SEC PROPOSES RULES PURSUANT TO THE SARBANES-OXLEY ACT: FINANCIAL EXPERTS, CODES OF ETHICS, INTERNAL CONTROLS ASSESSMENTS AND IMPROPER INFLUENCE ON AUDITORS

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On October 18 and 22, 2002, the Securities and Exchange Commission proposed a series of new rules and revisions to SEC forms to implement four separate provisions of the Sarbanes-Oxley Act of 2002 (the "Act").[1] The proposals relate to the presence of "financial experts" on audit committees, codes of ethics, required assessments of internal controls by managements and prohibitions against improper influence on audits of financial statements. The proposals represent a portion of the substantial number of new rules that the SEC is required to issue pursuant to the Act.[2]

EXECUTIVE SUMMARY

The SEC's proposals would affect reporting companies by:

- requiring disclosure in annual reports of whether the company has one or more independent "financial experts" serving on its audit committee and, if not, an explanation of why not (Section 407);

- requiring disclosure in annual reports of whether the company has a code of ethics for its principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions and also requiring disclosure on a current (i.e., two business days) basis of any changes to, or waivers from, the code for the specified senior officers (Section 406);

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1 SEC Release No. 34-46685 and IC-25773 relating to improper influence on audits (the "October 18 SEC Release") and Nos. 33-8138, 34-46701 and IC-25775 relating to financial experts, codes of ethics and assessments of internal controls (the "October 22 SEC Release").

2 This memorandum supplements our memoranda regarding the Sarbanes-Oxley Act. These memoranda are available upon request or at our website: *www.simpsonthacher.com.*

- increasing management's responsibility for assessing and reporting on internal controls for financial reporting (Section 404); and

- expanding the activities that may be considered an unlawful influence on the audit process (Section 303).

The SEC has requested comments on the proposed rules and revisions to SEC forms under Sections 404, 406 and 407 on or before November 29, 2002, and on the proposed rules under Section 303 on or before November 25, 2002. The Act requires the SEC to issue final rules under Sections 406 and 407 by January 26, 2003, and under Section 303 by April 26, 2003. The Act does not provide a deadline for the issuance of final rules under Section 404. The Act also does not indicate a target or deadline for the *effectiveness* of any of the rules, and thus discretion is left to the SEC with respect to when final rules will become effective and whether there will be transition periods.[3]

Listed companies should note that each of the New York Stock Exchange and the Nasdaq Stock Market has filed with the SEC proposed new standards regarding corporate governance and disclosure (the "Proposed NYSE Standards" and the "Proposed Nasdaq Standards," respectively) that overlap with the SEC's proposed rules regarding financial experts and codes of ethics. The interplay between the SEC's rules and the related Proposed NYSE Standards and Proposed Nasdaq Standards is discussed in more detail below. The Proposed NYSE Standards and Proposed Nasdaq Standards remain subject to SEC approval and may be revised prior to final approval. In fact, the SEC has publicly stated that it intends to work towards harmonizing the Proposed NYSE Standards and Proposed Nasdaq Standards.

"FINANCIAL EXPERT" DISCLOSURE REQUIREMENTS

STATUTORY AND REGULATORY BACKGROUND

Section 407 of the Act directs the SEC to issue rules requiring each issuer to disclose whether its audit committee has at least one member who is a "financial expert" and, if not, an explanation of why it has no financial expert on its audit committee. The Act also requires the SEC to define "financial expert," taking into consideration whether a person, through education and experience as a public accountant or auditor or a principal financial officer, comptroller, or

[3] As discussed more fully below, the SEC has stated that it intends to provide a transition period for final effectiveness of its proposed rules contemplated by Section 404 of the Act, which relate to managements' assessments of internal controls for financial reporting.

principal accounting officer of an issuer, or from a position involving the performance of similar functions, has:

- an understanding of generally accepted accounting principles and financial statements;
- experience in the preparation or auditing of financial statements of generally comparable issuers and the application of generally accepted accounting principles in connection with the accounting for generally comparable estimates, accruals and reserves;
- experience with internal accounting controls; and
- an understanding of audit committee functions.

Issuers with securities listed on the NYSE or quoted on Nasdaq also should consider the related requirements in the Proposed NYSE Standards or Proposed Nasdaq Standards, as applicable, each of which address the composition of a listed company's audit committee and may require issuers to have a financial expert on their audit committee. These are discussed below under "Comparing Proposed 407 Rules, Proposed NYSE Standards and Proposed Nasdaq Standards."

PROPOSED RULES

General

The SEC's proposed rules under Section 407 of the Act (the "Proposed 407 Rules") would require all domestic companies and foreign private issuers filing annual reports on Form 10-K, 10-KSB, 20-F or 40-F[4] to disclose in those reports:[5]

- the name of each audit committee member that the board of directors has determined to be a financial expert;

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[4] The Proposed 407 Rules would apply to boards of directors without audit committees and to companies without boards of directors as discussed below under "Companies without Audit Committees or Boards of Directors."

[5] The Proposed 407 Rules would be codified in new Item 15 of Part III of Form 10-K and Form 10-KSB, each requiring the disclosure specified by new Item 309 of Regulations S-K and S-B, as applicable; new Item 15(b) to Form 20-F; and new General Instruction B.(8) to Form 40-F. With respect to Forms 10-K and 10-KSB, Part III permits an issuer, under certain circumstances, to incorporate the disclosure by reference from its definitive proxy or information statement.

- with respect to each such financial expert, if any, whether the financial expert is independent, and if not, an explanation of why the financial expert is not independent; or

- if the company does not have a financial expert on its audit committee, an explanation of why it does not have a financial expert on its audit committee.[6]

Although the Act only requires disclosure of whether a company's audit committee has an individual who is a financial expert, the Proposed 407 Rules would require disclosure of the names of each audit committee member who the board of directors determines satisfies the SEC's definition of financial expert. The Proposed 407 Rules would not require disclosure between annual reports of changes in a financial expert's status as an expert or as a member of the audit committee.[7]

Definition of Financial Expert

The Proposed 407 Rules would define the term "financial expert" to mean a person who:

- through education and experience:
  - as a public accountant or auditor; or
  - as a principal financial officer, controller, or principal accounting officer of a company that, at the time the person held such position, was required to file Exchange Act reports; or
  - in one or more positions that involve the performance of similar functions (or that results, in the judgment of the company's board of directors, in the person having similar expertise and experience[8]); *and*

- satisfies *all* of the following criteria:

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[6] The Proposed 407 Rules do not provide guidance with respect to the nature of such explanation or the extent of detail required in such an explanation.

[7] However, the pending Form 8-K proposals would require a company to disclose all changes in the composition of a board of directors within two business days of the occurrence of the change. This was proposed in SEC Release Nos. 33-8106 and 34-46084 (June 17, 2002), which we discuss in our memorandum dated June 27, 2002, entitled "*SEC Proposes New Rules Relating to 8-K Disclosure and Officer Certifications*."

[8] In the event that a company's board of directors makes such a judgment, the Proposed 407 Rules would require the basis for the board's judgment to be publicly disclosed.

1. an understanding of generally accepted accounting principles and financial statements;

2. experience applying such generally accepted accounting principles in connection with the accounting for estimates, accruals, and reserves that are generally comparable to the estimates, accruals and reserves, if any, used in the company's financial statements;

3. experience preparing or auditing financial statements that present accounting issues that are generally comparable to those raised by the company's financial statements;

4. experience with internal controls and procedures for financial reporting; *and*

5. an understanding of audit committee functions.

Although the definition appears to provide some measure of discretion to boards in making the financial expert determination, the SEC has made clear that any successful candidate would nevertheless need to satisfy *all* five of the listed criteria (the "Five Required Criteria") set forth above. In most cases, this requirement would only be satisfied, if at all, by someone with experience as a public accountant, auditor, CFO, controller or principal accounting officer.

Expansion of the Act's Provisions

Most of the Five Required Criteria were specified by the Act as items to be taken into consideration in formulating a definition. The rule proposed by the SEC has taken each item for consideration and converted it into a requirement. The definition, as proposed, would disqualify a number of existing audit committee members from filling the role of a financial expert. While we believe that many financially-sophisticated audit committee members would not have difficulty satisfying the requirements of items one and five of the Five Required Criteria, we believe that the other three requirements set standards that may be difficult for a significant number of potential candidates to satisfy. We discuss each of these required items in more detail below under "Financial Expert Determination and Disclosure – Qualitative Assessment."

FINANCIAL EXPERT DETERMINATION AND DISCLOSURE

Collecting the Relevant Information

In order to make the required financial expert determination, a board of directors should gather the information necessary to evaluate audit committee members as well as the other

members of the board.[9] Issuers are already required to ascertain and disclose the business experience of all directors.[10] Accordingly, a company can build on its existing process for gathering the information underlying such disclosure to seek the additional information required to make the financial expert inquiries.

For companies who currently collect business experience information only informally or not at all, we suggest beginning the process of collecting information by asking all board members and any nominees to complete a written background questionnaire that includes targeted questions aimed at eliciting the information necessary to make an initial determination as to whether a board member might qualify as a financial expert. The SEC suggests consideration of the following non-exhaustive list of factors in evaluating the totality of a candidate's education and experience in relation to the Five Required Criteria:

- the level of the person's accounting or financial education, including whether the person has earned an advanced degree in finance or accounting;

- whether the person is a certified public accountant (or the equivalent) in good standing, and the length of time that the person actively has practiced as a certified public accountant (or the equivalent);

- whether the person is certified or otherwise identified as having accounting or financial experience by a recognized private body that establishes and administers standards in respect of such expertise, whether that person is in good standing with the recognized private body, and the length of time that the person has been actively certified or identified as having such expertise;

- whether the person has served as a principal financial officer, controller or principal accounting officer of a company that, at the time the person held such position, was required to file reports pursuant to Section 13(a) or 15(d) of the Exchange Act, and if so, for how long he or she served in such position;

- the person's specific duties while serving as a public accountant, auditor, principal financial officer, controller or principal accounting officer or position involving the performance of similar functions;

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[9] Information should be collected on all board members, not just current audit committee members, because the board may wish to reconstitute the audit committee if the board determines that the only director qualifying as a financial expert is not at the time of consideration an audit committee member.

[10] Item 401 of Regulations S-K and S-B.

- the person's level of familiarity and experience with applicable laws and regulations regarding the preparation of financial statements that must be included in reports filed under Section 13(a) or 15(d) of the Exchange Act;

- the level and amount of the person's direct experience reviewing, preparing, auditing or analyzing financial statements that must be included in reports filed under Section 13(a) or 15(d) of the Exchange Act;

- the person's past or current membership on one or more audit committees of companies that, at the time the person held such membership, were required to file reports pursuant to Section 13(a) or 15(d) of the Exchange Act;

- the person's level of familiarity and experience with the use and analysis of financial statements of public companies; and

- whether the person has any other relevant qualifications or experience that would assist him or her in understanding and evaluating the registrant's financial statements and other financial information and to make knowledgeable and thorough inquiries whether:

  - the financial statements fairly present the financial condition, results of operations and cash flows of the company in accordance with generally accepted accounting principles; and

  - the financial statements and other financial information, taken together, fairly present the financial condition, results of operations and cash flows of the company.

The SEC has indicated that satisfaction of any specific number of these factors would be neither necessary nor sufficient for a person to be considered a financial expert. The Proposed 407 Rules intentionally do not provide a "bright line test" to determine whether an individual satisfies all of the Five Required Criteria. Although this list of factors may provide useful guidance for collecting information, the focus of the board's attention should be on how these factors relate to the Five Required Criteria.

Making a Qualitative Assessment

Following the assembly of the requisite information regarding each director's financial expertise, the board of directors should conduct a qualitative assessment of each potential financial expert's level of knowledge or experience, focusing on the Five Required Criteria. The qualitative assessment should take into account the following considerations:

1. *An understanding of generally accepted accounting principles and financial statements.*

It should generally not be difficult to identify individuals that satisfy this requirement. Many individuals in the financial community, even non-accountants, may have such an understanding if, for example, they regularly review and analyze financial statements prepared using generally accepted accounting principles. On the other hand, this item may be more challenging for foreign private issuers insofar as the SEC has indicated that, when evaluating a member of its audit committee, the board of directors of a foreign private issuer should consider the director's experience with (a) public companies in the foreign private issuer's home country, (b) generally accepted accounting principles used by the issuer and (c) the reconciliation of financial statements with U.S. generally accepted accounting principles.

2. *Experience applying such generally accepted accounting principles in connection with the accounting for estimates, accruals and reserves that are generally comparable to the estimates, accruals and reserves, if any, used in the registrant's financial statements.*

It appears that only an individual with a strong accounting background would possess the requisite accounting experience to satisfy this item. This item seems to require a thorough understanding of, and significant practical experience with, accounting practices, as well as a comprehensive understanding of an issuer's critical accounting policies. In addition, the requirement that an individual have experience applying accounting principles to estimates, accruals and reserves comparable to those of the issuer may, in some cases, restrict the field of candidates to those working (or having worked) in the same or a related industry as the issuer.

3. *Experience preparing or auditing financial statements that present accounting issues that are generally comparable to those raised by the registrant's financial statements.*

This item may require that every financial expert be or have been an accountant, which appears to exceed even item two with respect to the extent of accounting experience required. Thus, for example, where a CFO might be able to satisfy item two above, a CFO whose experience derived principally from treasury-type activities may not be able to satisfy this test. In addition, in the case of companies subject to special accounting issues, such as regulated industries, the requirement that the individual's experience be with financial statements that present accounting issues that are generally comparable to those of the issuer may be satisfied, in some cases, only by individuals who have acquired experience preparing and auditing financial statements in the same or a related industry as the issuer.[11]

[11] Experience with financial statements of an industrial company in a particular industry may be sufficient to qualify a director as a financial expert for industrial companies in a related industry. However, experience with financial statements of an industrial company would not likely be sufficient in and of itself to qualify a director as a financial expert for a financial services company.

4. *Experience with internal controls and procedures for financial reporting*.

This item appears to require that an individual have had experience involving an issuer's processes in place designed to provide reasonable assurance regarding the achievement of objectives in the reliability of financial reporting; effectiveness and efficiency of operations; and compliance with applicable laws and regulations. Such persons might include an auditor or individuals who have worked in positions responsible for either overseeing, designing or maintaining a company's internal controls for financial reporting.

5. *An understanding of audit committee functions*.

Individuals who have served on boards of directors and/or audit committees for public companies, individuals who have served in management positions that involved meaningful interaction with audit committees or individuals who have been an auditor of a public company may have an understanding of audit committee functions sufficient to satisfy this requirement.

Making the Independence Determination

The Proposed 407 Rules would require disclosure as to whether any audit committee member satisfying the definition of financial expert is also independent.[12] Under Section 301 of the Act, all audit committee members of listed companies will soon need to be independent. On

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[12] For this purpose, new Item 309 to Regulations S-K and S-B, new Item 15(b) to Form 20-F and new General Instruction B.(8) to Form 40-F reference the definition of independence codified in Section 10A(m) of the Exchange Act, which defines an "independent" director as one who, except in his or her capacity as a member of the audit committee, another board committee or the board:

- does not accept any consulting, advisory or other compensation from the issuer; and
- is not an affiliated person of the issuer or its subsidiaries.

"Affiliated person" is defined in Section 3(a)(19) of the Exchange Act by reference to Section 2(a) of the Investment Company Act, which provides that an "affiliated person" of another person is:

- any person directly or indirectly owning, controlling, or holding with power to vote, 5% or more of the outstanding voting securities of such other person;
- any person 5% or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person;
- any person directly or indirectly controlling, controlled by, or under common control with, such other person;
- any officer, director, partner, copartner, or employee of such other person;
- if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and
- if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

the other hand, reporting companies that do not have listed securities will not be subject to the requirements of Section 301. Accordingly, these issuers, which can include subsidiaries of public companies or private equity portfolio companies with outstanding debt securities, will be required to publicly disclose information about the qualifications and independence of their audit committee members that they were not previously required to disclose.

COMPARING PROPOSED 407 RULES, PROPOSED NYSE STANDARDS AND PROPOSED NASDAQ STANDARDS

As noted above, each of the NYSE and Nasdaq has filed with the SEC proposed new listing standards regarding corporate governance which, among other things, address the composition of a listed company's audit committee.[13] The Proposed Nasdaq Standards currently would require each issuer's audit committee to have at least one "financial expert" as defined pursuant to the Proposed 407 Rules. The critical distinction between the SEC's Proposed 407 Rules and the Proposed Nasdaq Standards is that the Proposed 407 Rules require only *disclosure*, while the Proposed Nasdaq Standards mandate that companies *actually have* a financial expert on their audit committees.

The Proposed NYSE Standards would require each member of the issuer's audit committee to be "financially literate" and at least one member to "have accounting or related financial management expertise" (these requirements are the same as the NYSE's current standards). Although the Proposed NYSE Standards do not currently require that audit committees include a "financial expert," the NYSE indicated that it would await the SEC's interpretation of the definition of "financial expert" before acting.

The NYSE's and Nasdaq's proposed requirements regarding financial experts may be reconsidered and revised in light of the SEC's rulemaking. The SEC has stated its intention to work toward harmonizing NYSE and Nasdaq requirements, and a representative of Nasdaq has recently suggested that Nasdaq may de-link its financial expert requirement from the SEC's proposed definition of financial expert. In the event that the NYSE and/or Nasdaq ultimately do require listed companies to have a financial expert on their audit committee, the requirement would likely be subject to the same phase-in periods as is the case for compliance with other audit committee composition standards (24 months for NYSE-listed companies or a company's first annual meeting occurring after January 1, 2004 for Nasdaq-listed companies).

LIABILITY OF FINANCIAL EXPERTS

The October 22 SEC Release indicates that designation of a director as a financial expert should not, *per se*, impose a higher degree of individual responsibility or obligation on the designated member, nor should it reduce the level of responsibility and potential liability held

[13] The corporate governance listing standards would only apply to companies listing common stock.

by other audit committee or board members.[14] Nevertheless, in some cases state law may hold an individual to a standard of responsibility and liability commensurate with an individual's experience, access to information and expertise. In this regard, an audit committee member who is identified as a financial expert by virtue of his or her special knowledge, experience and expertise could be held to a higher standard of responsibility than other audit committee members. Furthermore, at least one federal case lays a basis for attaching liability to a director who has failed to meet a heightened level of care necessary for one with such director's expertise.[15] While designation as a financial expert, in and of itself, should not *change* an individual's liability the formal designation that a person is a "financial expert" may prevent such audit committee member from successfully disclaiming expertise in specific areas of finance and accounting.

COMPANIES WITHOUT AUDIT COMMITTEES OR BOARDS OF DIRECTORS

The Proposed 407 Rules would apply to companies that have boards of directors but do not have separate audit committees, because the Act defines "audit committee" as "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 . . . *if no such committee exists with respect to an issuer, the entire board of directors . . .*" (emphasis added).[16] These companies must disclose whether they have financial experts on their boards and, if not, an explanation of why not.

The Proposed 407 Rules would also apply to entities that have neither audit committees nor boards of directors, such as some limited liability companies and limited partnerships that do not have a corporate general partner. These entities must explain that their organizational structure does not provide for an oversight body. If these types of entities do have an oversight body, however, then presumably (although not expressly stated in the Proposed 407 Rules) they would have to disclose whether they have a financial expert on such oversight body.

FOREIGN PRIVATE ISSUERS

The Proposed 407 Rules would require the same financial expert disclosure by foreign private issuers in annual reports filed on Form 20-F and Form 40-F as that which would be required by domestic issuers on Forms 10-K and 10-KSB. In the case of a foreign private issuer,

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[14] The October 22 SEC Release states that the SEC does not intend for a "financial expert" to be considered an expert for purposes of Section 11 of the Security Act of 1933, as amended, solely as result of the designation.

[15] *See Escott v. BarChris Construction Corp.*, 283 F.Supp. 643 (S.D.N.Y. 1968).

[16] This is the definition set forth in Section 3(a)(58) of the Exchange Act, as added by the Act.

however, the SEC notes that, when evaluating a member of its audit committee, the board of directors should consider the director's experience with (a) public companies in the foreign private issuer's home country, (b) generally accepted accounting principles used by the issuer and (c) the reconciliation of financial statements with U.S. generally accepted accounting principles.

With respect to foreign private issuers that have a two-tiered board structure comprised of a management board and a supervisory or non-management board, the SEC has indicated that that the supervisory or non-management board would be the body "best equipped" to make the financial expert determination.

REGISTERED INVESTMENT COMPANIES

The Proposed 407 Rules would require registered management investment companies (open-end and closed-end)[17] filing reports on Form N-CSR to disclose in such reports:

- the name of each audit committee member that the board of directors has determined to be a financial expert;
- with respect to each such financial expert, if any, whether the financial expert is independent, and if not, an explanation of why the financial expert is not independent; or
- if the investment company does not have a financial expert on its audit committee, that fact and an explanation of why it does not have a financial expert on its audit committee.

The Proposed 407 Rules would use the same definition of "financial expert" for investment companies as for operating companies, excluding the element concerning foreign private issuers. As with operating companies, an investment company would be permitted to conclude that in lieu of having experience as a public accountant, auditor, principal financial officer, principal accounting officer, or controller, or experience in a position involving the performance of similar functions, a director has experience in a position that results, in the judgment of the board, in the person having similar experience and expertise and that such a person satisfies the criteria to be a financial expert. In that case, the investment company would be required to disclose the basis for such determination.

With respect to the independence determination, a financial expert would be considered "independent" if he or she:

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[17] Unit investment trusts would not be subject to the Proposed 407 Rules. Small business investment companies would be required to make similar disclosures in their Form N-SAR.

- except in his or her capacity as a member of the audit committee, the board of directors or other board committee, does not accept any consulting, advisory or other compensatory fees from the issuer; and

- is not an "interested person" of the investment company as defined in Section 2(a)(19) of the Investment Company Act.

The proposed disclosure requirements would apply to all registered management investment companies, regardless of whether required to file reports under Section 13(a) or 15(d) of the Exchange Act.

ASSET-BACKED ISSUERS

The Proposed 407 Rules would exempt asset-backed issuers from the financial expert disclosure requirements.

CODES OF ETHICS

STATUTORY AND REGULATORY BACKGROUND

Section 406 of the Act requires the SEC to issue rules requiring each issuer to disclose whether or not it has adopted a code of ethics for senior financial officers and, if not, the reason for not doing so. The Act defines "code of ethics" to mean any standards that are reasonably necessary 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 the issuer's periodic reports; and

- compliance with governmental rules and regulations.

The Act directs the SEC to require the immediate disclosure by any issuer, by means of the filing of a Form 8-K, dissemination by the Internet or by other electronic means, of any change to, or waiver from, its code of ethics for senior financial officers.

Issuers with securities listed on the NYSE or quoted on Nasdaq also need to consider the related requirements in the Proposed NYSE Standards or Proposed Nasdaq Standards, as applicable, each of which set forth requirements regarding codes of ethics for listed companies. These requirements are discussed below under "Comparing Proposed 406 Rules, Proposed NYSE Standards and Proposed Nasdaq Standards."

PROPOSED RULES

General

The SEC's proposed rules under Section 406 of the Act (the "Proposed 406 Rules") would require all domestic companies and foreign private issuers filing annual reports on Form 10-K, 10-KSB, 20-F or 40-F to disclose in such reports:[18]

- whether the company has adopted a written code of ethics that applies to the company's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions;[19] and

- if the company has not adopted such a code of ethics, the reasons for not having done so.

Although the Act contemplates requiring the code of ethics to apply only to senior financial officers, the Proposed 406 Rules would require that the code of ethics apply to the principal executive officer as well (i.e., in most cases, the CEO). The Proposed 406 Rules would also require an issuer to file a copy of its code of ethics as an exhibit to its annual report on Form 10-K, 10-KSB, 20-F or 40-F, as the case may be.

Definition of "Code of Ethics"

The Proposed 406 Rules define "code of ethics" to mean a codification of standards that is reasonably designed to deter wrongdoing and to promote:

- honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;

- avoidance of conflicts of interest, including disclosure to an appropriate person or persons identified in the code of any material transaction or relationship that reasonably could be expected to give rise to such a conflict;

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[18] The Proposed 406 Rules would be codified as additional requirements of Item 10 of Part III of Form 10-K and Item 9 of Form 10-KSB, each requiring the disclosure specified by new Item 406 of Regulations S-K and S-B, as applicable; new Item 15(c) to Form 20-F; and new General Instruction B.(9) to Form 40-F. With respect to Forms 10-K and 10-KSB, Part III permits an issuer, under certain circumstances, to incorporate the disclosure by reference from its definitive proxy or information statement

[19] Although the Proposed 406 Rules would require that the code of ethics apply to specified officers, the SEC encourages companies to apply the code of ethics to as broad a spectrum of personnel and affiliates as practicable.

- full, fair, accurate, timely and understandable disclosure in reports and documents that a company files with, or submits to, the SEC and in other public communications made by the company;

- compliance with applicable governmental laws, rules and regulations;

- the prompt internal reporting to an appropriate person or persons identified in the code of violations of the code; and

- accountability for adherence to the code.

The October 22 SEC Release indicates that an issuer retains discretion to determine the *appropriate* person to whom a conflict of interest or a violation of the code should be reported, with the caveats that the person not be involved in the matter giving rise to the conflict of interest and that the person have sufficient authority in the company to adequately deal with the violator. Because codes of ethics are required to apply to officers who carry substantial authority within the company, we believe that a reasonable interpretation of the SEC's guidance suggests that the company would need to designate its general counsel or a comparable senior officer to receive disclosure of any material transaction that reasonably could be expected to give rise to a conflict of interest involving the specified officers.

Under the Proposed 406 Rules, a company would be permitted to satisfy the code of ethics requirements with a pre-existing code of ethics, but only if the pre-existing code meets all of the criteria that would be required by the Proposed 406 Rules. An issuer that plans to use a pre-existing code of ethics to satisfy the Proposed 406 Rules should carefully review such pre-existing code to ensure that it satisfies the rule's requirements. The Proposed 406 Rules *would not require* an issuer to adopt a code of ethics if it has not already done so, or even to amend its existing code of ethics, but they *would require* a company that does not have a code of ethics that meets all the requirements of the Proposed 406 Rules to explain why it does not have such a code. We expect that virtually all reporting companies will adopt codes of ethics as contemplated by the Proposed 406 Rules.

Current Disclosure Regarding Changes or Waivers

General. The Proposed 406 Rules would require issuers to make prompt disclosure of the following occurrences:

- a change to a company's code of ethics that applies to the "specified officers"; or

- a grant of a waiver from an ethics code provision for a "specified officer."

A "specified officer" would include any of the senior officers that would be required to be covered by a code of ethics in order for such code of ethics to comply with the Proposed 406

Rules (i.e., the principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions).

It should be noted that the requirement to disclose the granting of a waiver from the code of ethics applies only to a waiver with respect to the specified officers. If the code of ethics applies to additional employees, the Proposed 406 Rules would not require disclosure of waivers from the code for these other employees. Furthermore, as long as the company responded to a violation of the code of ethics by one of the specified officers in accordance with the terms of the code of ethics and, thus, no waiver from the code were granted, the Proposed 406 Rules would not require disclosure of the fact that a violation of the code had occurred. In light of the desirability of minimizing the need to grant waivers that would trigger disclosure of violations of codes of ethics by specified persons, we would recommend that codes of ethics be drafted to provide maximum flexibility in holding violators accountable.

Implied waivers. The SEC has indicated that an issuer would be deemed to have granted a waiver in respect of a violation of its code of ethics by a specified officer if the violation is ignored or if the specified officer is not held accountable for the violation on a basis consistent with the code of ethics. Because all waivers would be required to be disclosed within two business days of the grant of the waiver, implied waivers could present issues as to whether a company is in compliance with reporting requirements. As a practical matter, we believe that no implied waiver should be deemed to exist in circumstances where the relevant officer or officers had not yet learned of the occurrence or possible occurrence of the violation, provided that a company had in place an adequate procedure for the reporting of violations. In addition, even after the relevant officer or officers learned of the occurrence or possible occurrence of a violation, we believe that no implied waiver should be deemed to exist while the incident is investigated and the appropriate remedy or sanction is considered, provided that the process is conducted in a reasonable manner and on a timely basis.

Method of Disclosure. An issuer may provide the required disclosure of changes to, or waivers from, its code of ethics on a Form 8-K report with a two business day reporting deadline or by posting the information on the company's website. If an issuer wishes to post notices of waivers from or changes to its code of ethics on its website rather than making the filings, it must notify investors in advance of this election by disclosing in its most recently filed annual report that it intends to disclose these events on its website and provide the website address. An election to disseminate information through its website would not affect the two business day reporting deadline, i.e., an issuer would still be required to post the disclosure on its website within two business days of any change to, or waiver from, its code of ethics. An issuer would also be required to continue to post the disclosure on its website for at least the 12-month period following its initial posting and further to retain the disclosure for possible SEC review for a period of not less than five years from the conclusion of that 12-month period (i.e., six years in total).

COMPARING PROPOSED 406 RULES, PROPOSED NYSE STANDARDS AND PROPOSED NASDAQ STANDARDS

The Proposed 406 Rules differ in three important respects from the requirements of the Proposed NYSE Standards and Proposed Nasdaq Standards:

- *Individuals covered*. The Proposed 406 Rules require that a code apply only to the principal executive officer and the specified principal financial officers. The Proposed NYSE Standards and Proposed Nasdaq Standards would require that codes apply to all directors, all officers and all employees.

- *Issue-areas covered*. The Proposed NYSE Standards suggest that listed companies should address a broader range of topics in their codes of ethics compared to the Proposed 406 Rules. For example, confidentiality and protection and proper use of company assets are topics that the NYSE suggests be covered in listed companies' codes of ethics. The Proposed Nasdaq Standards are more general, only requiring that codes address "the issues of conflicts of interest and compliance with laws, rules and regulations."

- *Waivers*. The Proposed 406 Rules require current (i.e., two business day) disclosure of waivers. The Proposed NYSE Standards and Proposed Nasdaq Standards require only "prompt" disclosure. Furthermore, the Proposed NYSE Standards and Proposed Nasdaq Standards would require disclosure of any waiver for directors or executive officers as compared to the Proposed 406 Rules, which require disclosure of any waivers for the specified officers.

Companies may need to make modifications to their existing codes of ethics or even to create new codes of ethics to comply with the requirements of the various rules. In light of the differing requirements of the Proposed 407 Rules and Proposed NYSE Standards or Proposed Nasdaq Standards, as applicable, listed companies will likely confront the issue of whether to use a single code of ethics or two or more codes of ethics. Each company must consider this issue in light of its particular circumstances, including, for example, its current practice with respect to codes of ethics, the number and variety of its employees and the nature of the risks faced by the company and its employees.

Many companies have codes of ethics that are included as part of employee handbooks or more comprehensive codes of conduct. In light of the fact that the final rules under Section 406 of the Act and the final NYSE and Nasdaq listing standards regarding corporate governance will likely require that companies make their codes of ethics publicly available, we would recommend that companies separate their codes of ethics from any surrounding human resource information, operational policy guidelines and other information. This separation will obviate the need to publicize proprietary administrative matters and eliminate the possibility of

confusion regarding whether a waiver for a breach of the company's operating policies would constitute a waiver from the code of ethics that would need to be publicly disclosed.

FOREIGN PRIVATE ISSUERS

The Proposed 406 Rules would require foreign private issuers to make the same disclosure in annual reports filed on Forms 20-F and 40-F as domestic issuers would be required to make on Forms 10-K or 10-KSB. Foreign private issuers would also have to file their codes as exhibits to their Form 20-F or 40-F in the same manner as domestic issuers would be required to provide such exhibits to Forms 10-K or 10-KSB. Unlike domestic issuers, however, foreign private issuers would not be required to disclose changes to, or waivers from, their codes of ethics for specified officers on a current basis. Instead, foreign private issuers would be required to make such disclosure annually on Form 20-F or Form 40-F.[20]

REGISTERED INVESTMENT COMPANIES

The Proposed 406 Rules would require registered investment companies to disclose in reports on Forms N-SAR and N-CSR:

- whether each of the investment company, its investment adviser, and its principal underwriter has adopted a written code of ethics that applies to the principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions of, respectively, the investment company, its investment adviser and its principal underwriter;[21] and

- if the investment company, its investment adviser or its principal underwriter has not adopted such a code of ethics, the reasons for not having done so.

The Proposed 406 Rules would use the same definition of a code of ethics for investment companies as for operating companies. Rule 17j-1 under the Investment Company Act currently requires investment companies and their investment advisers and principal underwriters to adopt codes of ethics designed to prevent fraud in connection with personal trading in securities by employees. The Proposed 406 Rules, however, would cover a broader range of conduct than that required by Rule 17j-1, including:

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[20] The SEC notes that even though it would not require a foreign private issuer to disclose on a current (two business day) basis any changes to, or waivers from, its code of ethics for specified officers, the SEC would encourage prompt disclosure of any such change or waiver on a Form 6-K or the company's website.

[21] In the case of a unit investment trust, the disclosure requirements would apply with respect to the unit investment trust's sponsor, depositor, trustee and, in certain cases, principal underwriter.

- disclosure provided in filings with the SEC;
- compliance with governmental laws, rules and regulations; and
- ethical conduct generally, including the handling of actual or apparent conflicts of interest.

We believe that the additional provisions in codes of ethics that would be required by the Proposed 406 Rules should be incorporated through amendments to an investment company's existing code of ethics.

The proposed disclosure requirements would apply to all registered investment companies, regardless of whether they are required to file reports under Section 13(a) or 15(d) of the Exchange Act. Management investment companies generally would provide the required disclosure on proposed Form N-CSR, and small business investment companies and unit investment trusts would provide the required disclosure on Form N-SAR. The Proposed 406 Rules would generally apply to the same entities covered by Rule 17j-1 (investment companies, investment advisers and certain principal underwriters). Like Rule 17j-1, the Proposed 406 Rules would cover the code of ethics of an investment company's principal underwriter only if:

- the principal underwriter is an affiliated person of the investment company or the investment company's investment adviser; or
- an officer, director or general partner of the principal underwriter serves as an officer, director or general partner of the investment company or of its investment adviser.

The Proposed 406 Rules would also require registered investment companies to include any written code of ethics and any amendment to that code of ethics as an exhibit to the investment company's reports on Form N-CSR or N-SAR.[22]

The Proposed 406 Rules would require that if the investment company, its investment adviser or its principal underwriter had made any amendments to, or granted any waivers from, any code of ethics applicable to the investment company's, investment adviser's or principal underwriter's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions, during the period covered by the investment company's report on Form N-CSR or N-SAR, the investment company would need to provide a brief description of the amendment or waiver in the investment company's report on Form N-CSR or Form N-SAR, as applicable. As an alternative,

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[22] Proposed Form N-CSR would permit a registered management investment company to incorporate its code of ethics by reference from another document, such as its registration statement.

the investment company would be permitted to disclose any such amendment or waiver by posting the information on its Internet website within two business days after the occurrence of the amendment or waiver. If the investment company wished to make the disclosure in this manner, it would be required to have disclosed in its most recent report on Form N-SAR or N-CSR its intention to post the information on its website and its website address. In addition, the investment company would have to post the information on its website for a 12-month period and would have to retain the information for a period of not less than six years following the end of the fiscal year in which the amendment or waiver occurred.

ASSET-BACKED ISSUERS

The Proposed 406 Rules would exempt asset-backed issuers from the code of ethics requirements.

MANAGEMENT'S ASSESSMENT OF INTERNAL CONTROLS

STATUTORY BACKGROUND

Section 404 of the Act requires the SEC to adopt rules requiring each annual report filed under the Exchange Act to contain an internal control report that:

- states that management is responsible for establishing and maintaining an adequate internal control structure and procedures for financial reporting ("Internal Controls"); and

- contains an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the Internal Controls.

The Act requires the issuer's public accounting firm to attest to, and report on, the assessment of Internal Controls made by management. The attestation must be made in accordance with standards for attestation engagements to be promulgated by the new Public Company Accounting Oversight Board (the "Oversight Board").

PROPOSED RULES

General

The SEC's proposed rules under Section 404 of the Act (the "Proposed 404 Rules") would require all domestic companies and foreign private issuers filing annual reports on Form 10-K,

10-KSB, 20-F or 40-F to disclose in such reports an internal control report of management (the "Internal Control Report") that includes:[23]

- a statement that management is responsible for establishing and maintaining adequate Internal Controls;
- conclusions about the effectiveness of the company's Internal Controls based on management's evaluation of them in accordance with specified SEC rules[24] as of the end of the company's most recent fiscal year; and
- a statement that the registered public accounting firm that prepared or issued the company's audit report relating to the financial statements included in the company's annual report has attested to, and reported on, management's evaluation of the company's Internal Controls.

The Proposed 404 Rules would not specify a required format for the Internal Control Report. Instead, the rules would permit each issuer to prepare the report based upon its particular circumstances.

The Proposed 404 Rules would also require issuers to file auditor attestation reports in annual reports on Forms 10-K, 10-KSB, 20-F and 40-F.[25] The Proposed 404 Rules would require such auditor attestations to indicate the scope of the auditor's examination and to set forth the auditor's opinion that management's conclusions regarding the effectiveness of Internal Controls contained in its Internal Control Report are fairly stated, in all material respects. If an auditor is unable to provide such an opinion, the attestation would be required to include the auditor's opinion to that effect and an explanation as to why the auditor cannot provide such an opinion.

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[23] The Proposed 404 Rules include amendments to Rules 13a-14, 13a-15, 15d-14, and 15d-15 and new paragraph (c) to Item 307 of Regulations S-K and S-B; new Item 15(a) to Form 20-F; and new General Instruction B.(7) to Form 40-F.

[24] Exchange Act Rule 13a-15 or 15d-15, as applicable.

[25] The proposed rules would be codified in Item 14 of Part III of Form 10-K and Form 10-KSB, each requiring the disclosure required by new paragraph (c) of Item 307 of Regulations S-K and S-B, as applicable; new Item 15(a) to Form 20-F; and new General Instruction B.(7) to Form 40-F (in each case referencing new amendments to Regulation S-X regarding attestation reports that an issuer's registered public accounting firm will be required to provide). With respect to Forms 10-K and 10-KSB, Part III permits an issuer, under certain circumstances, to incorporate the disclosure by reference from its definitive proxy or information statement.

Definition of Internal Controls

The Proposed 404 Rules would define "internal controls and procedures for financial reporting" to be controls that pertain to the preparation of financial statements for external purposes that are fairly presented in conformity with generally accepted accounting principles as addressed by the Codification of Statements on Auditing Standards §319 ("Auditing Standards §319") or any superseding definition or other literature that is issued or adopted by the Public Company Accounting Oversight Board (the "Oversight Board").

The Auditing Standards §319 defines "internal controls" as a process – effected by an entity's board of directors, management and other personnel – designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- reliability of financial reporting;
- effectiveness and efficiency of operations; and
- compliance with applicable laws and regulations.

The Auditing Standards §319 further provides that Internal Controls consist of the following five interrelated components:

- ***Control environment***, which sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure;
- ***Risk assessment***, which is the entity's identification and analysis of relevant risks to the achievement of its objectives, forming a basis for determining how the risks should be managed;
- ***Control activities***, which are the policies and procedures that help ensure that management directives are carried out;
- ***Information and communication***, which are systems that support the identification, capture and exchange of information in a form and time frame that enable people to carry out their responsibilities; and
- ***Monitoring***, which is a process that assesses the quality of internal control performance over time.

These five items provide the framework for effective Internal Controls, in similar fashion to providing a framework more generally for disclosure controls and procedures.[26] The SEC believes that this definition is consistent with the purpose of Internal Controls, which is to permit the preparation of the issuer's financial statements in accordance with generally accepted accounting principles by ensuring that:

- issuers have processes designed to provide reasonable assurance that the issuer's transactions are properly authorized;
- the issuer's assets are safeguarded against unauthorized or improper use; and
- the issuer's transactions are properly recorded and reported.

Quarterly Assessments

Under Section 302 of the Act and related SEC rules (the "302 Certification"), the principal executive officer and principal financial officer of each issuer must certify *quarterly* to, among other things, any significant changes to Internal Controls.[27] Thus, in addition to requiring an annual Internal Control Report, the Proposed 404 Rules would also require a quarterly assessment of Internal Controls by an issuer's management, with the participation of the issuer's principal executive officer and principal financial officer, in order to evaluate the effectiveness of the design and operation of Internal Controls and to provide a basis for the 302 Certification as it relates to Internal Controls. The Proposed 404 Rules would require that such quarterly evaluations be made *as of the end of the period* covered in the report.[28]

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[26] For a more detailed discussion of these components in the context of disclosure controls and procedures, see our memorandum dated October 21, 2002, entitled "*Disclosure Controls and Procedures,*" which is available upon request or at our website: *www.simpsonthacher.com*.

[27] Exchange Act Rules 13a-15 and 15d-15 adopted August 29, 2002, pursuant to Section 302 of the Act. For a more detailed discussion of these rules and Section 302 of the Act, see our memorandum dated September 6, 2002, entitled "*SEC Adopts New CEO/CFO Certification Rules Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002,*" which is available upon request or at our website: *www.simpsonthacher.com*.

[28] The requirement that the evaluation of Internal Controls be done as of the end of the quarter covered by the report would also apply to quarterly evaluations of disclosure controls and procedures. In contrast, in their current form, rules regarding the 302 Certification require that evaluations of disclosure controls and procedures be conducted within 90 days of the filing of the report. The SEC proposes conforming changes to Exchange Act Rules 13a-14, 13a-15, 15d-14 and 15d-15 and the form of certification in Forms 10-Q, 10-QSB, 10-K, 10-KSB, 20-F and 40-F.

Transition Period

The Proposed 404 Rules would be effective in respect of fiscal years beginning on or after September 15, 2003. In part, this delay is necessitated by the Act's contemplation of the Oversight Board's role in adopting auditor attestation standards (and the Oversight Board may not be operational until April 26, 2003). In addition, the SEC believes that companies and auditors will require substantial time to design and implement procedures and train personnel to comply with the proposed heightened standards. Therefore, although the Proposed 404 Rules if adopted would implicate the requirements for the 302 Certification, companies should for the time being continue to make the 302 Certification as required by the SEC's current rules regarding Section 302 of the Act, pending additional guidance from the SEC.

Additional Issues

The Proposed 404 Rules would clarify certain current rules. For example, the Proposed 404 Rules would highlight that material weaknesses are a subset of significant deficiencies and thus must also be disclosed to the auditor and audit committee pursuant to the 302 Certification.[29] The Proposed 404 Rules also confirm that an issuer's principal executive officer and principal financial officer need not personally design the issuer's disclosure controls and procedures, and need only supervise their design.

FOREIGN PRIVATE ISSUERS

The Proposed 404 Rules would apply to foreign private issuers in the same manner as U.S. domestic issuers.

REGISTERED INVESTMENT COMPANIES

Investment companies registered under the Investment Company Act are exempt from the requirements of Section 404 of the Act. Nevertheless, the Proposed 404 Rules would make technical changes to rules and forms covering investment companies in order, in part, to conform them with some of the changes being proposed for operating companies, including:

- specifying that an investment company's management must evaluate the effectiveness of its disclosure controls and procedures, with the participation of the principal executive and financial officers, as of the end of the period covered by each report filed on Form N-SAR or Form N-CSR and must include disclosure about the evaluation in the report;

[29] The SEC cites accounting literature that confirms that a "material weakness" is a "reportable condition" and thus also a subset of "significant deficiency."

- defining "internal controls and procedures for financial reporting" in the same manner as for operating companies;

- requiring disclosure in Form N-SAR or Form N-CSR of any significant changes to Internal Controls made during the period covered by the report;

- expressly requiring shareholder reports to be filed as an exhibit to proposed Form N-CSR rather than as an Item response, and revising the form of certification in Forms N-SAR and N-CSR to make clear that the report being certified includes exhibits;

- requiring the signing officers to state that they are responsible for establishing and maintaining Internal Controls, and that they have disclosed to the investment company's auditors and audit committee all significant deficiencies in the design and operation of Internal Controls which could adversely affect the investment company's ability to record, process, summarize and report financial information required to be disclosed in the reports that it files or submits under the Exchange Act and the Investment Company Act;

- requiring an investment company to file a Form 12b-25 if it will not be able to file a report on proposed Form N-CSR in a timely manner, which would provide the investment company with an automatic extension of time to file proposed Form N-CSR of up to 15 calendar days following the prescribed due date; and

- clarifying that terms used in Form N-CSR have meanings as defined in the Investment Company Act and the rules and regulations thereunder.

ASSET-BACKED ISSUERS

The Proposed 404 Rules would exempt asset-backed issuers from the requirements mandating management's assessment of Internal Controls.

FDIC-INSURED DEPOSITORY INSTITUTIONS

Bank and thrift holding companies that are required to file reports under Section 13(a) or 15(d) of the Exchange Act would be subject to the Proposed 404 Rules. The SEC is coordinating with the FDIC and other federal banking regulators to attempt to eliminate unnecessary duplication between the Proposed 404 Rules and the FDIC's similar requirements. The SEC expects to provide further guidance in its release adopting final rules under Section 404 of the Act.

NEW PROHIBITIONS REGARDING IMPROPER INFLUENCE ON AUDITORS

STATUTORY BACKGROUND

Section 303 of the Act provides that it shall be unlawful for any director or officer of an issuer, or any other person acting under the direction thereof, in contravention of rules to be adopted by the SEC, to take any action to fraudulently influence, coerce, manipulate or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading.

PROPOSED RULES

General

The SEC's proposed rules under Section 303 of the Act (the "Proposed 303 Rules") would provide that:[30]

- no officer or director of an issuer, or any other person acting under the direction thereof, shall directly or indirectly take any action to fraudulently influence, coerce, manipulate or mislead any independent public or certified public accountant engaged in the performance of an audit or review of the financial statements of that issuer that are required to be filed with the SEC if that person knew or was unreasonable in not knowing that such action could, if successful, result in rendering such financial statements materially misleading; and

- actions that "could, if successful, result in rendering such financial statements materially misleading" include, but are not limited to, actions taken at any time with respect to the professional engagement period to fraudulently influence, coerce, manipulate or mislead an auditor:

  - to issue a report on an issuer's financial statements that is not warranted in the circumstances (due to material violations of generally accepted accounting principles, generally accepted auditing standards or other standards);

  - not to perform audit, review or other procedures required by generally accepted auditing standards or other professional standards;

[30] The Proposed 303 Rules are codified in new Rules 13b2-2(b)(1) and 13b2-2(b)(2).

- not to withdraw an issued report; or

- not to communicate matters to an issuer's audit committee.

The SEC notes that this list of prohibited activities would not be exhaustive, only illustrative. The Proposed 303 Rules would supplement existing SEC rules in Regulation 13B-2, which already prohibit officers and directors of issuers from making false or misleading statements to an accountant in connection with any audit or examination of the financial statements of the issuer.

Key Aspects

Key aspects of the proposed prohibition include the following:

- "*Under the direction*". In addition to providing the SEC with new means of addressing officer and director activity that is already prohibited by existing securities laws and regulations, the Proposed 303 Rules would also reach the actions of a wide variety of other parties. The SEC has indicated that it would interpret the term "direction" much more broadly than "supervision" to include:

  - the issuer's employees;

  - customers;

  - vendors or creditors who, under the direction of an officer or director, provide false or misleading confirmations or other false or misleading information to auditors, or who enter into "side agreements";

  - in appropriate circumstances, other partners or employees of the accounting firm (such as consultants or forensic accounting specialists retained by counsel for the issuer); and

  - attorneys, securities professionals or other advisers who, for example, pressure an auditor to limit the scope of the audit, to issue an unqualified report on the financial statements when such a report would not be warranted, to not object to an inappropriate accounting treatment, or to not withdraw an issued opinion on the issuer's financial statements.

- *Types of conduct prohibited.* The types of conduct that the SEC suggests might constitute improper influence include, directly or indirectly:

  - offering or paying bribes or other financial incentives, including offering future employment or contracts for non-audit services;

- providing an auditor with inaccurate or misleading legal analysis;
- threatening to cancel or canceling existing non-audit or audit engagements if the auditor objects to the issuer's accounting;
- seeking to have a partner removed from the audit engagement because the partner objects to the issuer's accounting;
- blackmailing; and
- making physical threats.

The SEC would perform a facts and circumstances test that would take into account the purpose of the conduct in order to determine whether conduct would violate the Proposed 303 Rules.

- *"Engaged in the performance of an audit"*. The SEC would interpret the rules to mean that the period which is covered by the prohibition begins when the accountant is selected to perform audit or review services and continues until the public notification that the professional relationship has ended. The SEC prefers a reading that would include "the professional engagement period" as well as "any other time the auditor is called upon to make decisions regarding the issuer's financial statements."[31]

- *Negligence standard*. The proposed mental state requirement is generally consistent with existing rules under Regulation 13B-2.

- *Exclusive SEC enforcement authority*. The SEC has exclusive authority to enforce this prohibition.

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[31] The SEC suggests that such "other times" would include:

- during negotiations for retention of the auditor;
- subsequent to the professional engagement period when the auditor is considering whether to issue a consent on the use of prior years' audit reports; and
- in limited circumstances, before the professional engagement begins as, for example, when an officer, director or person acting under the direction of an officer or director offers to engage an accounting firm on the condition that the firm either issue an unqualified audit report on financial statements that do not conform with generally accepted accounting principles, or limit the scope or performance of audit or review procedures in violation of generally accepted auditing standards.

- *No private right of action.* Neither Section 303 of the Act nor the Proposed 303 Rules would create a private right of action for security holders of the issuer.

- *Potential criminal liability*: Violation of this provision may give rise to criminal liability under Section 32 of the Exchange Act.[32]

REGISTERED INVESTMENT COMPANIES

Registered investment companies[33] would be covered by the Proposed 303 Rules in a manner similar to operating companies. Investment companies, however, typically have contracts with service providers who perform almost all of the management, administrative and other aspects of the investment company's operations, including preparation of financial statements. As a result, the prohibitions in the Proposed 303 Rules would also cover officers and directors of applicable service providers, such as the investment company's investment adviser, administrator and, for unit investment trusts, its sponsor, depositor and trustee.

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[32] Section 32 of the Exchange Act, as amended by the Act, provides that:

- any person who willfully violates any provision of the Exchange Act (other than Section 31 related to fees), or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of the Exchange Act; or

- any person who willfully and knowingly makes, or causes to be made, any statement in any application, report, or document required to be filed under the Exchange Act or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in Section 15(d) of the Exchange Act, or by any self-regulatory organization in connection with an application for membership or participation therein or to become associated with a member thereof, which statement was false or misleading with respect to any material fact,

shall upon conviction be fined not more than $5,000,000, or imprisoned not more than 20 years, or both, except that when such person is a person other than a natural person, a fine not exceeding $25,000,000 may be imposed; but no person shall be subject to imprisonment under Section 32 for the violation of any rule or regulation if he or she proves that he or she had no knowledge of such rule or regulation. Section 32 contains different penalties for violations of Section 15(d) (relating to failure to file specified information, documents or reports) and Section 30A (relating to the Foreign Corrupt Practices Act).

[33] Business development companies, which are not required to register under the Investment Company Act, would also be subject to the Proposed 303 Rules.

Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as additional memoranda regarding recent corporate governance developments, can be obtained from our website, *www.simpsonthacher.com*

SIMPSON THACHER & BARTLETT LLP