictionary (2d edition) defines "arrange" (entry 8) as:

> "To come to, or make, a settlement with other persons as to a matter to be done, so that all concerned in it shall do their part."
>
> Cited literary examples include Burke, "That the acts done should be arranged with the Rajah." (1786) and Macauley, "The details of a butchery were frequently discussed, if not definitely arranged." (1849).
>
> Webster's Third New International Dictionary defines "arrange" (v.i., entry 1) as:
>
> "to come to an agreement, understanding or settlement (arranged with the travel agent for a June passage)."
>
> Each of these carries a connotation of substantial involvement in bringing an event to pass.

12 This assumes no other business relationships with the broker as discussed above.

13 Executive officers are required to be identified in Item 10 of the issuer's Form 10-K.

14 Section 1745 of the Pennsylvania BCL states:

> "Expenses (including attorneys' fees) incurred in defending any action or proceeding referred to in this subchapter may be paid by a business corporation in advance of the final disposition of the action or proceeding upon receipt of an undertaking by or on behalf of the representative to repay the amount if it is ultimately determined that he is not entitled to be indemnified by the corporation as authorized in this subchapter or otherwise."

Section 145 of the Delaware GCL states:

> "Expenses (including attorneys' fees) incurred by an officer or director in defending any civil, criminal, administrative, or investigative action, suit or proceeding may be paid by the corporation in advance of the final disposition of such action, suit or proceeding upon receipt of an undertaking by or on behalf of such director of officer to repay such amount if it shall ultimately be determined that he is not entitled to be indemnified by the corporation as authorized in this Section."

15 The Comment to Subchapter E of the Model Business Corporation Act states:

> "Today, when both the volume and the cost of litigation have increased dramatically, it would be difficult to persuade responsible persons to serve as directors if they were compelled to bear personally the cost of vindicating the propriety of their conduct in every instance in which it might be challenged."

16 15 Pa. C.S. §1746. See also Delaware General Corporation Law, §145; Model Business Corporation Act, §2.02(b)(5).

17 15 Pa.C.S. §1745. To similar effect is Delaware General Corporation Law, §145(e).

18 Model Business Corporation Act, §8.53(a).

19 Section 2(a)(7) of the Sarbanes-Oxley Act provides:

> "The term 'issuer' means an issuer (as defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. §78c), the securities of which are registered under section 12 of that Act (15 U.S.C. §78l), or that is required to file reports under section 15(d) (15 U.S.C. §78o(d)), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. §77a et seq.), and that it has not withdrawn."

20 Section 3(a)(7) of the Exchange Act defines "director" as:

> "[A]ny director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated."

21 Rule 3b-7 under the Exchange Act provides:

> "The term 'executive officer,' when used with reference to a registrant, means its president, any vice president of the registrant in charge of a principal business unit, division or function (such as sales, administration, or finance), any other officer who performs a policy making function or any other person who performs similar policy making functions for the registrant. Executive officers of subsidiaries may be deemed executive officers of the registrant if they perform such policy making functions for the registrant."

22 The Model Business Corporation Act requires that the representation be explicit. Other statutes do not require an explicit representation, and frequently article/bylaw/contract provisions do not require such an explicit representation. However, we believe the undertaking to repay should conceptually be viewed for Sarbanes-Oxley purposes as equivalent to an implicit representation of entitlement, together with agreement to a remedy provision requiring a refund if the representation turns out to be untrue.

23 "loan, n. 1**.** An act of lending; a grant of something for temporary use <Trina gave him the laptop as a loan, not a gift>. 2. A thing lent for the borrower's temporary use esp., a sum of money lent at interest <Larry applied for a car loan>." Black's Law Dictionary, Seventh Ed. 1999.

24 The fact that the credit might later be forgiven does not alter this original understanding. If funds were advanced with the understanding that an originally created obligation to repay would be later forgiven, this would not constitute an "extension of credit in the form of a loan" in the ordinary understanding of the term.

25 In an extreme case, where it could be demonstrated that both the corporation and the recipient understood at the outset that the recipient was not entitled to the payment, and the payment was made notwithstanding the understanding, with a view to later repayment when a court determination confirmed the ineligibility, it could be argued that the payment constitutes an extension of credit in the form of a loan.

26 Upon an ultimate determination of ineligibility, in the absence of immediate repayment, an extension of credit in the form of a loan might be considered to exist.

27 The Report of the Senate Committee on S.2673 (which bill would have required enhanced disclosure of loans, but no prohibition) made reference to multimillion dollar loans to executives of Enron, WorldCom, Qwest, Global Crossing and AES Corp. and multibillion dollar loans to the founder of Adelphia. Several of these loans were later forgiven by the corporation. The prohibition on loans appearing in §402 arose in the course of the proceedings of the Conference Committee.

28 Thus a program of loans to executives could not protected as being part of the corporation's compensation package, as constituting "business," not "personal" loans outside the statute's prohibition.

29 See Delaware General Corporation Law, §145; Model Business Corporation Act, §2.02(b)(5). The Pennsylvania Business Corporation Law (§1746(a)) suggests that a corporation may provide for indemnification of a person "both as to action in his official capacity and as to action in another capacity while holding that office." Most corporations limit their indemnification to actions in the person's official capacity, for the corporation or another entity at the corporation's request. To the extent that a corporation seeks to indemnify and pay expenses for actions unrelated to the person's role as an officer or director, the argument above that

the arrangement is not "personal" may be unavailable. See, however, discussion above as to the term "extension of credit in the form of a loan."

30 The Federal Reserve Board, for margin lending purposes, views the date of an extension of credit as the date upon which the contractual obligation to extend becomes binding. Federal Reserve Regulatory Service, Vol. II, ¶ 5-798.2.

31 See SEC Release No. 33-8176 (Jan. 22, 2003) (the "Approving Release"). The Approving Release can be located at http://www.sec.gov/rules/final/33-8176.htm.

32 See SEC Release No. 33-8145 (Nov. 4, 2002) (the "Proposing Release").

33 See SEC Release No. 34-47225 (Jan. 22, 2003) for the release approving Regulation BTR. The approving release can be located at http://www.sec.gov/rules/final/34-47225.htm. The approving release includes a number of modifications from the rules as initially proposed on November 6, 2002. See SEC Release No. 34-46778 (Nov. 6, 2002) for the proposing release. The proposing release can be located at http://www.sec.gov/rules/proposed/34-46778.htm.

34 "Final Rule Relating to Notice of Blackout Periods to Participants and Beneficiaries," 68 Fed. Reg. 3716 (Jan. 24, 2003), which can be located at http://www.dol.gov/pwba/regs/fedreg/final/2003001430.htm.

35 Release Nos. 33-8177; 34-47235.

36 Release Nos. 33-8138; 34-46701; IC-25775.

37 The final rules use the term "audit committee financial expert" in place of the term "financial expert." The release states that this term suggests more pointedly that the designated person has characteristics that are particularly relevant to the functions of the audit committee.

38 Forms 10-KSB; 20-F and 40-F.

39 Pub. L. 107-204, 116 Stat. 745 (2002).

40 Regulation S-K, Item 401(h)(1)(i).

41 Regulation S-K, Item 401(h)(1)(ii).

42 Regulation S-K, Item 401(h)(1)(ii). If more than one audit committee financial expert is named, the independence disclosure is required for each.

43 Sections 303.01(B)(2)(a) and (3) of the NYSE's listing standards.

44 Section 121(A) of the AMEX's listing standards.

45 Rule 4200(a)(15) of NASDAQ's listing standards.

46 Regulation S-K, Item 401(h)(1)(i)(B).

47 Regulation S-K, Item 401(h)(1)(iii).

48 The final rules include an instruction that for foreign private issuers, the term "generally accepted accounting principles" means the body of such principles used by the issuer in its primary financial statements.

49 In this sense, this attribute may be considered as roughly comparable to the current NYSE requirement that one member of the audit committee have accounting or related financial management expertise. NYSE Rule 303.01(B)(2)(c). See also AMEX Rule 121(B)(b)(i); NASDAQ Rule 4350(d)(2)(A).

50 Regulation S-K, Item 401(h)(2)(ii).

51 Regulation S-K, Item 401(h)(2)(iii).

52 Regulation S-K, Item 401(h)(2)(iv).

53 Regulation S-K, Item 401(h)(2)(v).

54 Regulation S-K, Item 401(h)(3).

55 Regulation S-K, Item 401(h), Instruction 2.

56 Regulation S-K, Item 401(h)(4).

57 NYSE Rule 303.01.

58 NASD Rule 4350(d)(2); AMEX Company Guide §121.

59 Proposed Rule 4350(d)(2)(A)(ii).

60 Release 33-8138, 67 F.R. 66210, n.38.

61 SEC Release No. 33-8182 (Jan. 28, 2003) (the "Approving Release").

62 Item 303 of Regulation S-B, Item 5 of Form 20-F and General Instruction B of Form 40-F were also amended.

63 SEC Release No. 33-8144 (Nov. 4, 2002) (the "Proposing Release").

64 For foreign private issuers and MJDS filers, the reference to FAS 133 is omitted.

65 "Final Rule: Implementation of Standards of Professional Conduct for Attorneys," Release 33-8185, available at http://www.sec.gov/rules/final/33-8185.htm ("Final Rule Release").

66 See "Proposed Rules: Implementation of Standards of Professional Conduct for Attorneys," Release No. 33-8150, available at http://www.sec.gov/rules/proposed/33-8150.htm ("Original Rule Release").

67 "Proposed Rule: Implementation of Standards of Professional Conduct for Attorneys," Release No. 33-8186, available at http://www.sec.gov/rules/proposed/33-8186.htm ("Revised Noisy Withdrawal Release").

68 The Final Rule Release indicates that the SEC added the phrase "United States" before federal or state law in order to make it clear that the Rule applies to violations of U.S., and not foreign, laws.

69 In the Final Rule Release, the SEC indicates that, while Section 307 of the Act refers to non-employee directors, it intends to amend this provision to conform to the final rules defining "independent" director under Section 301 of the Act when those rules are adopted.

70 In its evaluation of the financial impact of the Rule, the SEC estimated that approximately 20 percent of public companies would utilize a QLCC, although there was no formal basis for this estimate.

71 The rule provides that an attorney, without the consent of the issuer client, may reveal confidential information to the extent the attorney reasonably believes such is necessary (i) to prevent the issuer from committing a material violation likely to cause substantial financial injury to the financial interests or property of the issuer or investors; (ii) to prevent the issuer from committing an illegal act; or (iii) to rectify the consequences of a material violation or illegal act in which the attorney's services have been used.

72 See SEC Release No. 33-8138 (Oct. 22, 2002) (the "Proposing Release"). The Proposing Release can be located at http://www.sec.gov/rules/proposed/33-8138.htm.

73 See SEC Release No. 33-8177 (Jan. 23, 2003) (the "Approving Release"). The Approving Release can be located at http://www.sec.gov/rules/final/33-8177.htm.

74 In the final rule, the SEC withdrew one of the components of the code of ethics that it had included in the Proposing Release. As proposed, the code would have had 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. In the Approving Release, the SEC stated that the conduct addressed by this proposed component was addressed by the requirement of honest and ethical conduct and the ethical handling of actual and apparent conflicts of interest.

75 See Note 2, supra.

76 The final rule states that the company must explain why it has not adopted "such" a code of ethics. (See Items 406(a) of Regulation S-K, and S-B, Item 16B(a) of Form 20-F and paragraph (9)(a) of General Instruction B to Form 40-F.) This is understood to mean that the code of ethics adopted must contain all of the elements of the SEC's definition of "code of ethics" and be applicable to the company's CEO and Senior Financial Officers. Failure to comply with one or both of these prongs would result in the company having to explain why its code of ethics does not apply to all of the specified officers or why the terms of its code differ from the SEC's standards.

77 In the Approving Release, Note 2, supra, the SEC stated that when a company has multiple websites that it uses for various purposes (such as investor relations, product information and business-to-business activities), the website address to be disclosed would be the website the company normally uses for its investor relations functions.

78 There is no need to disclose technical, administrative or other non-substantive amendments to the code of ethics.

79 New Item 10(c) of Form 8-K.

80 If the foreign private issuer elects to disclose the required information through its website, such information must remain available on the website for at least a 12-month period. Following the 12-month period, the foreign private issuer must retain the information for a period of not less than five years. Item 16B of Form 20-F and paragraph (9) of General Instruction B of Form 40-F.

81 Release No. 33-8183; 34-47265; 35-27642; IC-25915; IA-2103, 68 FR 6006 (February 5, 2003). http://www.sec.gov/rules/final/33-8183.htm.

82 15 U.S.C. §78j-1.

83 "Issuer" is defined in Section 2(a)(7) of the Sarbanes-Oxley Act as a public reporting company.

84 The services prohibited by the statute are:

(1) bookkeeping or other services related to the accounting records or financial statements of the audit client;

(2) financial information systems design and implementation;

(3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports;

(4) actuarial services;

(5) internal audit outsourcing services;

(6) management functions or human resources;

(7) broker or dealer, investment adviser, or investment banking services;

(8) legal services and expert services unrelated to the audit; and

(9) any other service that the [Public Company Accounting Oversight] Board [established pursuant to Section 201 of the Sarbanes-Oxley Act] determines, by regulation, is impermissible.

15 U.S.C. §78j-1(g).

85 As a technical matter, the provisions of new §10A(i) of the Exchange Act, requiring audit committee approval of audit services, became effective on the effective date of the Sarbanes-Oxley Act, July 30, 2002. As a practical matter, most public issuers have for some time secured audit committee approval of audit services.

86 17 CFR §210.2-01.

87 Under Regulation S-X, audited financial statements must be the subject of an audit by "independent" public accountants.

88 The audit and professional engagement period includes the period covered by any financial statements being audited or reviewed and also the period beginning when the accountant either signs an engagement letter or begins audit procedures, and ending when the audit client or the accountant notifies the SEC that the client is no longer the accountant's audit client. This definition is unchanged by the proposed rule. §210.2-01(f)(5).

89 Item 15 of Form 20-F, Item 10 of Form 40-F, Item 16 of Part III of Form 10-K, Item 16 of Form 10-KSB, and Item 5 of Form N-CSR.

90 §210.2-01(b).

91 §210.2-01(c)(4)(i).

92 68 FR at 6011.

93 §210.2-01(c)(4)(ii).

94 68 FR at 6012.

95 §210.2-01(c)(4)(iii).

96 In certain foreign countries, these reports require the auditor to express an opinion on the fairness of a transaction, the value of a security, or the adequacy of consideration to shareholders.

97 §210.2-01(c)(4)(iv).

98 §210.2-01(c)(4)(v).

99 68 FR at 6013.

100 §210.2-01(c)(4)(vi)-(viii).

101 §210.2-01(c)(4)(ix).

102 §210.2-01(c)(4)(x).

103 68 FR at 6016.

104 68 FR at 6017.

105 68 FR at 6017.

106 In addition to the provisions discussed herein, the rules add requirements concerning the rotation of members of the audit engagement team (§210.2-01(c)(6)), and compensation of members of the audit engagement team (§210.2-01(c)(8)).

107 §210.2-01(c)(7).

108 §210.2-01(c)(7)(i).

109 15 U.S.C. §78j-1(i)(3).

110 §210.2-01(c)(7)(ii)(C).

111 Item 9, paragraph (e).

112 Item 9, paragraph (e)(1).

113 68 FR at 6030. New Section 10A(i) of the 1934 Act, added by Section 202 of the Sarbanes-Oxley Act, also indicates that providing comfort letters in connection with securities underwritings and statutory audits required for insurance companies for state law purposes are included in the category of auditing services.

114 Item 9, paragraph (e)(2).

115 68 FR at 6030.

116 Item 9, paragraph (e)(3).

117 68 FR at 6031.

118 68 FR at 6030.

119 68 FR at 6031.

120 Item 9, paragraph (e)(5)(i).

121 68 FR at 6031.

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Bulletin 02-29—Sarbanes-Oxley of 2002 [August 2002]

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Bulletin 02-32—Securities and Exchange Commission Rulemaking-August 27, 2002 Meeting Regarding Director and Officer Trading Reports, Accelerated 10-Q and 10K Filing Deadlines and Certificates [August 2002]

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Bulletin 02-33—Sarbanes-Oxley Should Not Preclude all Broker-Assisted Cashless Option Exercises by Insiders [August 2002]

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Bulletin 02-33B—New Loans to Executives [August 2002]

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Bulletin 02-37—Payment of Litigation Expenses of Indemnified Directors and Officers Under section 402 of the Sarbanes-Oxley Act [September 2002]

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Bulletin 03-02—The Effect of the Sarbanes–Oxley Act on Public Company Audit Committees [January 2003]

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Bulletin 03-09—Sarbanes-Oxley Act–Effective Dates of SEC Rules Required to be Issued in Final Form by January 26, 2003 [January 2003, updated February 27, 2003]

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Bulletin 03-11—The Sarbanes-Oxley Act of 2002–SEC Approves Final Rules Regarding Non-GAAP Financial Measures [January 2003]

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Bulletin 03-12—The Sarbanes-Oxley Act of 2002–SEC Adopts Final Rules Regarding Trading Prohibitions During Pension Fund Blackout Periods [January 2003]

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Bulletin 03-13—Audit Committee Financial Experts [January 2003]

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Bulletin 03-16—The Sarbanes-Oxley Act of 2002–SEC Approves Final Rules Regarding Disclosure of Off-Balance Sheet Arrangements and Aggregate Contractual Obligations [February 2003]

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