SARBANES-OXLEY: A CLOSER LOOK

JANUARY 2003

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This publication was prepared by KPMG LLP as a summary of selected elements of the Sarbanes-Oxley Act of 2002 and certain final and proposed rules of the U.S. Securities and Exchange Commission. This publication is meant to provide a high-level overview of elements of the Sarbanes-Oxley Act's requirements that impact audit committees and senior management of publicly traded companies. This publication reflects the status of these selected elements of the Sarbanes-Oxley Act as of January 31, 2003. Audit committees and senior management should consult with legal counsel and accounting advisers in the application of the Sarbanes-Oxley Act and any final and proposed rules of the U.S. Securities and Exchange Commission.

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PREFACE

Compliance obligations are mounting as a result of the SEC's recent issuance of ten final rules and four proposals relating to the Sarbanes-Oxley Act of 2002. The process of complying with the sweeping changes in U.S. securities laws is complex, and executives and audit committee members at publicly traded companies face challenges in the immediate future.

This publication summarizes thousands of pages of the Act and the resulting new and proposed SEC rules and interpretive commentary. It also provides a foundation for understanding the new responsibilities for corporate governance, management reporting, financial statement disclosures, management assessment of internal controls, and the changed responsibilities of auditors.

The information here is intended to help audit committee members understand their broader duties and to clarify the issues that face senior executives, who now are confronted with greater potential exposure to personal liability as a result of the new laws.

In addition to meeting our self-imposed obligation to assist our clients in meeting the mandates of the new legislation, one of the aims of this publication is to help undo some misconceptions about what the law does and does not require. Further, we summarize critical provisions, such as permitted non-audit services, audit committee pre-approval of services, audit partner rotation requirements, and the reporting of auditor fees, as well as additional disclosures in filings with the SEC.

This publication focuses on four key areas of the legislation:

- Corporate responsibilities of management and audit committees
- Enhancement of financial disclosures
- Independence of auditors and audit committees
- Role of the Public Company Accounting Oversight Board

The result, we hope, is a reference tool that can provide guidance when questions arise. We encourage readers to engage in a dialogue with KPMG's professionals, and with their counsel on legal matters, as we all operate in this new era.

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TITLE I
PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

The Public Company Accounting Oversight Board (Board) was established by the Sarbanes-Oxley Act of 2002 (Act) with broad powers to regulate audits and auditors of public companies. The Securities and Exchange Commission (the SEC or Commission) has appointed four of the five members of the Board, which has held two meetings, but has not yet defined and made public its operating procedures. This chapter describes the Board's responsibility, structure, and authority.

BOARD RESPONSIBILITIES

The Board's responsibilities under the Act are to:

- Set its budget and manage its operations
- Inspect and register public accounting firms (registered firms) that prepare audit reports for issuers
- Establish, adopt, or modify auditing, quality control, ethics, independence, and other standards for public company audits
- Enforce compliance with the Act, the rules of the Board, professional standards, and the securities laws relating to the preparation and issuance of audit reports and the related obligations and liabilities of auditors
- Investigate registered firms for potential violations of applicable rules relating to audits
- Impose sanctions for violations
- Perform such other duties or functions as the Board or Commission determines necessary

BOARD STATUS AND COMPOSITION

The Board is a nonprofit corporation—not a U.S. government agency—and it will be funded by SEC registrants and registered public accounting firms. The Act requires that the five Board members be prominent, "financially literate" individuals of integrity and reputation. In appointing them, the Commission must consult with the Secretary of the Treasury and the Chairman of the Federal Reserve Board. Members serve full-time for five-year, staggered terms, with a two-term limit. Two of the members must be or have been certified public accountants; the remaining three must not be and cannot have been CPAs. The Chair may be held by a CPA who has not been in practice for at least five years prior to Board appointment.

No member of the Board may be otherwise employed or engage in any other professional business activity of any nature during his or her Board service. Nor may any member serving on the Board share in a public accounting firm's profits or receive any payments from it other than fixed retirement payments.

THE BOARD'S RELATIONSHIP TO THE SEC

The Commission has the power of appointment and can remove a member for good cause. It must approve all Board rules before they become effective and can amend the Board's rules, adding to them or deleting from them. All disciplinary sanctions are subject to review by the Commission, which can modify or cancel them. The Board must file an annual report with the Commission, which has the power to rescind elements of the Board's authority, censure it or its members, or limit its activities, if it determines that doing so would be in the public interest.

BOARD MEMBERS

The following board members were appointed on October 24, 2002.

At the date of this publication, the Chair position is open.

Charles D. Niemeier: The Board's Acting Chairman. Niemeier came to the Board from the SEC, where he was the Chief Accountant in the Division of Enforcement and cochairman of the Financial Fraud Task Force.

Kayla J. Gillan: A 16-year veteran of the California Public Employees' Retirement System (CalPERS), who spent her last six years at CalPERS as its chief legal adviser. She is knowledgeable in public pension, trust, and securities law. After leaving CalPERS in August 2002, Gillan held the position of vice president of Independent Fiduciary Services, a Washington, D.C. firm that specializes in public and private trusts.

Daniel L. Goelzer: A former partner at the law firm of Baker & McKenzie and a former general counsel to the Commission for more than seven years. Goelzer's practice focused on securities and corporate law.

Willis D. Gradison Jr.: A former nine-term Ohio congressman, former head of the Health Insurance Association of America, and former lobbyist at the Washington firm of Patton Boggs, LLP.

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REGISTRATION OF PUBLIC ACCOUNTING FIRMS

Only firms registered with the Board may prepare or issue audit reports on the financial statements of SEC registrants or participate in doing so. Accounting firms will have to submit detailed information in an initial registration application, update it as necessary, and submit annual reports. Registered firms must adhere to Board rules and cooperate with Board investigations and inspections, or they will lose their registered status and, thereby, their permission to audit public companies.

Public accounting firms that intend to audit issuers' financial statements must register within 180 days after the Commission declares the Board operational. That date is expected to be no later than October 23, 2003 (180 days after April 26, 2003, the date that the Board must be declared operational).

An accounting firm's registration must include:

- A list of the firm's audit clients that are SEC registrants and the fees it receives for audit and non-audit services
- Current financial information of the firm
- A statement of the firm's quality-control policies
- A list of the firm's accounting personnel
- Licensing information on the firm and its accounting personnel
- Copies of periodic disclosures documenting disagreements between the firm and any issuer
- Information about ongoing civil or criminal proceedings against the firm or any "associated person" in connection with any audit report

The term "associated person" includes all partners and professional employees and independent contractors or entities that, in connection with the preparation or issuance of any audit report, share in the firm's profits or receive any other form of compensation from the firm or participate as an agent or otherwise on behalf of the firm. (For example, an "associated person" includes the member firms of KPMG International that participate in audits for SEC registrants.)

CONSENT

Applicants for registration must consent to cooperate and comply with any Board request for testimony or the production of documents. Applicants also must agree to secure and enforce similar consents from associated persons as a condition of their continued association with the firm.

BOARD ACTIONS ON APPLICATIONS

Within 45 days of receipt of an application, the Board will approve, disapprove, or request further information. A written notice of disapproval will be treated as a disciplinary sanction and will be reported to the Commission, state regulatory authorities, any foreign accountancy licensing board that has issued a license to the firm, and the public.

PERIODIC REPORTS

Each registered firm will submit an annual report to the Board. The Board will determine the report's contents. A firm may be required to report more frequently, to update its application, or to supply additional information. The Board will assess and collect a registration fee and an annual fee from each registered firm, in amounts sufficient to cover the costs of processing and reviewing reports and applications. Submitted documents will be available for public inspection, subject to laws related to the confidentiality of proprietary, personal, or other information.

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THE BOARD'S STANDARD-SETTING ROLE

The Board is authorized to adopt, revise, or repeal auditing, quality control, and ethics standards governing registered firms' audits of public companies. To that end, the Act mandates that the Board convene "expert advisory groups," including accountants and others, "to make recommendations concerning the content (including proposed drafts) of auditing, quality control, ethics, independence, or other standards required to be established under this section." The Board's rules will be subject to comment in a public process before the Board and the Commission approve them.

The Act does not authorize the Board to set accounting standards. Instead, the Act establishes funding for an accounting standards organization, which is likely to be the Financial Accounting Standards Board (FASB).

WORK PAPER RETENTION

The Act requires the Board to establish audit work paper retention rules and mandates more generally that registered firms maintain audit work papers and other information related to any audit report for seven (7) years.

As mandated by section 802 of the Act, the Commission recently released final rules that require the accountant to retain records relevant to the audit or review, including:

- Work papers and other documents that form the basis of the audit or review
- All other documents (including electronic records) that are created, sent, or received in connection with the audit or review and contain conclusions, opinions, analyses, or financial data related to the audit or review.*

The auditor must retain documents that contain information or data related to a significant matter that is inconsistent with the auditor's final conclusions regarding that particular matter for the audit or review. The rule requires that these records be retained for seven (7) years after the auditor concludes the audit or review of the financial statements.

SECOND-PARTNER REVIEW

The Act requires the Board to include in its auditing standards a requirement for a concurring or second-partner review and approval of the audit report. The concurring partner reviews (1) critical decisions made by the lead audit partner and (2) the financial statements before the audit report is issued. A similar concurring partner review responsibility has long been required under the rules of the AICPA SEC Practice Section.

AUDITOR REPORTS ON INTERNAL CONTROLS

Current standards do not require an auditor to report specifically on an entity's internal control. However, under section 103 of the Act, the Board must adopt auditing standards that require audit reports to describe the scope of the auditor's tests of the issuer's internal controls and procedures for financial reporting, required by section 404. As of the date of this publication, final rules implementing section 404 have not been issued.

The report must disclose:

- The test findings
- An evaluation of whether the internal control structure and procedures:
  - Maintain records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer
  - Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles and that the issuer's receipts and expenditures are in accordance with management's and the directors' authorizations
- A description of material weaknesses in such internal controls and of any material noncompliance revealed by the tests

The Auditing Standards Board of the AICPA is deliberating a new auditing standard and revisions to the attestation standards to address the audit of internal controls and procedures for financial reporting pursuant to section 404.

*SEC Release No. 33-8180; Final Rule: Retention of Records Relevant to Audits and Reviews, January 24, 2003

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BOARD INSPECTIONS OF REGISTERED FIRMS

The Board will replace the traditional firm-on-firm peer review system with its own inspections of registered firms. The Act authorizes the Board to review engagements that are the subject of litigation, previously excluded from peer reviews.

Inspections by the Board are intended to identify any violations by the firm or member of the firm of the Act, rules of the Board, rules of the Commission, the firm's quality-control policies, and professional standards. The Board will report any violations to the Commission and relevant state regulatory authorities and may choose to begin a formal investigation or take disciplinary action.

The Board will conduct annual inspections of firms that audit more than 100 issuers and conduct inspections once every three years of registered firms that audit fewer than 100 issuers. Special inspections may be conducted at the Board's discretion or the Commission's request.

SANCTIONS

The Board will be responsible for establishing procedures to investigate and discipline registered firms and their personnel suspected of violations of relevant rules. In its investigations the Board can require client testimony and production of audit work papers in possession of the firm or any associated person, wherever domiciled. Sanctions for violations can include suspending or revoking a firm's registration and financial penalties of up to $15 million. The Board can also bar individuals from employment by registered firms.

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TITLE II
AUDITOR INDEPENDENCE

The auditor independence provisions of the Sarbanes-Oxley Act, and the SEC rules that flesh them out, affect not only auditors but also audit committees and the executives and directors of public companies. The provisions change relationships between auditors and clients, the marketplace for services, and the potential penalties for violations. Title II imposes new obligations on audit committees, restricts the circumstances in which clients can hire their outside auditor's partners and employees, and limits the terms of service by audit partners on an engagement.

The rules are complex and have a number of transitional provisions. The rule on auditor rotation and the conditions under which audit clients may hire auditors, for example, spells out how long audit partners may stay on an engagement, how long audit partners must stay off of an engagement before returning, and how long an auditor must wait before accepting employment with a company at which he or she was engaged as the auditor.* Other provisions define required communications by auditors to audit committees, describe services that may not be performed for audit clients, and mandate procedures audit committees must follow to pre-approve permitted services.

Under prior SEC independence rules, violations of independence requirements could disqualify an auditor from serving on an engagement and subject individual auditors and the firm to administrative sanctions. Under the new rule, certain independence violations will be violations of the Securities Exchange Act of 1934 and/or may be "unlawful acts," which could result in more severe consequences and penalties against violating audit firms, individuals, and clients.

The SEC's rule will become effective on May 6, 2003, and is subject to interpretation by the Public Companies Accounting Oversight Board (the Board). Various provisions intended to permit an orderly transition to the new requirements are important for full compliance. The transition provisions are described in the detailed sections below.

As the detailed account will show, most provisions of the rule apply to the "audit client." Audit client is a comprehensive term that includes subsidiaries and certain investors and "investees." Other provisions of the rule apply more narrowly to the "issuer" or the "issuer and its subsidiaries."

SECTION 201: SERVICES OUTSIDE THE SCOPE OF PRACTICE OF AUDITORS

The independence provisions of the Act and the SEC rules prohibit a registered firm from performing specified non-audit services for audit clients. Non-audit services are services other than those provided in connection with an audit or a review of the financial statements. The Act and the rules do not prohibit auditors from providing any services to their non-audit clients. Registered firms may be engaged to provide any permitted non-audit service for an audit client as long as the issuer's audit committee pre-approves that service.

TAX SERVICES

The SEC's proposing release discussed extensively the provision of tax services by audit firms. The discussion confused many readers of the proposing release, and the SEC received a significant number of comments. The SEC's final release clarifies the issue by reiterating its long-standing position that an accounting firm can provide tax services to its audit clients without impairing the registered firm's independence. The release says that auditors may continue to provide tax services such as tax compliance, tax planning, and tax advice to audit clients, as long as such services are pre-approved by the audit committee. The release also says that this position is consistent with section 201 of the Act and with the intent of Congress.

*Release No. 33-183; 34-47265; 35-27642, Final Rule: Strengthening the Commission's Requirements Regarding Auditor Independence, January 28, 2003.

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However, the release says that audit committees should carefully consider whether to approve certain tax strategy services where (1) the auditor promotes the strategy to the client, (2) the strategy may not have a business purpose other than tax avoidance, and (3) the tax treatment may not be supported in the tax code.

The rule also states that in foreign jurisdictions where only an attorney can provide tax services, such services are permitted if an accounting firm in the United States could provide them.

OTHER NON-AUDIT SERVICES

The Act's amendments codify those non-audit services that may not be offered by registered firms to their audit clients. The restrictions generally continue to apply to "audit clients," which includes an issuer and its "affiliates," as defined. The Act prohibits specific activities, listed below, and it gives the Board the authority to prohibit other services.

An auditor is prohibited from providing the following services to an audit client:

- Bookkeeping or other services related to the accounting records or financial statements
- Financial information systems design and implementation services
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports
- Actuarial services
- Internal audit outsourcing services
- Management functions
- Human resources functions
- Broker-dealer, investment adviser, or investment banking services
- Legal services
- Expert services unrelated to the audit
- Any other service that the Board determines, by regulation, is impermissible

The intent of these provisions is to draw a clear line around a limited list of non-audit services that accounting firms may not provide to public company audit clients because providing those non-audit services creates the appearance of a conflict of interest.

The rule prohibitions on bookkeeping; financial information systems design and implementation; appraisal, valuation, fairness opinions, or contribution-in-kind reports; actuarial; and internal audit outsourcing discussed below are based on a "rebuttable" presumption that such services are subject to audit procedures. The rule prohibits the issuer's auditor from performing 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."

The details of each prohibition are discussed below.

BOOKKEEPING AND OTHER SERVICES RELATED TO THE ACCOUNTING RECORDS OR FINANCIAL STATEMENTS OF THE AUDIT CLIENT

The general prohibition on performing bookkeeping services for an audit client continues unchanged. In addition, payroll services remain prohibited because the Commission views them as a management function. The rule eliminates the limited exceptions that were permitted by the prior rules. Auditors may no longer provide bookkeeping services in emergency or other unusual situations, or in connection with immaterial foreign subsidiaries or divisions of audit clients.

The release discusses auditor involvement in preparing statutory financial statements and clearly indicates that independence is impaired if an auditor prepares such financial statements that are filed with the SEC. However, an auditor is permitted to provide advice and certain assistance with statutory-to-GAAP financial statement conversions and similar engagements as long as the auditor does not actually perform the conversion, make accounting entries, or perform management functions. Additionally, a registered firm may provide assistance in the preparation of non-U.S. statutory financial statements as long as those statements are not included in, or form the basis for, financial statements filed with the Commission.

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FINANCIAL INFORMATION SYSTEMS DESIGN AND IMPLEMENTATION SERVICES

The rule prohibits designing or implementing hardware or software systems that aggregate source data underlying the financial statements, or that generate information that is significant to the client's financial statements, or other information systems taken as a whole. Services involving the design or implementation of non-financial systems continue to be permitted. Most of the services provided by information risk management professionals, including information systems security reviews and audit assist services, are unaffected by this rule.

The release clarifies that an auditor may evaluate internal controls or make recommendations to management as part of an audit or attest service. Furthermore, an auditor may make recommendations on internal control matters to management or other service providers in conjunction with the design and installation of a system by another service provider.

APPRAISAL OR VALUATION SERVICES, FAIRNESS OPINIONS, OR CONTRIBUTION-IN-KIND REPORTS

The rule continues the present ban on appraisals, valuations, fairness opinions, or contribution-in-kind reports. However, the release states that performing appraisals or valuations for non-financial reporting purposes would not be prohibited, citing as examples an auditor's involvement with "transfer pricing studies, cost segregation studies and other tax-only valuations." The rule also permits the use of a registered firm's specialist in an audit assist function as long as the audit client or a specialist hired by the audit client provides the technical skills or knowledge used to determine the amounts recorded in the financial statements.

ACTUARIAL SERVICES

The rule extends the ban on actuarial services to encompass any "actuarially oriented advisory service" relating to the determination of amounts recorded in an audit client's financial statements. The prior rules prohibited these services primarily with respect to insurance reserves for insurance company audit clients. Therefore, auditors are now prohibited from calculating amounts for post-employment benefits and similar liabilities for audit clients.

The rule permits advice and assistance to audit clients in understanding actuarial methods, models, assumptions, and other inputs used in computing financial statement amounts, as long as these services do not extend to the determination of amounts to be recorded in the financial statements. Attest services by actuaries continue to be permitted.

Consistent with the rules on valuation services, the rule would allow the use of a registered firm's actuary in an audit assist function as long as the audit client has its own actuary, or hires an outside actuary, for purposes of determining amounts recorded in the financial statements.

INTERNAL AUDIT OUTSOURCING

The rule prohibits most internal audit services. Previously, outsourcing to an entity's financial statement auditor of up to 40 percent of an audit client's total internal audit work was permitted, as was full internal audit outsourcing for companies with less than $200 million in assets.

In its discussion of these revisions, the Commission makes clear that in connection with an audit or attest engagement an accountant may evaluate a company's internal controls and may make recommendations to improve them. Furthermore, the ban on outsourced internal audit services does not extend to nonrecurring evaluations of discrete items or other programs that are not, in substance, the outsourcing of the internal audit function.

The release cites an example in which an agreed-upon procedures engagement relating to internal controls is a permitted service. The rule also permits an auditor to perform operational internal audits as long as these engagements are unrelated to internal accounting controls, financial systems, and financial statements.

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MANAGEMENT FUNCTIONS

Consistent with prior independence rules, performing management functions for an audit client is prohibited, including acting temporarily or permanently as a director, officer, or employee of an audit client, or performing any decision-making, supervisory, or ongoing monitoring function.

The release makes clear the Commission's belief that auditors do not impair their independence when they:

- Obtain an understanding of an audit client's internal accounting and risk management controls
- Assess the effectiveness of an audit client's internal accounting and risk management controls
- Make suggestions for improvements in the design and implementation of both internal controls and risk management controls

The release states that designing and implementing internal controls is prohibited because it involves decision making and is clearly different from obtaining an understanding of internal controls and testing their operation—activities that are integral parts of an audit.

HUMAN RESOURCES

Restrictions on human resource functions are unchanged from prior rules. Providing human resource services, such as recruiting, negotiating for the client, and recommending or advising a client to hire a specific person for a specific job, continues to be prohibited.

BROKER-DEALER, INVESTMENT ADVISER, OR INVESTMENT BANKING SERVICES

Acting as a broker-dealer (whether registered or unregistered), promoter, or underwriter on behalf of an audit client is prohibited under the rule. Furthermore, making investment decisions on behalf of an audit client or otherwise having discretionary authority over a client's investments, having custody of a client's assets, and similar activities are also prohibited.

LEGAL SERVICES

Under the rule, providing any service to an audit client that can be provided only by an attorney is prohibited. This provision is broader than the prior rules, which limited this prohibition to services that required an individual to be "admitted to practice before the courts of a United States jurisdiction."

The rule will prohibit many legal services that were formerly permitted in non-U.S. jurisdictions, such as legal services that involve immaterial matters or are of a routine or ministerial nature.

At the same time, the release conveys the Commission's intent not to prohibit foreign accounting firms from providing services that an accounting firm in the United States may provide. An example of such a situation occurs in France, which requires individuals to be attorneys in order to provide tax services.

EXPERT SERVICES

The rule adds expert services to the list of prohibited non-audit services, as required by the Act. The rule prohibits an auditor from providing expert opinions or other expert services either to an audit client or to an audit client's legal representative for the purpose of advocacy in litigation or in regulatory or administrative investigations or proceedings.

The rule makes clear that an auditor may provide factual accounts of work performed by the auditor and may explain positions that the auditor may have taken or the conclusions that were reached in connection with any service provided to an audit client. Services to counsel engaged by an audit client in connection with, or in anticipation of, litigation are prohibited.

The release language clarifies that while many types of services provided by an auditor could potentially be viewed as "expert services," this prohibition applies only to services involving advocacy in proceedings and investigations, and does not apply to permitted non-audit services such as tax services. Therefore, tax services involving IRS examinations, tax appeals, ruling requests,

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etc., are permitted. However, consistent with current independence requirements, the release also indicates that representing an audit client in tax court is prohibited.

The rule permits an auditor to assist an audit committee in its responsibilities. In this regard, the rule permits an auditor to perform internal investigations, forensic services, or fact-finding services on behalf of an audit committee or the audit committee's legal representative. Once completed, the auditor may allow his or her work product to be used by the audit client and its counsel. However, if litigation or other proceedings subsequently commence, further services of this nature are prohibited.

As part of the audit, the auditor may investigate a matter that could involve fraud. If, during the course of this engagement, litigation or a regulatory investigation commences, the auditor may complete the engagement as long as he or she does not become subject to the direction or influence of the audit client's legal counsel.

The rule also permits an auditor to provide his or her work product to the audit client or counsel in connection with litigation or for the purpose of explaining in court positions taken or conclusions reached by the auditor in performing professional services.

TRANSITION

The rule provides transition relief for any contract to provide the services described above for a period of up to 12 months after May 6, 2003. The transition applies to contracts in place prior to May 6, 2003, as long as the service was not prohibited under existing rules.

SECTION 202: PRE-APPROVAL REQUIREMENTS

Section 301 of the Act requires an audit committee to be directly responsible for the oversight of its auditors. A significant component of that role is the Act's requirement that an audit committee pre-approve all services provided by the auditor.

The pre-approval requirements apply to services provided by the principal auditors of an issuer and its subsidiaries. They do not extend to other affiliates of the issuer such as equity method "investees."

The SEC rule requires that all permissible non-audit services and all audit, review, and attest engagements be approved in either of the following ways before the auditor is engaged:

- The engagement is approved by the audit committee.
- The engagement is entered into pursuant to pre-approval policies and procedures.

The Commission's release makes it clear that it is equally acceptable for an audit committee to pre-approve services based on policies and procedures or on an engagement-by-engagement basis.

PRE-APPROVAL POLICIES AND PROCEDURES

The rule permits, but does not require, an audit committee to establish detailed policies and procedures for the pre-approval of services to be provided by the auditor. The rule requires that if such policies and procedures are adopted they be detailed as to the particular service.

For convenience, the audit committee may designate one or more independent audit committee members to pre-approve services. The pre-approval may be any time in advance of the service (there is no limit on the number of services that can be pre-approved at any one meeting), and such services should be reported to the audit committee at each of its scheduled meetings. However, the rule clearly prohibits the delegation of the pre-approval process to management.

DE MINIMIS EXCEPTION

A de minimis exception is provided in the rule; however, its use should be rare. The exception waives the pre-approval requirements for non-audit services that meet *all* of the following conditions:

- The aggregate amount of all such services is not more than 5 percent of the total amount of fees paid by the audit client

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to the accountant during the fiscal year in which the services are provided.

- Such services were not recognized as non-audit services by the entity at the time of the engagement.
- The services are promptly brought to the attention of the audit committee and approved prior to the completion of the audit.

POLICY DISCLOSURES

Disclosure of established pre-approval policies and procedures is required, along with other matters relating to auditor fees discussed below. The Commission expects these disclosures to address auditor independence oversight in a clear and concise manner and, if applicable, how application of the de minimis exception is monitored.

FEE DISCLOSURES

The final rule adopts required disclosures designed to give investors a better understanding of how audit committees are managing relationships with the independent auditor. The rule requires disclosure by the issuer of fees billed by the principal accountant in four categories:

- Audit
- Audit-related
- Tax
- All other

The fee disclosures must include each of the two most recent years, instead of the one-year requirement in the prior rules. Additionally, the issuer is required to describe, in qualitative terms, the types of services provided under all categories, other than audit services, and the percentage of fees for each category that were approved pursuant to the de minimis pre-approval exception.

AUDIT SERVICES

"Audit" fees include those necessary to perform the generally accepted auditing standards (GAAS) audit and quarterly reviews of the issuer's consolidated financial statements. "Audit" fees also include fees for review of the tax provision and for accounting consultations on matters reflected in the financial statements.

Audit fees should also include audit or other attest services required by statute or regulation (foreign or domestic), such as comfort letters, consents, reviews of SEC filings, statutory audits in non-U.S. locations, reports on an issuer's internal controls and procedures for financial reporting required under section 404, and statutory audits required by insurance regulators.

AUDIT-RELATED SERVICES

"Audit-related" fees include services that are traditionally performed by the auditor. These audit-related services include employee benefit plan audits, due diligence assistance, accounting consultation on proposed transactions, internal control reviews, and audit or attest services not required by statute or regulation.

TAX SERVICES

"Tax" fees include all tax services other than those included in "audit" and "audit-related." According to the SEC, this category would include fees for tax compliance, tax planning, and tax advice. Tax planning and tax advice encompass a diverse range of services, including assistance with tax audits and appeals, tax advice related to mergers and acquisitions, employee benefit plans, and requests for rulings or technical advice from taxing authorities.

ALL OTHER FEES

"All other" fees should include all other non-audit services.

EFFECTIVE DATE

The pre-approval requirements are effective for all new engagements that are entered into on or after May 6, 2003. Pre-approval policies and fees disclosures are effective for fiscal years ending after December 15, 2003, with early application encouraged. For issuers that file annual proxy or information statements, these disclosures should be made in that document. Domestic issuers may incorporate by reference the required disclosures into the annual report filed with the Commission. Other issuers that do not file annual proxy or information statements, should include the disclosures in the annual report they file with the Commission (e.g., Form 20-F).

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EXAMPLE FEE DISCLOSURES

The following table presents fees for professional audit services rendered by KPMG LLP for the audit of the Company's annual financial statements for 2002 and 2003, and fees billed for other services rendered by KPMG LLP.

	2002	2003
Audit fees	$300	$400
Audit-related fees (1)	$100	$110
Audit and audit-related fees	$400	$510
Tax fees (2)	$ 50	$ 60
All other fees (3)	$ 25	$ 20
Total fees	**$475**	**$590**

(1) Audit-related fees consist principally of fees for audits of financial statements of certain employee benefit plans and due diligence services.

(2) Tax fees consist of fees for tax consultation and tax compliance services.

(3) All other fees consist of fees for services for operational internal auditing.

The disclosure of the subtotal of "Audit and audit-related fees" and "Total fees" are permitted, but are not required.

SECTION 203: AUDIT PARTNER ROTATION

The aim of the audit partner rotation rules is to provide a "fresh look" to the audit engagement. The SEC rule implementing section 203 prohibits specified audit partners from providing audit services to an issuer for more than five (5) or seven (7) consecutive years, depending on the partner's role on the audit engagement. The transition provisions indicate that certain partners will first be affected for issuers' fiscal years beginning after May 6, 2003. U.S. partners subject to rotation, other than the lead and concurring partners, and non-U.S. partners subject to rotation, regardless of their role, will begin counting continuous years of service for issuers' fiscal years beginning after May 6, 2003 (i.e., a "new clock" starts with the fiscal year commencing after May 6, 2003).

SCOPE

The rule indicates that partner rotation requirements are applicable to an "audit partner." The following are included in the definition of audit partner:

- Lead audit partner
- Concurring partner
- Client service partner (those other partners who maintain "regular contact with management and the audit committee")
- Audit partners (excluding "specialty" partners) at the issuer (i.e., parent) level, who provide 10 or more hours of audit, review, or attest services
- Lead audit partners on significant subsidiaries (A significant subsidiary is defined as "a subsidiary of the issuer whose assets or revenues constitute 20% or more of the assets or revenues of the issuer's respective consolidated assets or revenues.")

AUDIT PARTNER DEFINED

An "audit partner" is any partner, principal, or shareholder who is a member of the audit engagement team who has responsibility for decision making on significant auditing, accounting, and reporting matters that affect the financial statements or who maintains regular contact with management and the audit committee.

The rule for partner rotation extends beyond the audit engagement to partners who serve on the engagement team that conducts the timely review of the registrant's interim financial information. The rule also extends to partners who conduct the attest engagement on management's report on internal controls that will be required under section 404 of the Act.

EXCEPTIONS

Numerous partners may participate in an audit in a support capacity. The rule does not apply to partners on subsidiaries that constitute less than 20 percent of the consolidated assets or revenues of the issuer. In addition, the rule does not apply to positions other than lead partners on subsidiaries that do meet the 20 percent test. "Specialty" partners are excluded from the definition of audit partner. The rule indicates "specialty partners are, among others, those partners who consult with others on the audit engagement during the audit, review, or attestation engagement regarding technical or industry-specific issues." Tax partners who review the tax provision and information risk management partners that provide assistance in the review of internal controls would be excluded from rotation. Partners in "national offices" who are consulted on technical matters are also excluded.

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ROTATION "TIME OUT" REQUIREMENTS

Current AICPA SEC Practice Section membership rules (not SEC rules) require lead audit partner rotation at least every seven years, followed by a two-year break in service. There were previously no rotation requirements for other partners, including the concurring partner.

The rule indicates that an accountant, including a registered public accounting firm, will not be deemed independent from an audit client unless certain rotation requirements have been followed.

To maintain independence, the lead and concurring partners must rotate after serving in a combination of either of these roles for five consecutive years and are subject to a five-year "time out" period after rotation. All other "audit partners" subject to the rotation requirements (lead audit partners on significant subsidiaries, audit partners at the issuer level, and client service partners) must rotate after seven years and be subject to a two-year "time-out" period.

The release provides that a partner could serve as the lead partner on a significant subsidiary or as a non-lead audit partner at the parent or issuer level for a period of time (e.g., two years) prior to becoming the lead partner on the engagement and still be able to serve in that lead role for five years before a "time-out" would be required, provided he or she does not exceed five years as the lead partner and does not exceed seven years in total.

For example, an audit partner may serve in a role other than lead partner or concurring partner for the 2005 and 2006 audits in order to become familiar with the issuer's operations. That same partner could be the lead partner for the 2007 to 2011 audits.

TRANSITION

The partner rotation requirements will begin to take effect for an issuer's first fiscal year beginning after May 6, 2003. For calendar-year issuers, the rotation requirements would begin to take effect with the 2004 first-quarter review.

The rotation requirements applicable to the lead partner are effective for the first fiscal year beginning after May 6, 2003. In determining when the lead partner must rotate, time served in the capacity of lead or concurring partner prior to May 6, 2003, is included.

For example, if a lead partner serves a calendar-year issuer and 2003 is that partner's fifth, sixth, or seventh year as lead partner for that audit client, he or she would be able to complete the 2003 audit. Rotation would be required for 2004.

To facilitate the process of staggering the rotation of the lead and concurring partners, the rotation requirements for the concurring partner are effective one year later than for the lead partner.

For example, if a concurring partner of a calendar-year issuer were in his or her fourth or greater year in that role in 2003, he or she would be able to serve in that capacity for the 2004 audit. Rotation would be required for 2005.

For other partners affected by the rotation rules, other than the lead and concurring partners, the rule is effective for the issuer's first fiscal year beginning after May 6, 2003. However, in determining the time served, the first fiscal year commencing after May 6, 2003, will constitute the first year of service for such partners. This provision provides these partners with a "new clock" for measuring years of service.

For example, a lead partner on a significant subsidiary with a calendar year-end, 2004 would constitute the first year in the seven-year rotation period, regardless of how many years he or she had previously served in that capacity.

Finally, an accommodation was also made for partners of non-U.S. firms. All partners of non-U.S. firms who are subject to rotation requirements will also receive a "new clock" as of the date rotation requirements take effect, regardless of their role on the audit.

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TRANSITION PROVISIONS	WHEN ROTATION REQUIREMENTS TAKE EFFECT	DETERMINING ACCUMULATED YEARS OF SERVICE
Lead audit partner	Issuer's fiscal year beginning after May 6, 2003	Includes time served prior to May 6, 2003
Concurring review partner	Issuer's fiscal year beginning after the first anniversary of May 6, 2003	Includes time served prior to May 6, 2003
Other partners subject to rotation, including all non-U.S. firm partners subject to rotation, regardless of role	Issuer's fiscal year beginning after May 6, 2003	The first fiscal year beginning after May 6, 2003, will constitute the first year of service; prior service is not counted

For example, for a partner in a non-U.S. firm who is serving as the lead partner for an issuer with a calendar year-end, 2004 would constitute the first year of the five-year rotation period without regard to the number of years he or she had previously served in that capacity. The table above summarizes these transition provisions.

COMPENSATION OF AUDIT PARTNERS

The Commission's rule on the compensation of audit partners focuses on the most senior members of the engagement team. The Act did not require the Commission to rule on audit partner compensation. The rule applies to the same group of audit partners who are subject to the rotation requirements in section 203.

The limitations on compensation apply during the entire "audit and professional engagement period," which is an extended period that generally begins when a new audit client is accepted (the earlier of (1) when the audit partner signs the engagement letter or (2) when audit procedures are first performed, including planning procedures) and ends with the filing of a Form 8-K notifying the Commission of the termination of the relationship.

While the rule does not specifically state that only direct compensation for "selling non-audit services" will be limited, that is the practical effect. The release indicates that an audit partner could receive distributions or other compensation from a "pool" attributed to the audit practice, a geographic unit comprising several services or offices, or the overall firm. In addition, the performance evaluation of an audit partner may include consideration of the overall management of a client relationship, which could include factors indirectly related to selling services (both audit and non-audit) to an audit client.

Although the rule applies only to "audit partners," the Commission expects that audit committees will consider the effect on independence if senior staff members on the audit engagement team are compensated for selling non-audit services to the client.

These compensation limitations are effective for an accounting firm's fiscal years beginning after May 6, 2003.

SECTION 204: AUDITOR REPORTS TO AUDIT COMMITTEES

Auditors are currently required by GAAS to communicate specified matters related to the conduct of an audit or review of interim information to those who have responsibility for oversight of the financial reporting process, which is commonly the audit committee. Both the AICPA and the SEC have mandated this requirement.

The rule requires additional annual communications and applies beginning on or after May 6, 2003. Early application of the communications is permitted. The AICPA's Auditing Standards Board is in the process of amending the auditing standards addressing communications with audit committees to consider the SEC rules.

Section 204 mandates specific information auditors must report to audit committees before the issuance of an audit report. The SEC has indicated its belief that the rule implementing section 204 largely codifies requirements under GAAS and that requiring certain communication prior to the filing of an audit report with the SEC will facilitate open dialogue between auditors and audit committees. Under GAAS, certain communications to the audit committee were required to occur in a timely manner, but not necessarily before the issuance of the auditor's report on the issuer's financial statements.

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REQUIRED COMMUNICATIONS

The rule requires that the auditor communicate to the audit committee:

- All critical accounting policies and practices used by the issuer in preparing its financial statements
- All alternative accounting and disclosure treatments of material financial information within generally accepted accounting principles (GAAP) that have been discussed with management, including the ramifications of the use of such alternative treatments and disclosures and the treatment preferred by the accounting firm
- Other material written communications between the accounting firm and management of the issuer

COMMUNICATIONS WITH AUDIT COMMITTEES REQUIRED BY GAAS

Existing professional standards, prior to the application of the new rule, provide that the following matters relative to the conduct of the audit be communicated:

- Methods used to account for significant unusual transactions
- Effects of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus
- Processes used by management in formulating particularly sensitive accounting estimates and the basis for the auditor's conclusions regarding the reasonableness of those estimates
- Material audit adjustments proposed and immaterial adjustments not recorded by management
- Auditor's judgments about the quality of the company's accounting principles
- Disagreements with management over the application of accounting principles, the basis for management's accounting estimates, and the disclosures in the financial statements

CRITICAL ACCOUNTING POLICIES AND PRACTICES

Auditors are currently required to ensure that the audit committee is informed of the client's significant accounting policies and any changes to those policies. The SEC's December 2001 Financial Reporting Release (FRR) No. 60, *Cautionary Advice Regarding Disclosure About Critical Accounting Policies*, defines "critical accounting policies" as those accounting policies "that are both most important to the portrayal of the company's financial condition and results and require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain."

In addition, FRR No. 60 describes the audit committee's and management's involvement with critical accounting policies as follows:

> "Prior to finalizing and filing annual reports, audit committees should review the selection, application and disclosure of critical accounting policies. Consistent with auditing standards, audit committees should be apprised of the evaluative criteria used by management in their selection of the accounting principles and methods. Proactive discussions between the audit committee and the company's senior management and auditor about critical accounting policies are appropriate."

The SEC's May 2002 proposed rule, Disclosure in Management's Discussion and Analysis About Application of Critical Accounting Policies, describes a "critical accounting estimate" as:

> "An accounting estimate recognized in the financial statements (1) that requires the registrant to make assumptions about matters that are highly uncertain at the time the accounting estimate is made and (2) for which different estimates that the company reasonably could have used in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, would have a material impact on the presentation of the registrant's financial condition, changes in financial condition or results of operations."

The final rule implementing section 204 does not require that discussions with the audit committee, either orally or in writing, follow a specific form. However, the Commission expects that these disclosures will include, at a minimum, the reasons why estimates or policies meeting the criteria in FRR No. 60 are, or are not, considered critical and how current and anticipated future events affect those determinations. In addition, a qualitative assessment of management's disclosures along with any proposed modifications by the accountants that were not included in the annual report should be communicated.

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ALTERNATIVE ACCOUNTING TREATMENTS

The rule requires communication, either orally or in writing, by auditors to audit committees of (1) alternative accounting treatments permitted by GAAP, (2) policies and practices related to material items that have been discussed with management, including the ramifications of the use of such alternative treatments and disclosures, and (3) the treatment preferred by the accounting firm. The release states that the communication must cover recognition, measurement, and disclosure considerations related to the accounting for specific transactions as well as general accounting policies. Communication requirements regarding alternative accounting treatments are limited to matters material to the issuer's financial statements.

Communications regarding specific transactions must identify the underlying facts, financial statement accounts affected, and applicability of existing corporate accounting policies to the transactions. In addition, if the accounting treatment proposed does not comply with existing corporate accounting policies or if an existing corporate accounting policy is not applicable, the communication should explain why the existing policy was not appropriate or applicable and discuss the basis for selecting the alternative policy.

Regardless of whether the accounting policy selected is new, the communication should address the entire range of alternatives available under GAAP that management and the auditors discussed along with management's reasons for not selecting those alternatives. If the accounting treatment selected is not, in the auditor's opinion, the preferred method, the communication should address the reasons management gave for not selecting the method preferred by the auditor.

Communications regarding general accounting policies should focus on the initial selection of and changes in significant accounting policies and should include the effect of management's judgments and accounting estimates, as well as the auditor's judgments about the quality of the company's accounting principles. These discussions should include the range of alternatives available and the rationale for the policy selected by management.

OTHER MATERIAL WRITTEN COMMUNICATIONS

Material written communications that were provided to management by auditors should be provided to audit committees as well to facilitate their oversight role. The kinds of communications include:

- Schedule of unadjusted audit differences
- Management representation letter
- Reports on observations and recommendations on internal controls
- Engagement letter
- Independence letter

This list is not exhaustive, and the SEC encourages auditors to critically consider what additional written communications should be provided to audit committees.

TIMING

Communications with the audit committee are required to occur prior to the filing of the issuer's annual report (i.e., Form 10-K, 20-F) with the SEC. As a result, communications will occur at least annually, but the audit committee and auditor may arrange for communications to occur as frequently as quarterly in connection with an auditor's timely review of quarterly information or on a real-time basis. These communications are required to occur prior to filing registration statements and other periodic or current reports when audit reports are included in the filings.

SECTION 205: CONFORMING AMENDMENTS

Section 205 amends the Exchange Act to conform it to the provisions that were added and changed by the Sarbanes-Oxley Act. These amendments principally define the term "audit committee" and "registered public accounting firm" in section 3(a) of the Exchange Act, and replace "independent public accountant" with "a registered public accounting firm" and "the accountant" with "such firm" in section 10A of the Exchange Act.

The terms are defined in the Glossary.

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SECTION 206: CONFLICTS OF INTEREST

A goal of the Act is to ensure that relationships created by employment of audit engagement personnel in key roles in the company do not compromise auditor independence and, thereby, negatively affect audit quality. Section 206 states that it is unlawful for a registered firm to perform audits for an issuer if specified senior officers were previously employed by the accounting firm and participated as an audit engagement team member in any capacity in the issuers audit in the one-year period preceding the initiation of the audit (the "cooling-off" period). While the Act applied the cooling-off period to employees of a registered public accounting firm who participated in any capacity in the audit, the final rule further defines the concept in its definition of the "audit engagement team."

The rule leaves in place the current independence requirements relating to former partners or professionals of an accounting firm who become employed by, or otherwise associated with, an audit client in specified roles. Those rules require the termination of all financial relationships between former partners and former professionals and the audit firm and the elimination of any continuing influence over the audit firm's operations prior to becoming employed by a client in specified roles.

AUDIT ENGAGEMENT TEAM

The term audit engagement team means all partners (or person in an equivalent position) and professional employees participating in an audit, review, or attestation engagement of an audit client. This provision applies to the following members of the "audit engagement team" of the issuer (or, for most clients, at the parent-company level):

- The lead audit engagement partner
- The concurring partner
- Any other member of the audit engagement team who provided more than 10 hours of audit, review, or attest services for the issuer within the one-year period preceding the commencement of the audit of the current year's financial statements (e.g., tax personnel who review the tax provision and information risk management personnel who assist in the review of internal controls).

The 10-hour exception was adopted based on the recognition that engagement team members who devote a minimal number of hours to an audit engagement do not develop relationships with client management during their limited involvement.

FINANCIAL REPORTING OVERSIGHT ROLE

The Act stipulates that the cooling-off period applies to specific corporate positions: chief executive officer, controller, and chief financial and accounting officers, and those employed in an equivalent position.

The final rule issued by the SEC uses the more encompassing term "accounting role or financial reporting oversight role" to describe the employment role that requires a cooling-off period. The "financial reporting oversight role" refers to the position held by any individual who has direct responsibility to oversee those who prepare the issuer's financial statements and related information (e.g., MD&A) that are included in filings with the Commission. A person in a financial reporting oversight role influences, or is in a position to influence, the contents of financial statements or anyone who prepares the financial statements.

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The rule is broader than the requirements of the Act because it expands the number of positions at a client that would require a "cooling-off period." The new requirement includes the following 11 positions at an issuer or any equivalent position:

- Member of the board of directors
- Chief executive officer
- President
- Chief financial officer
- Chief operating officer
- General counsel
- Chief accounting officer
- Controller
- Director of internal audit
- Director of financial reporting
- Treasurer

The cooling-off period does not apply if the engagement team member takes a position with an audit client that does not meet the definition of a "financial reporting oversight role."

DEFINITION OF COOLING-OFF PERIOD

Under the rule, the issuer may not employ a member of the audit engagement team during the one-year period preceding the date that audit procedures commenced. An audit firm is deemed to begin the current-year audit on the day after the audit client has filed its annual report with the Commission for the prior year. In effect, a member of the audit engagement team who participated on any portion of the current year audit, including quarterly reviews, may not become employed by the audit client in a financial reporting oversight role without impairing independence until the succeeding year's audit is completed and the Form 10-K or equivalent is filed. Thus, in most situations the cooling-off period will be longer than one year.

For example, assume an engagement period begins on March 16, 2003 (the next day after the 2002 Form 10-K is filed). The 2003 Form 10-K is filed on April 5, 2004. Also assume that the 2004 Form 10-K is filed March 10, 2005. If an audit engagement team member provided audit, review, or attest services for an issuer at any time during the 2003 engagement period (March 16, 2003 to April 5, 2004), and he or she begins employment with that issuer in a financial reporting oversight role prior to March 11, 2005, the accounting firm would be deemed not to be independent with respect to that issuer.

APPLICABILITY TO SUBSIDIARY TEAM MEMBERS AND OTHER SITUATIONS

The rule applies only to positions at the issuer level and does not extend to affiliates or subsidiaries of the issuer. Although the SEC considered replacing issuers with the broader term "audit clients," it recognized the difficulty in monitoring and controlling such a potentially broad scope and concluded that no significant threat to independence exists beyond the issuer.

In addition, employment relationships involving former audit firm personnel who become employed at the issuer in a financial reporting oversight role as a result of business combinations are grandfathered, provided the audit committee is aware of the prior relationship with the accounting firm and provided the employment is not in contemplation of the business combination. The rule also provides for emergency or unusual circumstances that are expected to be rare. Again, the audit committee must be made aware of such situations and believe that the use of the exception is in the best interest of investors.

TRANSITION

The rule applies to new employment relationships entered into on or after May 6, 2003. Employment relationships existing before May 6, 2003, are grandfathered.

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SECTION 207: STUDY OF MANDATORY ROTATION OF REGISTERED PUBLIC ACCOUNTING FIRMS

Section 207 directs the General Accounting Office to study the potential costs and benefits of requiring the mandatory rotation of registered public accounting firms. Mandatory rotation of firms refers to a prescribed limit on the period of years in which a particular registered public accounting firm may be the auditor of record for a particular issuer. Although Congress enacted mandatory partner rotation rules in section 203, lawmakers believed that the merits of mandatory rotation of audit firms warranted further study.

Congress chose to do this study after Senate testimony revealed a broad divergence of opinion on the potential costs and benefits of mandatory rotation of firms. The study is due no later than July 30, 2003.

SECTION 208: COMMISSION AUTHORITY

This section authorized and required the SEC to issue regulations to “carry out” Title II’s provisions within 180 days of enactment, January 26, 2003, which resulted in the SEC’s issuance of rules and regulations implementing Title II.

Section 208 also makes it unlawful for any registered public accounting firm (or associated person) to prepare or issue any audit report with respect to any issuer, if the firm or associated person is not independent.

SECTION 209: CONSIDERATIONS BY APPROPRIATE STATE REGULATORY AUTHORITIES

The SEC did not intend that state boards of accountancy or other state regulators base their rules on the Act’s provisions. Indeed, the Act does not change state regulation of accounting firms, whether or not the firm is registered pursuant to section 102 of the Act. Titles I and II of the Act apply only to accounting firms that audit public companies; they are not applicable to audits of private companies. Section 209 directs state regulators to determine independently whether the Act’s standards should be applied to non-registered public accounting firms. The State of California, for example, has already enacted several new laws governing the activities of auditors practicing in that state. The State of New York is also considering new laws as a result of the Act. Moreover, a number of professional and industry groups are now reviewing the Act to determine how rules that are designed to enhance the reliability of financial reporting by public companies could potentially be applied to private companies.

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TITLE III
CORPORATE RESPONSIBILITY

Title III imposes new responsibilities on all corporate participants in the financial reporting process. It requires auditors to report directly to the audit committee, obligates audit committees to perform specified tasks, mandates that management formally acknowledge its participation in the financial reporting process, and imposes civil penalties on those who knowingly falsify financial statements. An issuer's failure to comply with the audit committee independence requirements would lead to delisting.

Title III contains provisions that:

- Give the audit committee the responsibility to appoint, compensate, and oversee the registered firm that performs the issuer's audit
- Compel an issuer's officers to certify the truth of financial reports
- Outlaw improperly influencing an auditor
- Provide mechanisms for the return of ill-gotten gains by executives to benefit those who were harmed
- Bar officers and directors from trading a company's stock during pension-fund blackout periods
- Strengthen SEC rules that can bar certain individuals from serving as an officer or director of an issuer
- Establish rules of professional responsibility for attorneys

SECTION 301: PUBLIC COMPANY AUDIT COMMITTEES

Section 301 addresses the following areas of audit committee responsibilities:

- Relationships to auditors
- Audit committee independence
- Procedures to address complaints regarding accounting, internal accounting controls, or auditing matters
- Authority and funding to hire advisers

Companies not in compliance with the SEC's requirements for audit committees are subject to delisting by the national securities exchange or association.

The Act defines an audit committee as a committee (or equivalent body) established by and composed of members of an issuer's board of directors to oversee the accounting and financial reporting processes and audits of the financial statements. If the issuer does not establish such a committee, the entire board of directors serves in that capacity. Designating the entire board as the committee for purposes of the Act's obligations could provide issuers with an incentive to create audit committees of the board, particularly given the extent of the obligations.

RELATIONSHIPS TO AUDITORS

The Act requires an audit committee to be directly responsible for the appointment, compensation, and oversight of the registered firm's work, including the resolution of disagreements over financial reporting between management and its auditor.

The SEC's proposal to turn these requirements into rules adds the word "retention" to the Act's list of audit committee responsibilities to make explicit that hiring authority includes firing authority.[1] In addition, the proposal states that the requirement would apply not only to the financial statement audit but also to related work and other audit or attest services, such as services performed to attest to management's assertion on internal controls and procedures for financial reporting proposed under section 404. If company bylaws or home-country regulations require shareholder ratification of the independent auditor, the audit committee would issue the nomination or provide the recommendation.

Section 301 does not give the audit committee explicit authority over internal auditors, but the SEC's proposal asks whether audit committees should be required to exercise the same authority over internal auditors as over independent auditors.

1 SEC Release No. 33-8173, Proposed Rule: Standards Relating to Listed Company Audit Committees, January 8, 2003. The Act requires the Commission to adopt final rules no later than April 26, 2003. Comments on the proposed rule are due by February 18, 2003.

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AUDIT COMMITTEE INDEPENDENCE

An audit committee member must be independent. The SEC's proposed independence requirements add detail to the Act's provisions by focusing on the audit committee member's compensation and the concept of an "affiliated person." The proposal distinguishes between investment companies and other issuers and contains exemptions.

COMPENSATION

Audit committee members of non-investment company issuers would not be independent if they accepted, directly or indirectly, any consulting, advisory, or other compensatory fee from the issuer apart from that associated with their roles as members of the board of directors and its committees.

Payments to a spouse or specified family members would be indirect acceptance of a payment, as would payments to an entity (1) in which the director is a partner, member, or principal or occupies a similar position and (2) which provides accounting, consulting, legal, investment banking, financial, or other advisory services to the listed issuer. Payments made to all shareholders, such as dividends, would not be prohibited by these provisions.

The SEC's proposal notes that the existing and proposed rules of organizations that set listing requirements, such as the New York Stock Exchange and National Association of Securities Dealers, restrict a broader range of business and personal relationships between audit committee members and the issuer in the interests of independence. In particular, the Commission notes that the proposal would not preclude a conclusion that an audit committee member is independent based on ordinary-course commercial business relationships, whereas these other organizations may preclude such a conclusion.

SAFE HARBOR

A non-investment company audit committee member who is an affiliated person of the issuer or any of its subsidiaries, apart from his or her capacity as a member of the board of directors and any board committee, also would not be independent. An affiliated person is someone who directly, or indirectly through an intermediary, controls the issuer, is controlled by it, or along with the issuer is under common control.

The proposal adds a safe harbor presumption that a person who is not an executive officer, director, or 10 percent shareholder of the issuer would not be considered a controlling party. A director, executive officer, partner, member, principal, or designee of an affiliate would be considered an affiliated person, but serving on a controlled subsidiary's board of directors does not violate a director's independence under certain circumstances.

IPO EXCEPTION

Recognizing the difficulty of appointing independent audit committee members before a company has gone public, the proposed rule would exempt one audit committee member from the independence requirements for 90 days after the effective date of a company's initial registration statement. This provision would permit, for example, a venture capital firm to continue to have representation on the audit committee during the IPO process.

PENDING PROPOSAL COMMENTS

The final scope of the SEC's proposals on independence could expand. The SEC requested comments on whether (1) to extend independence tests to "look back" periods before a member's appointment to the audit committee, (2) to extend prohibited payments to relationships in the ordinary course of business, (3) to modify "safe harbor" tests, and (4) to change the exemption period for initial registrations.

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PROCEDURES TO ADDRESS COMPLAINTS

The proposed rule implementing section 301 requires audit committees to establish procedures to receive, retain, and treat complaints from employees and others about accounting, internal accounting controls, or auditing matters. The procedures established must address "whistleblower complaints" by establishing for "the confidential, anonymous submission by employees…of concerns regarding questionable accounting or auditing matters." This proposal would enable employees and others to take their concerns directly to the audit committee with the knowledge that procedures were in place to act on their complaints.

The SEC's proposal does not go beyond the Act's language on this requirement. However, the proposing release's questions to respondents suggest that the final rule might go further. The release asks whether the SEC should prescribe more detailed procedures and whether an issuer's procedures should be disclosed.

AUTHORITY AND FUNDING TO HIRE ADVISERS

The proposed requirement recognizes that audit committees may not be equipped to address all accounting, financial reporting, and legal matters. Accordingly, it grants the audit committee the authority to hire advisers to help carry out its duties.

The proposed rule would require the company to provide the audit committee with funds to pay the registered firm as well as any outside advisers. The proposal states that the funding necessary is to be determined by the audit committee.

THE THREAT OF DELISTING

The Act requires the SEC to direct the national securities exchanges and association to prohibit the listing of any company not in compliance with the SEC's requirements for audit committees. Under the SEC's proposal, listed companies would be required to notify the relevant exchange or association promptly when an executive officer becomes aware of a material noncompliance. The proposal also directs the exchanges and association to establish procedures to give issuers an opportunity to correct problems that would be a basis for delisting their securities or prohibiting their listing.

The new listing requirements would become operative no later than one year from the publication of the SEC's final rule in the *Federal Register*. The exchanges and association would have to submit proposals to the SEC for their compliance with the final rule within 60 days of its publication in the *Federal Register*, with another 210 days permitted before the Commission must approve a version of the submitted proposal. The SEC rule is expected to be adopted by April 2003.

Both the proposal and comments made during the SEC's open meeting suggest that the proposed rule is meant to set a "baseline" for audit committees and that the SEC expects the exchanges and association to add regulations and information on implementation and enforcement.

APPLICABILITY

The proposed requirements would apply to both U.S. and foreign private issuers with listed securities. All classes of listed securities would be covered. See Appendix A for a discussion of the SEC's proposed section 301 requirements for investment companies.

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EXEMPTIONS

The proposal contains specific exemptions from the audit committee independence requirements. The exemptions include a temporary exemption subsequent to initial registration, holding company and majority-owned subsidiary relationships in certain cases, and the unique circumstances faced by foreign private issuers. Listings of non-equity securities by consolidated majority-owned subsidiaries of the issuer subject to the requirements would also be exempt, as would certain securities that represent futures products and standardized options. Multiple listings by the same issuer would not be covered if a class of common equity or similar securities already caused the issuer to be subject to the proposed requirements.

EXEMPTIONS IN THE SEC'S PROPOSAL FOR FOREIGN PRIVATE ISSUERS

The exemptions would permit audit committee members to include (1) employees who are not executive officers if they are elected or named based on local legal or listing requirements, (2) one foreign government member, and (3) one non-voting, non-chair member with observer status who is a shareholder or representative of a shareholder or group owning more than 50 percent of the voting securities. The foreign government representative and the more-than 50 percent shareholder representative cannot be executive officers and both are subject to the prohibitions on compensatory fees.

In the case of two-tier boards of directors, the term "board of directors" would apply to the supervisory or non-management board, which could either form an audit committee or designate the entire board as the audit committee, if its members are independent under the rules. In addition, the audit committee's responsibility to oversee the audit could be performed by boards of auditors or statutory auditors out of respect for that practice in some countries.

DISCLOSURE

All issuers, including non-listed issuers, would have to disclose in their proxy reports whether their audit committee members are independent. If the entire board were acting as an issuer's audit committee, the independence disclosure would have to address all members of the board. Listed companies would use the definition of independence from the applicable listing standards. Non-listed companies would make the disclosure by choosing a definition from any adopted by a national securities exchange or association and approved by the Commission and identifying which independence definition was used.

Companies that use any of the exemptions proposed in the SEC release, other than the multiple-listing exemption, would have to disclose that fact. Additionally, the disclosure must include their assessment of whether and (if so) how the exemption would materially adversely affect the audit committee's performance in relation to its obligations. The disclosure would appear in proxy filings and, at least by reference, in annual report filings.

SECTION 302: CORPORATE RESPONSIBILITY FOR FINANCIAL REPORTS

About a month after the Act became law, the Commission issued rules to implement the section 302 requirements.[2] Therefore, since August 29, 2002, certifications by principal executive and financial officers have been required in the periodic reports of U.S. and foreign public companies, that is, annual and interim period reports. The certifications pertain to the content of each report and to a company's system of controls designed to enable it to meet its periodic disclosure obligations. A separate certification is required for each principal officer, and the certifications must use the exact wording prescribed in the rules.

The rules require these principal executive and financial officers to certify that the report is accurate, complete, and fairly presented and to take responsibility for maintaining and evaluating the issuer's "disclosure controls and procedures." The certifications affirm that the officers have made required disclosures to the independent auditors and to the audit committee about fraud and about significant deficiencies and material weaknesses in internal controls. The officers must also affirm that they have disclosed their evaluations of the effectiveness of the "disclosure controls and procedures" and must indicate whether there have been significant changes in the internal controls or in factors that might significantly change them.

2 SEC Release No. 34-46427, Final Rule: Certification of Disclosure in Companies' Quarterly and Annual Reports, August 29, 2002.

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The certification requirements, which are summarized below, are very specific and introduce several new terms and concepts.

CERTIFYING PERIODIC REPORTS

In every periodic report filed with the SEC, each principal executive and financial officer must affirm, based on his or her knowledge, that the report is accurate and complete and the financial statements and other financial information are, in all material respects, fairly presented.

For purposes of the certifications, the term "financial statements and other financial information" includes the financial statements (including note disclosures), selected financial data, management's discussion and analysis of financial condition and results of operations (MD&A), and other financial information in the report.

CONTENTS OF SECTION 302 CERTIFICATION

In every periodic report filed for periods ending on or after August 29, 2002, each principal executive officer or officers and principal financial officer or officers must affirm:

(1) He or she has reviewed the report being filed;

(2) Based on his or her knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the report;

(3) Based on his or her 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 periods presented in the report;

(4) He or she and the other certifying officers are responsible for establishing and maintaining "disclosure controls and procedures" (as the term is defined in paragraph (c) of Rules 13a-14 and 15d-14) for the issuer and have:

- (i) Designed the disclosure controls and procedures to ensure that material information relating to the issuer, including its consolidated subsidiaries, is made known to them by others within those entities, particularly during the period in which the periodic reports are being prepared;
- (ii) Evaluated the effectiveness of the issuer's disclosure controls and procedures as of a date within 90 days prior to the filing date of the report (the "Evaluation Date"); and
- (iii) Presented in the report their conclusions about the effectiveness of the disclosure controls and procedures based on their evaluation as of the Evaluation Date;

(5) He or she and the other certifying officers have disclosed, based on their most recent evaluation, to the issuer's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent functions):

- (i) All significant deficiencies in the design or operation of internal controls that could adversely affect the issuer's ability to record, process, summarize, and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and
- (ii) Any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and

(6) He or she and the other certifying officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their most recent evaluation, including corrective actions with regard to significant deficiencies and material weaknesses.

The concept of "fair presentation" used in the certifications goes beyond the notion of fair presentation in accordance with GAAP. In the SEC's view, a "fair presentation" of an issuer's financial statements and other financial information encompasses:

- The selection of appropriate accounting policies
- Proper application of appropriate accounting policies
- Disclosure of financial information that is informative and reasonably reflects the underlying transactions and events
- The inclusion of any additional disclosures necessary to provide investors with a materially accurate and complete picture of an issuer's financial condition, results of operations, and cash flows

DISCLOSURE CONTROLS AND PROCEDURES

The term "disclosure controls and procedures" refers to controls and procedures designed to ensure that the issuer has the financial and non-financial information required to meet its reporting obligations under the Exchange Act. The rule requires that issuers establish and maintain an overall system of disclosure controls and procedures so their principal executives and financial officers can supervise and review periodic evaluations of disclosure controls and procedures and report the results to security holders.

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The adopting release noted that failure to maintain adequate disclosure controls and procedures, review them, and otherwise comply with the certification rules could be subject to Commission actions even if the failure did not lead to flawed disclosure.

These certification requirements are intended to complement, not replace, existing requirements for issuers to establish and maintain systems of internal controls with respect to their financial reporting obligation.

Disclosure controls and procedures are broader than internal controls over financial reporting. They should ensure timely collection and evaluation of information potentially subject to filing disclosure requirements. The disclosure controls and procedures should capture information that is relevant to management's assessment of the need to disclose developments and risks that pertain to the issuer's businesses.

Disclosure controls and procedures should also cover information that must be evaluated in the context of the disclosure requirements of Exchange Act Rule 12b-20, which states, "[I]n addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading."

EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES

The principal executive and financial officers bear ultimate responsibility for designing, establishing, maintaining, reviewing, and evaluating the issuer's disclosure controls and procedures. The rules require the issuer, under the supervision of the principal executive and financial officers, to evaluate the effectiveness of the issuer's disclosure controls and procedures within 90 days prior to the filing date of any quarterly or annual report. The issuer's senior officers are responsible for determining the extent of procedures to be performed and documentation of such procedures.

The SEC did not provide detailed procedures for the evaluation of disclosure controls and procedures. The rule states that each issuer should develop an evaluation process that is consistent with its business and internal management and supervisory practices.

The release recommends that issuers create a separate committee to consider the materiality of potential disclosure information and determine disclosure obligations on a timely basis. The committee should report to senior management, including the principal executive and financial officers.

DISCLOSURE OF SIGNIFICANT CHANGES

Periodic reports must disclose significant changes in, or factors that could affect, an issuer's internal controls subsequent to the date of the most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses in internal controls.

APPLICABILITY

The certification and disclosure requirements apply to annual and quarterly reports, to amendments of such reports, and to transition reports relative to a change in fiscal year.

The certification requirements do not apply to annual reports on Form 11-K or to current reports on Form 8-K or Form 6-K. However, the SEC requires that disclosure controls and procedures be designed, maintained, and evaluated to ensure full and timely disclosure of matters required in current reports, as well as definitive proxy materials and definitive information statements, even though there are no specific certification requirements relating to reports on those forms.

SECTION 302: CERTIFICATION LOGISTICAL MATTERS

- The final rule amends Exchange Act requirements to include the certifications immediately after the signature sections of the reports.
- An officer required to certify may not permit the certification to be signed on his or her behalf pursuant to a power of attorney or other form of confirmed authority.
- The certification is in addition to, and does not alter, the current signature requirements for quarterly and annual reports filed under the Exchange Act.
- A separate certification is required for each principal officer.

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ISSUERS AFFECTED

The rule applies to principal executive and financial officers of any issuer who files quarterly and annual reports under the Exchange Act, including:

- Banks and savings associations
- Small business issuers
- Asset-backed securities issuers
- Certain foreign private issuers
- Business development companies and face-amount certificate companies
- Registered management investment companies and registered unit investment trusts

Appendix A describes the effect of the rule on investment companies.

DISTINCTION BETWEEN SECTION 302 AND SECTION 906 CERTIFICATIONS

The certifications required by section 302 are separate from those required under Title IX, section 906. Under section 906, which was effective July 30, 2002, CEOs and CFOs are required to certify that financial statements comply with SEC reporting rules and that the financial statements fairly represent the company's financial condition and results of operations. Section 906 requires separate certifications by the chief executive(s) and financial officer(s) and provides specific penalties for false certification.

The SEC has discussed with the Department of Justice whether the certifications required under sections 302 and 906 can be combined, but no resolution has been announced as of the date of publication.

EFFECT OF PROPOSED RULE IMPLEMENTING SECTION 404

Section 404 requires management to assess the effectiveness of the issuer's "internal control structure and procedures for financial reporting" with respect to each annual report. The assessment reported by management must be the subject of an attestation report by the issuer's external auditor. The SEC's proposed rule implementing section 404 would amend the section 302 final rule described above.[3] See Title IV for a description of the proposed rule implementing section 404.

SECTION 303: IMPROPER INFLUENCE ON CONDUCT OF AUDITORS

This section makes it unlawful for any officer or director, or any person acting under their direction, to fraudulently influence, coerce, manipulate, or mislead an issuer's auditor engaged in the audit of its financial statements for the purpose of rendering the financial statements materially misleading.

The rules will supplement existing Exchange Act rules that make it unlawful to falsify books and records, make false or misleading statements, or omit making complete statements to auditors.

The implementing rules proposed by the SEC apply to the audit of the annual financial statements, the review of interim financial statements, and the issuance of consents to the use of an auditor's report in a SEC filing.[4] Final rules are expected to be issued by April 26, 2003.

3 SEC Release No. 34-46701, Proposed Rule: Disclosure Required by Sections 404, 406, and 407 of the Sarbanes-Oxley Act of 2002, October 22, 2002.
4 SEC Release No. 34-46685, Proposed Rule: Improper Influence on Conduct of Auditors, October 18, 2002

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SCOPE OF PERSONS COVERED

The Exchange Act defines "officer" to include the company's president, vice president, secretary, treasurer or principal financial officer, comptroller or principal accounting officer, and any person routinely performing corresponding functions with respect to any incorporated or unincorporated organization. The proposal interprets the term "officer" to include an issuer's chief executive officer and other executive officers. In this context, "other executive officers" means president; vice president of a principal business unit, division, or function; and any other officer or person who performs a policy-making function. Executive officers of subsidiaries are considered executive officers of the issuer if they perform policy-making functions for the issuer.

The proposed rule, like the Act, applies to the activities of any persons acting under the direction of an officer or director of the issuer. The SEC has indicated that it interprets the term "direction" in the Act to encompass behavior broader than "supervision." It could include the behavior not only of the issuer's employees but also of its customers, vendors, or creditors who, under the direction of an officer or director, provide false or misleading information to auditors, such as completing a false audit confirmation. Persons acting under the direction of officers and directors may also include partners or employees of the issuer's accounting firm, attorneys, securities professionals, or other advisers.

CONDUCT COVERED

The SEC proposal lists the following types of improper influence:

- 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 auditor objects to the company's accounting
- Blackmailing
- Making physical threats

The SEC notes that "the facts and circumstances of each case, including the purpose of the conduct, would be relevant to determine if conduct would violate the proposed rule." The application of the rule would not depend on whether the conduct actually succeeds in affecting the audit or review. There is no requirement that the purpose of the improper conduct be achieved.

CONDUCT ACTIONABLE UNDER SECTION 303

The Act uses the phrase "for the purpose of rendering such financial statements misleading" to describe conduct actionable under section 303. The Commission is proposing alternative wording: "[A]n officer, director, or person acting under the direction of the officer who engaged in conduct to improperly influence an auditor would be culpable if he or she knew, or was unreasonable in not knowing, that the improper influence could, if successful, result in rendering financial statements materially misleading."

It would constitute improper influence to attempt to influence an auditor to:

- Issue an inappropriate auditor's report on the financial statements
- Not perform audit, review, or other procedures required by GAAS or other professional standards that, if performed, might divulge material misstatements in the financial statements
- Not withdraw a previously issued audit report when required by GAAS
- Not communicate matters to the audit committee

PERIOD COVERED FOR CONDUCT DIRECTED AT AUDITORS

The proposed rules would apply throughout the professional engagement and any other time the auditor is called upon to make decisions regarding an issuer's financial statements after the professional engagement has ended. This period includes the time during which an auditor is considering whether to consent to the use, reissuance, or withdrawal of prior audit reports. The proposal uses the term "engaged in the performance of an audit" to describe this period.

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SECTION 304: FORFEITURE OF BONUSES AND PROFITS

The provisions of this section were developed to prevent executives from retaining profits from selling their company stock or receiving a bonus or other profit, if they have misled the public about the financial health of the company.

Section 304's forfeiture provisions apply "if an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws." In that event, the chief executive(s) and financial officer(s) must reimburse the issuer for:

- Any bonus or other incentive-based or equity-based compensation received during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the non-compliant financial document
- Any profits they realized from the sale of issuer securities during that 12-month period

Issuers should consult legal counsel for guidance on the provisions of section 304, which became effective July 30, 2002.

SECTION 305: OFFICER AND DIRECTOR BARS AND PENALTIES

Courts have historically rejected SEC requests to remove persons from management or a board even when their misconduct was considered egregious. The courts considered the requests inconsistent with provisions in the Securities Act and the Exchange Act. The two Acts require proof of both a violation of the securities laws and "substantial unfitness" of the officer or director before a bar can be imposed.

Section 305 of the Act, effective July 30, 2002, removes the "substantial unfitness" standard and replaces it with an "unfitness" standard. The section also extends the court's ability to impose equitable relief against the officer or director necessary or appropriate to protect investors.

SECTION 306: INSIDER TRADES DURING PENSION FUND BLACKOUT PERIODS

Prior to section 306 executives could exercise and cash out their employee stock options and sell other issuer securities acquired through the company's equity compensation plans during a pension fund blackout period, while rank-and-file employees were precluded from selling their employer's equity securities in their individual pension plan accounts during such a blackout period.

The rule implementing section 306 prohibits directors and executive officers from purchasing and selling or otherwise acquiring any equity security of the issuer during a pension blackout period.[5] The Commission adopted new Regulation Blackout Trading Restriction (BTR) to clarify the scope and operation of section 306(a) of the Act.

PENALTIES FOR VIOLATION

Violators of this rule may have action brought against them to disgorge the profits from any purchase, sale, or other acquisition or transfer of the securities of the issuer and are also subject to all other remedies available to the Commission.

BLACKOUT PERIOD

A blackout period is a period of time of at least three consecutive business days during which at least 50 percent of the issuer's individual plan participants or beneficiaries are prevented from engaging in equity securities transactions that are held in their plan accounts.

In the case of a foreign private issuer, the section 306(a) trading prohibition is triggered only if the 50 percent test is satisfied and the number of U.S. plan participants subject to the temporary trading suspension is either greater than 15 percent of the issuer's worldwide workforce or greater than 50,000.

5 SEC Release 34-47225, Final Rule: Insider Trades During Pension Fund Blackout Periods, January 22, 2003.

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Pension plan "blackout periods" occur for a variety of administrative purposes. Their occurrence and timing are often, but not always, within the control of the plan administrator. The most common reasons for imposing a blackout period include:

- Changes in investment alternatives
- Changes in the frequency of portfolio valuations
- Changes in plan record-keepers or other service providers
- Changes in plan trustees
- Corporate mergers, acquisitions, and spin-offs that affect the pension coverage of groups of participants

ISSUERS AND PERSONS SUBJECT TO TRADING PROHIBITION

Section 306(a) and Regulation BTR apply to directors and executive officers of domestic issuers, foreign private issuers, small business issuers, and, in rare instances, registered investment companies.

The rules apply to all equity securities of, or pertaining to, an issuer. These securities include both the issuer's equity securities and derivative securities relating to an issuer's equity security, whether or not the derivative security is issued by the issuer.

EXEMPT TRANSACTIONS

The categories of transactions exempt from the prohibition are transactions that occur automatically, are made pursuant to an advance election, or are otherwise outside the control of the director or executive officer. They include:

- Acquisitions of equity securities under dividend or interest reinvestment plans
- Purchases or sales of equity securities that satisfy Exchange Act affirmative defense conditions
- Purchases or sales of equity securities, other than discretionary transactions pursuant to certain "tax-conditioned" plans, such as stock purchase plans and excess benefit plans
- Compensatory grants and awards of equity securities pursuant to programs under which grants and awards occur automatically
- 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 involving a bona fide 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
- Increases or decreases in equity securities holdings resulting from a stock split, stock dividend, or pro rata rights distribution

TRANSACTIONS SUBJECT TO TRADING PROHIBITION

The trading prohibition applies to the acquisition or disposition of equity securities during a blackout period if the acquisition or disposition involves an equity security acquired in connection with service or employment as a director or executive officer.

ACQUIRED IN CONNECTION WITH SERVICE

Regulation BTR defines instances where an acquisition of an equity security by a director or executive officer is "in connection with service or employment as a director or executive officer." This would include acquiring the securities:

- Under a compensatory plan, contract, authorization, or arrangement
- As a result of any transaction or business relationship
- As "directors qualifying shares" or other securities that he or she must hold to satisfy minimum ownership requirements or guidelines for directors or executive officers

Securities also would be considered to be "acquired in connection with service or employment as a director or executive officer" if prior to becoming, or while, a director or executive officer the individual acquires or receives the securities:

- As a direct or indirect inducement to service or employment as a director or executive officer
- As a result of a business combination in respect of an equity security of an entity involved in the business combination that he or she had acquired in connection with service or employment as a director or executive officer of that entity

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The rule establishes that any equity securities sold or otherwise transferred during a blackout period by a director or executive officer of an issuer will be considered to have been acquired in connection with service or employment as a director or executive officer, unless he or she is able to establish otherwise. To establish this defense, the director or executive officer must specifically identify the origin of the security in question.

Securities received as an inducement to becoming an employee or a non-executive officer will not be considered acquired in connection with service or employment as a director or executive officer, even if the individual later becomes a director or executive officer.

REQUIRED NOTICES: CONTENT AND TIMING

Regulation BTR specifies the content and timing of the notice that issuers must provide to their directors and executive officers and to the Commission about a blackout period. Under Regulation BTR the notice will be considered timely if an issuer provides it no later than five business days after the issuer receives the notice from the plan administrator required by the Department of Labor rules. If the issuer receives no such notice, the issuer must provide notice to directors and executive officers at least 15 calendar days in advance of commencement of the blackout period in any media form that is reasonably accessible to the intended recipient.

CONTENT OF NOTICE

The required notice generally must include the following information:

- The reason or reasons for the blackout period
- A description of the plan transactions to be suspended during, or otherwise affected by, the blackout period
- The description of the class of equity securities subject to the blackout period
- The actual or expected beginning and ending dates of the blackout period or the expected beginning and ending calendar weeks of the blackout
- The name, address, and telephone number of the person designated by the issuer to respond to inquiries about the blackout period, or, in the absence of such a designee, the issuer's human resources director or person performing equivalent functions

In the case of a domestic issuer, the notice to the Commission is provided in a Form 8-K report on the same day notice is transmitted to directors and executive officers. The rule changes the annual reporting forms for foreign private issuers by requiring such issuers to file as an exhibit copies of all notices provided to directors and officers, unless previously provided in a report on Form 6-K.

The Act also amends ERISA requirements. ERISA plan participants must be given 30 days' notice prior to the start of the blackout period, and the notice should be given in any form that is "reasonably accessible."

EFFECTIVE DATE

The rule became effective on January 26, 2003, and is applicable to blackouts beginning on or after January 26, 2003. The Form 8-K filing requirements are effective March 31, 2003.

Issuers should consult the final SEC rules and legal counsel on matters of interpretation related to Regulation BTR.

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SECTION 307:
RULES OF PROFESSIONAL RESPONSIBILITY FOR ATTORNEYS

Section 307 imposes a so-called "up-the-ladder" requirement on lawyers "appearing and practicing" before the Commission. Under the requirement, an issuer's lawyer must report "evidence of material violation" of securities law or breach of fiduciary duty to the issuer's chief legal counsel or its chief executive officer. If neither responds "appropriately," the lawyer must report the evidence to the audit committee, another board committee, or the board itself. The reporting requirement applies whether the lawyer is an in-house attorney or its outside counsel.

This section of the Act directs the SEC to formulate rules "setting forth minimum standards of professional conduct" for the lawyers who appear or practice before the Commission on behalf of issuers. As of this writing, the SEC has issued one rule, but has postponed its final rule on the so-called and much debated "noisy withdrawal" provisions of its original proposal.[6] The effective date of the rule already adopted is August 5, 2003.

ATTORNEYS AFFECTED

The rule defines an attorney as a person who provides legal services to the issuer and who is in an attorney-client relationship with the issuer. Non-U.S. attorneys are subject to the rules if they are counseling clients as to U.S. law. The definition excludes a businessperson who happens to be an attorney.

APPEARING AND PRACTICING

The Commission defines "appearing and practicing" before the Commission expansively to include in-house and outside attorneys practicing in the United States or abroad. Appearing and practicing before the Commission means:

- Transacting any business with the Commission, including communications in any form
- Representing an issuer in a Commission administrative proceeding or in connection with any Commission investigation, inquiry, information request, or subpoena
- Providing advice in respect to the U.S. securities laws or the Commission's rules or regulations regarding any document that the attorney has notice will be filed with or submitted to or incorporated into any document that will be filed with or submitted to the Commission, including the provision of such advice in the context of preparing or participating in the preparation of any such document
- Advising an issuer as to whether information or a statement, opinion, or other writing is required under the U.S. securities laws or the Commission's rules or regulations to be filed with or submitted to or incorporated into any document that will be filed with or submitted to the Commission

Appearing and practicing before the Commission does not include conducting the four services just listed outside the context of providing legal services to an issuer with whom the attorney has an attorney-client relationship or is a non-appearing foreign attorney.

UP-THE-LADDER REPORTING

Once an attorney "reasonably believes'' that there is evidence of a material violation of the securities laws, breach of fiduciary duty, or "similar violation," the attorney has reached the "triggering point" and is then required to report to the chief legal counsel or the chief executive officer of the issuer. The rule imposes an up-the-ladder reporting obligation for an appearing and practicing attorney who becomes aware of evidence of a material violation by the issuer or any officer, director, employee, or agent of the issuer.

"Reasonably believes" means that an attorney believes in the validity of the matter in question and that the circumstances are such that the belief is not unreasonable.

6 SEC Release No. 33-8185, Final Rule: Implementation of Standards of Professional Conduct for Attorneys, January 29, 2003.

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Evidence of a material violation is defined as "credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur."

The chief legal officer must inquire into the evidence of a material violation as he or she reasonably believes is appropriate to determine whether the material violation described has occurred, is ongoing, or is about to occur. If the chief legal officer subsequently determines none of these conditions is present, he or she must notify the reporting attorney and advise the reporting attorney of the basis for such determination. Unless the chief legal officer "reasonably believes" that no 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 must advise the reporting attorney of the response.

A chief legal officer may refer a report of evidence of a material violation to a "qualified legal compliance committee," if one exists, in lieu of performing the inquiry.

APPROPRIATE RESPONSE

If the chief legal or executive officer does not provide an "appropriate response" to the evidence of a material violation, such as adopting appropriate remedial measures or sanctions relating to the violation, the issuer's attorney is required to report the evidence (1) to the issuer's audit committee, (2) to another committee of the board of directors comprising solely directors not employed directly or indirectly by the issuer, or (3) to the full board of directors.

A "safe harbor" provision is included in the rule to protect attorneys, law firms, issuers, and officers and directors of issuers from civil lawsuits when they report a violation.

NOISY WITHDRAWAL

The proposed rule would have required a lawyer to make a "noisy withdrawal" from representing the company if those to whom he or she reported the violation did not respond appropriately.

After reviewing comments on the proposal, the commissioners concluded that the "noisy withdrawal" provision could inhibit discussions between an issuer and its lawyers. It has ordered that the "noisy withdrawal" issue be the subject of further comment. The Commission also proposed an alternative whereby, if an attorney identifies evidence of a material violation and the issuer, in the attorney's judgment, refuses to appropriately respond, the attorney would have to resign but would not be required to either notify the Commission or disavow any filings. Instead, the issuer would be required to report the facts and circumstances of the attorney's resignation on Form 8-K within two days of the attorney's resignation.

QUALIFIED LEGAL COMPLIANCE COMMITTEE

A qualified legal compliance committee is a committee of an issuer (which also may be an audit or other committee of the issuer) that:

(1) Consists of at least one member of the issuer's audit committee (or, if the issuer has no audit committee, one member from an equivalent committee of independent directors) and two or more members of the issuer's board of directors who are not employed, directly or indirectly, by the issuer;

(2) Has adopted written procedures for the confidential receipt, retention, and consideration of any report of evidence of a material violation;

(3) Has been duly established by the issuer's board of directors, with the authority and responsibility:

- (i) To inform the issuer's chief legal officer and chief executive officer (or the equivalents thereof) of any report of evidence of a material violation;
- (ii) To determine whether an investigation is necessary regarding any report of evidence of a material violation by the issuer, its officers, directors, employees, or agents and, if it determines an investigation is necessary or appropriate, to:
  - (A) Notify the audit committee or the full board of directors;
  - (B) Initiate an investigation, which may be conducted either by the chief legal officer (or the equivalent) or by outside attorneys;
  - (C) Retain additional expert personnel as the committee considers necessary;
- (iii) At the conclusion of any such investigation, to:
  - (A) Recommend, by majority vote, that the issuer implement an appropriate response to evidence of a material violation;
  - (B) Inform the chief legal officer and the chief executive officer (or their equivalents) and the board of directors of the results of any such investigation under this section and the appropriate remedial measures to be adopted; and

(4) Has the authority and responsibility, acting by majority vote, to take all other appropriate action, including the authority to notify the Commission in the event that the issuer fails in any material respect to implement an appropriate response that the qualified legal compliance committee has recommended the issuer to take.

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SECTION 308:
FAIR FUNDS FOR INVESTORS

Section 308 requires that any disgorgement of profits ordered against those who have violated securities laws, or any other funds collected as a result of the imposition of penalties following securities laws violations, be added to a fund for the benefit of the victims of the violations if the Commission so directs. The Commission is authorized to accept, hold, administer, and use gifts, bequests, and devises of property for the disgorgement fund.

As required by section 308, the Commission analyzed its enforcement actions that included proceedings to obtain civil penalties or disgorgements over the five years preceding the Act. The study identified areas in which such penalties or disgorgements may be used to efficiently, effectively, and fairly provide restitution for injured investors.

The Commission concluded that several additional legislative amendments would help meet the goals of section 308:

- First, the Commission recommends amending the Fair Fund provision to permit the Commission to distribute penalty monies to investors whose injuries led to the penalty regardless of whether disgorgement was ordered.
- Second, the Commission recommends new legislation granting express authority to the Commission to contract with private collection attorneys.
- Third, the Commission recommends new legislation to exclude securities cases from state law property exemptions, such as homestead exemptions.

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TITLE IV
ENHANCED FINANCIAL DISCLOSURES

Title IV covers a lot of ground in terms of both new disclosures and their effect on corporate institutions. It requires increased disclosures of material off-balance-sheet arrangements and relationships, sets standards for non-GAAP (pro forma) financial information, and mandates that companies whose audit committees do not include an "audit committee financial expert" disclose that fact. Other new disclosures pertain to codes of ethics for senior financial officers, management assessments of a company's internal controls, auditor's attestation reports on the assessments, and additional prompt disclosures on Form 8-K. Already-required disclosures of transactions in company stock must be accelerated, and issuers are prohibited from making certain loans to directors or executive officers. New criteria for SEC reviews of issuers' financial reports would increase the frequency of those reviews.

SECTION 401:
DISCLOSURES IN PERIODIC REPORTS

Section 401 addresses disclosure requirements for off-balance-sheet arrangements and pro forma reporting. The SEC issued rules to implement the section's two sets of requirements. Each is discussed below.

SECTION 401(a): OFF-BALANCE-SHEET ARRANGEMENTS AND AGGREGATE CONTRACTUAL OBLIGATIONS

The SEC adopted rules implementing section 401, which requires issuers to disclose off-balance-sheet arrangements that currently have or are reasonably likely to have a material future impact on the issuer.[1] However, the rule's influence will be tempered by its debt to the previously issued interpretive guidance from the SEC's 2002 Financial Reporting Release (FRR) No. 61, *Management's Discussion and Analysis of Financial Condition and Results of Operations*. Most of the interpretive guidance is incorporated in the new rule, which applies to all issuers, including foreign private issuers, except for registered investment companies.

Mandated by the Sarbanes-Oxley Act, the rule requires a new section of Management's Discussion and Analysis (MD&A) for off-balance-sheet arrangements and a tabular disclosure of contractual obligations.

The final rule did not carry forward a proposed requirement to disclose aggregate contingent liabilities or commitments.

Calendar-year issuers will have to apply the new rule in reports or filings that include the December 31, 2003, financial statements. Prior to the effective date of the new rule, issuers would apply the interpretative guidance related to off-balance-sheet arrangements issued last year, unless they elect to adopt the new rule earlier.

OFF-BALANCE-SHEET ARRANGEMENTS

The final rule has a broad definition of an off-balance-sheet arrangement. It includes (1) any obligation of the registrant that meets the definition of a guarantee under GAAP (warranty and similar arrangements are not captured by the definition of guarantee); (2) a retained or contingent interest in assets transferred to an unconsolidated entity or similar arrangement that serves as credit, liquidity, or market risk support; (3) specified derivative arrangements accounted for and classified within stockholders' equity; or (4) any obligation, including a contingent obligation, arising out of a material variable interest in an unconsolidated entity that provides financing, liquidity, market, or credit risk support to the registrant or engages in leasing, hedging, or research and development services with the issuer. The definition brings in concepts from the FASB's recently issued Interpretations on guarantees and variable interest entities as well as its earlier Statement on derivatives.

1 SEC Release No. 34-47264, Final Rule: Disclosure in Management's Discussion and Analysis About Off-Balance-Sheet Arrangement and Aggregate Contractual Obligations, January 27, 2003.

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Contingent liabilities arising from litigation, arbitration, or regulatory actions are not considered off-balance-sheet arrangements. Routine transactions, such as executory contracts, employment agreements, consulting agreements, and minimum purchase commitments, are not included in the definition.

FOREIGN PRIVATE ISSUERS

Consistent with existing MD&A requirements for foreign private issuers, the disclosure about off-balance-sheet arrangements and the table of contractual obligations pertain to the primary financial statements presented in the filing regardless of whether those primary financial statements are prepared in accordance with U.S. GAAP. Foreign private issuers must apply the same definition of off-balance-sheet arrangements that U.S. registrants apply. For example, a foreign private issuer determining whether a contractual arrangement meets the definition of a variable interest would look to the definition in FASB Interpretation No. 46 on variable interest entities. The consolidation rules applied in the primary financial statements would, however, determine whether that arrangement was on- or off-balance-sheet. If the contractual arrangement was with an entity that was not consolidated in preparing the primary financial statements, the disclosures required by the SEC rule would be made in MD&A in the separate caption on off-balance-sheet arrangements.

THRESHOLD FOR DISCLOSURE

Registrants must discuss in a separately captioned section of MD&A, off-balance-sheet arrangements that currently have or are *reasonably likely to have* a material future effect on the issuer's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures, or capital resources. The Commission adopted this probability threshold in response to concerns that its original proposal to disclose arrangements that *may* have a material current or future effect would have established a lower disclosure threshold for off-balance-sheet arrangements than for other MD&A items, with the attendant risk that investors might be confused or misled by the different probabilities attaching to different disclosures. In addition, some raised concerns that the lower threshold would yield voluminous disclosures and would be more difficult to apply.

DISCLOSURES

The final rule is based on the principle that annual and interim MD&A disclosures must include information necessary to understand the off-balance-sheet arrangements and their material effects. As in the case of other MD&A disclosure requirements, management must present the key variables and other qualitative and quantitative factors that are necessary for an understanding of the issuer. For example, an issuer should disclose the nature and frequency of its asset securitization program if it materially relies on securitizations to meet its liquidity and capital resource needs. Other candidates for disclosure are material contractual provisions calling for termination or material reduction in the off-balance-sheet arrangement or the effect on an issuer's off-balance-sheet arrangements of a change in its credit rating.

DISCLOSURE REQUIREMENTS FOR OFF-BALANCE-SHEET ARRANGEMENTS

- The nature and business purpose of the arrangements
- The importance of the arrangements to the issuer's liquidity, capital resources, market risk support, credit risk support, or other benefits
- The amounts of the issuer's revenues, expenses, and cash flows that arise from the arrangements; the nature and amounts of any interests retained, securities issued, and other indebtedness incurred by the issuer in connection with the off-balance-sheet arrangements; and the nature and amounts of 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
- 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 off-balance-sheet arrangements that provide material benefits, and the course of action that the issuer has taken or proposes to take in response to those circumstances

The off-balance-sheet arrangements may be aggregated into groups or categories that provide information in an efficient and understandable manner. Aggregation intended to diminish materiality is not permitted.

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Disclosures generally are required for only the most recent fiscal year. However, the issuer should address changes from the previous year if the changes are necessary to an understanding of the current-year disclosure. Consistent with other MD&A disclosure requirements, new or material changes in off-balance-sheet arrangements are to be disclosed in interim period filings. Finally, the MD&A disclosures need not repeat information in the notes to the financial statements, if the specific information in the relevant notes is clearly cross-referenced in the MD&A. Cross-references should identify the significance of the information if it is not otherwise apparent.

CONTRACTUAL OBLIGATIONS

The final rule requires that the MD&A in annual reports include a tabular disclosure of contractual obligations for all registrants other than small-business issuers. While it is not required that the information in the table be disclosed in interim reports, interim interim reports should disclose material interim changes.

For the most part, the captions in the table represent items for which disclosure is required by GAAP in the financial statements notes or on the balance sheet. The exception is purchase obligations, which is a defined term under the new rule. A purchase obligation is a legally binding and enforceable agreement to purchase goods and services that specifies all significant terms (quantity, price, and timing of the transaction). Because of the broad definition, registrants may be required to develop new procedures to quantify these obligations.

One objective of the new rule was to require aggregate disclosure of contractual obligations in a single location. For that reason, the rule does not permit omitting the tabular data by cross-referencing it to the financial statements. The tabular disclosure of contractual obligations must at a minimum follow the specified format shown in the table below, although the categories can be disaggregated using detailed headings to more closely reflect the issuer's business

EFFECTIVE DATE

The off-balance-sheet arrangement disclosure provisions of the final rule do not take effect until an issuer files an annual report, registration statement, proxy, or information statement that includes financial statements for an annual period ending on or after June 15, 2003. For a calendar-year company, the new rule will take effect for reports or filings that include the December 31, 2003, financial statements.

Issuers (other than small-business issuers) must include the table of contractual obligations in registration statements, annual reports, and proxy or information statements for fiscal years ending after December 15, 2003.

Until superseded by the new rule, the existing interpretive guidance for MD&A that was included in FRR 61 is still applicable. However, the SEC permits early adoption of its new rule.

TABULAR DISCLOSURE

Contractual Obligations	Payments Due by Period				
	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 registrant's balance sheet under GAAP					
Total					

SECTION 401(b): COMMISSION RULES ON NON-GAAP MEASURES

The SEC issued final rules to implement section 401(b) of the Act,[2] which directs the SEC to adopt rules requiring that publicly disclosed pro forma financial information, now known as "non-GAAP financial measures," *not* be materially misleading and be

2 SEC Release No. 33-8176, 34-47226; FR-65, Final Rule: Conditions for Use of Non-GAAP Financial Measures, January 22, 2003.

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accompanied by a reconciliation to the related financial statements presented in accordance with GAAP.

The SEC created new Regulation G, which contains the basic requirements in the Act and applies to material *publicly disclosed* or *released* information containing a non-GAAP financial measure, such as press releases or webcasts. The rule will also require issuers to "furnish" the SEC with earnings releases and similar announcements of financial information for completed annual and interim periods. Amendments to Regulation S-K and other regulations impose additional requirements for filed non-GAAP financial measures, including prohibitions on the use of some non-GAAP financial measures commonly used today. Issuers will need to quickly give careful consideration to how the rules affect their current reporting practices; some of the requirements may apply to fiscal year 2002 depending on the timing of the filing or release of the information, and will apply to first-quarter 2003 reports and releases.

A NON-GAAP FINANCIAL MEASURE

A non-GAAP financial measure is a numerical measure or ratio of a company's historical or future financial performance, financial position, or cash flows that excludes or includes amounts included or excluded, respectively, *in* a GAAP measure. Examples of non-GAAP financial measures include income before restructuring charges; income before special items; earnings before interest, taxes, depreciation, and amortization (EBITDA); and funds from operations (FFO). Operating measures, statistical measures, and ratios that are calculated using GAAP amounts are excluded from the definition of non-GAAP financial measures. Examples of those measures are unit sales, number of subscribers, sales per square foot or same store sales (as long as sales are determined in accordance with GAAP), and operating margin calculated by dividing GAAP revenues into GAAP operating income. In addition, financial measures required to be disclosed by GAAP, SEC rules, or another regulator of the issuer are excluded from the definition of non-GAAP financial measures. For example, financial institution capital disclosure requirements of the FDIC and insurance reserve disclosures required by a state insurance commissioner are not non-GAAP financial measures. Segment information disclosures required by Statement of Financial Accounting Standards No. 131, *Disclosures about Segments of an Enterprise and Related Information,* are also not subject to the SEC's new rules.

REGULATION G

New Regulation G must be considered in any instances in which an issuer, or a person acting on its behalf, publicly discloses material information that includes a non-GAAP financial measure. Regulation G applies to almost all issuers that file reports with the SEC, with the exception of registered investment companies and certain foreign companies listed on a foreign exchange that disclose non-GAAP financial measures outside of the United States that are not based on U.S. GAAP.

Regulation G prohibits an issuer from publicly disclosing, in either written form or orally, a non-GAAP financial measure and related disclosure that is misleading. An issuer must present the GAAP measure most directly comparable to the non-GAAP measure, accompanied by a quantitative reconciliation of the non-GAAP financial measure to the GAAP measure. If the way in which the non-GAAP financial measure is calculated changes from period to period, the change must be disclosed.

Per-share non-GAAP financial measures are permitted as long as they are presented on a diluted basis and not expressly prohibited by GAAP, such as cash flow per share. Per-share presentations of EBITDA, earnings before interest and taxes (EBIT), and FFO are acceptable.

If a non-GAAP financial measure is released orally or by telephone, webcast, broadcast, or similar means, the required disclosures may be posted on the issuer's Web site as long as the location and availability of the disclosures are included in the presentation. While the rule does not stipulate the amount of time the disclosures must remain on the Web site, the SEC encourages issuers to provide ongoing access to the information for at least 12 months.

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MOST DIRECTLY COMPARABLE GAAP MEASURE

While issuers have flexibility in determining which GAAP measure is most directly comparable to the non-GAAP financial measure, the SEC Staff believes that liquidity measures (those that measure cash or "funds" generated from operations) should be reconciled with amounts from the statement of cash flows while performance measures should be reconciled with net income or income from continuing operations. The SEC Staff expects that issuers will generally report EBITDA or EBIT as a liquidity measure, which would require reconciliation to the statement of cash flows.

RECONCILIATION

The reconciliation of the non-GAAP financial measure to the most directly comparable GAAP measure should be presented in a schedule or other clearly understandable method. When a non-GAAP financial measure is used in a financial ratio, each non-GAAP component of the ratio must be reconciled to its comparable GAAP measure (with separate presentation of the ratio calculated using GAAP measures).

Forward-looking non-GAAP financial measures must be reconciled to the most directly comparable forward-looking GAAP measure, unless the GAAP measure is not available without unreasonable effort. Any reconciling information that is available without unreasonable effort should be presented and the information that is not available must be identified and its probable significance disclosed.

FILINGS WITH THE SEC

Amendments to Regulation S-K and other regulations specify the conditions for including non-GAAP financial measures in filings with the SEC. These conditions apply to domestic and foreign filers, except registered investment companies and Canadian filers on Form 40-F.

In addition to incorporating the requirements in Regulation G for fair presentation, the amendments require that issuers presenting non-GAAP financial measures in filings:

- Give equal or greater prominence to the most directly comparable financial measure calculated and presented in accordance with GAAP
- Reconcile the non-GAAP financial measure to the most directly comparable GAAP measure
- Disclose why management believes the non-GAAP financial measure is useful to investors
- To the extent not evident in other disclosure, disclose why management uses the non-GAAP financial measure

These statements may be included in the most recent annual report, or a more recent report, filed with the SEC and need not be repeated in every filing. The stated reasons for presenting the non-GAAP financial measure must be specific to the company and its business and industry. Disclosing only that the information is sought by analysts or required by debt covenants will not be sufficient.

The amended rules prohibit an issuer from:

- Presenting non-GAAP *liquidity* measures, which exclude charges or liabilities that required, or will require, cash settlement, or would have required cash settlement absent an ability to settle in another manner, other than EBITDA and EBIT
- Presenting non-GAAP *performance* measures that 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 when there was a similar charge or gain within the prior two years
- Presenting non-GAAP financial measures on the face of the financial statements or in the notes
- Presenting non-GAAP financial measures on the face of pro forma financial information provided pursuant to other SEC requirements
- Using titles or descriptions on non-GAAP financial measures that are the same as, or confusingly similar to, titles or descriptions used for GAAP financial measures

A foreign issuer may present a non-GAAP financial measure that conflicts with these prohibitions if it is required or expressly permitted by the issuer's home jurisdiction accounting standards-

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setter. Form 6-K for a foreign issuer is not subject to the requirements for filings.

Forward-looking non-GAAP measures are subject to the same unreasonable efforts standard and per-share presentations are subject to the same limited restrictions described under Regulation G.

WILL NON-GAAP PERFORMANCE MEASURES DISAPPEAR FROM SEC FILINGS?

It is unclear as of the release date of this publication how the SEC will ultimately interpret the language used in its new rules describing prohibited performance measures. One source of confusion is whether the SEC intends its prohibition to apply only to items that are *characterized* by a registrant is non-recurring, infrequent, or unusual if those items have occurred or will occur again within two years. The SEC is expected to address inconsistencies in interpretation in an upcoming Frequently Asked Questions document.

Preliminary informal discussion with the SEC staff has indicated that significant restrictions on the use of most non-GAAP performance measures may effectively eliminate presentation of non-GAAP performance measures in filings with the SEC. This guidance, however, is subject to change upon further interpretation by the SEC. First, any adjustment to GAAP income statement presentations is covered by the prohibitions, whether or not it is specifically identified as “non-recurring” or “special.” It may be difficult for management to conclude that it is reasonably likely (a threshold lower than *more likely than not*) that a particular non-recurring, infrequent, or unusual item will not recur within the next two years. Presentation of *adjusted* or *core* earnings that eliminate realized gains or losses on sales of long-lived assets or investments, restructuring charges, or impairment charges may not be acceptable, especially if the issuer’s financial statements have included those items in the past.

Second, the SEC is expected to apply a broad definition of the term *similar* in assessing whether similar items have occurred or will occur in the future. Thus, if a single restructuring plan generates a charge that contains several distinct components (e.g., employee severance, lease termination costs, and asset impairments), the SEC might view all of the components of the restructuring plan as similar. Also, size of the item does not affect the “similar” assessment, that is, a charge or gain that is only unusual in terms of size would not be considered dissimilar.

MANAGEMENT’S DISCUSSION AND ANALYSIS

The SEC has previously provided interpretive advice encouraging companies to quantify and discuss the effects on net income and earnings per share of unusual or infrequent items (specifically, restructuring charges) to enhance the reader’s understanding of the financial statements. However, the SEC also stated in that interpretation that discussions or graphic presentations that focus solely on pre-charge amounts or imply that pre-charge amounts are a more meaningful indicator of the results of operations are inappropriate.

While it is not clear how the SEC will balance the previous interpretive advice with the requirements of the new rules, it appears that narrative MD&A presentations allowed in the past that discuss what earnings and earnings per share would have been without a restructuring charge will continue to be acceptable, as long as they are balanced within the context of a meaningful discussion of GAAP earnings.

REQUIREMENT TO FURNISH EARNINGS RELEASES OR SIMILAR ANNOUNCEMENTS

The SEC expanded the Form 8-K reporting requirements to include new Item 12, “Disclosure of Results of Operations and Financial Condition.” New Item 12 requires that all domestic registrants *furnish to* (as opposed to *file with*) the SEC all releases or announcements disclosing material non-public financial information about completed annual or quarterly periods, regardless of whether the release or announcement includes non-GAAP financial measures. The Form 8-K is due within five days of the release or announcement (this time period is subject to change in the near future as part of an outstanding proposed rule to accelerate the filing dates for Form 8-K to

Item 12 of Form 8-K requires that any non-GAAP financial measures included in an earnings release be accompanied by:

- Presentation of the most directly comparable GAAP measure with equal or greater prominence,
- Quantitative reconciliation, and
- Disclosure of why the non-GAAP financial measure is useful to investors and management.

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within two days of reportable events). The amendment does not require registrants to issue earnings releases or other announcements. Foreign issuers are not subject to Form 8-K requirements.

Furnishing rather than filing the information required by new Item 12 permits companies to avoid the new prohibitions for filings. This means that any non-GAAP financial measure is acceptable in an earnings release as long as it is not misleading and it is reconciled to the most directly comparable GAAP measure. Furnishing rather than filing Form 8-K also causes the Item 12 information not to be incorporated by reference into registration statements, proxy statements, or other reports unless specifically incorporated by the registrant. If this information is *filed* under Item 5 of Form 8-K, it will be subject to the new restrictions on use of non-GAAP financial information in filings.

A separate Item 12 Form 8-K does not have to be furnished for non-public information that is disclosed orally or by webcast or broadcast within 48 hours of a related written release or announcement that has already been furnished to the SEC on Form 8-K. However, a company's oral, webcast, or broadcast presentation must be made broadly accessible to the public, with all related information, including reconciliation for any non-GAAP financial measures, available on the company's Web site.

Earnings releases and similar announcements are still subject to Regulation FD. If a company chooses to satisfy its Regulation FD requirements by furnishing a release on Form 8-K, the registrant may indicate that the information is being furnished under both Item 9 and Item 12, assuming the information provided satisfies both requirements.

EFFECTIVE DATES AND TRANSITION

Regulation G will apply to all public disclosures, including earnings releases and filings with the SEC, made as of March 28, 2003. The additional provisions applicable only to SEC filings will be effective for filings that include periods ending after March 28, 2003. If an issuer files a Form 10-K for the year ended December 31, 2002; January 31, 2003; or February 28, 2003, on or after March 28, 2003, and the filing contains a non-GAAP financial measure, the company must include a reconciliation of the non-GAAP measure to the most directly comparable GAAP measure. Reports filed on Form 10-Q would be similarly affected. The reconciliation would be provided even though that non-GAAP measure would be prohibited in reports filed for periods ending after March 28, 2003 (e.g., Form 10-Q for the quarterly period ending March 31, 2003). The requirement that domestic registrants furnish earnings releases and similar materials to the SEC on Form 8-K will apply to earnings and similar announcements after March 28, 2003.

NON-GAAP FINANCIAL MEASURES

Summary of Disclosure Requirements and Prohibitions

Disclosure Requirements/ Prohibitions	Regulation G—applies to all disclosures of non-GAAP measures	Filings with SEC (Regulation S-K applies)	Item 12 Form 8-K furnished to the SEC	Item 12 Form 8-K filed with the SEC
Presentation of most directly comparable GAAP measure	✓			
Reconciliation of non-GAAP measure to most directly comparable GAAP measure	✓	✓	✓	✓
Presentation, with equal or greater prominence, of most directly comparable GAAP measure		✓	✓	✓
Statement disclosing reasons management believes the measure is useful to investors		✓	✓	✓
Statement disclosing additional purposes, if any, for which management uses the measure		✓	✓	✓
Prohibitions on certain presentations (Item 10(e)(1)(ii), Regulation S-K)		✓		✓

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SECTION 402: ENHANCED CONFLICT OF INTEREST PROVISIONS

Issuers are prohibited under section 402 from making certain loans to their directors or executive officers. The section, which was effective on July 30, 2002, makes it unlawful for any issuer "…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)…." Any loans that were outstanding on July 30, 2002, are unaffected by the prohibition, provided they are not materially modified or renewed after that date.

The Act exempts certain extensions of credit, such as home improvement and manufactured home loans, consumer credit, credit cards, and certain bank and margin loans made in the ordinary course of the company's consumer credit business. Issuers should consult with legal counsel regarding the impact of section 402 on all their credit arrangements with directors and executive officers.

SECTION 403: DISCLOSURES OF TRANSACTIONS INVOLVING MANAGEMENT AND PRINCIPAL STOCKHOLDERS

The Commission's rules implementing section 403 of the Act require earlier disclosure of changes in beneficial ownership by officers, directors, and principal security holders (insiders). The rule became effective August 29, 2002.[3] Officers, directors, and principal security holders must file specific information with the SEC and with the national securities exchanges with which the stock is listed. Nearly all changes in ownership by insiders are now reportable within two business days on Form 4, including the following transactions: (1) open market purchases or sales of company stock, (2) stock option and restricted stock grants and stock option exercises, and (3) acquisitions of phantom stock through company deferred compensation programs. Previous rules required disclosure 10 days after the month in which the transaction was executed.

Legal counsel should be consulted in the application of these rules.

SECTION 404: MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS

An issuer's management is required to establish and maintain adequate internal controls and procedures for financial reporting and to report annually on (1) management's responsibility for the internal controls and procedures for financial reporting and (2) their effectiveness. The assessment reported by management, which is mandated by section 404, must be the subject of an attestation report by the external auditor.

The SEC proposed rules to implement section 404 in October 2002, but in January 2003 said that final rules implementing section 404 will be released after consultation with the Board. Therefore, the following discussion is based on the rule proposal.[4]

REPORTING AND DISCLOSURE REQUIREMENT

The proposed rule would require that each annual report filed include an internal control report that:

- States that management of the issuer is responsible for establishing and maintaining adequate internal controls and procedures for financial reporting
- Contains management's assessment, as of the end of the most recent fiscal year, of the effectiveness of the issuer's internal controls and procedures for financial reporting
- Includes a statement that the issuer's independent auditors have attested to, and reported on, management's evaluation of the issuer's internal controls and procedures for financial reporting

3 SEC Release No. 34-46421, Final Rule: Ownership Reports and Trading by Officers, Directors, and Principal Security Holders, August 27, 2002.
4 SEC Release No. 34-46701, Proposed Rule: Disclosure Required by Sections 404, 406, and 407 of the Sarbanes-Oxley Act of 2002, October 22, 2002.

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Uniform language would not be required for all issuers. Instead, reports would be tailored to each issuer's circumstances. The annual reports would include the registered firm's attestation report.

INTERNAL CONTROLS AND PROCEDURES FOR FINANCIAL REPORTING

"Internal controls and procedures for financial reporting" is defined as controls that pertain to the preparation of external financial statements fairly presented in conformity with GAAP, as described in current auditing literature or in any superseding definition or other literature issued or adopted by the Board.

The SEC's proposing release defines the term more specifically as controls that provide reasonable assurance that transactions are properly authorized, assets are safeguarded against unauthorized or improper use, and transactions are properly recorded to permit the preparation of financial statements that are fairly presented in conformity with GAAP.

Internal controls and procedures for financial reporting is a narrower segment of internal control than the "disclosure controls and procedures" addressed in management's section 302 certification.

MANAGEMENT'S RESPONSIBILITIES

To assess its internal controls and procedures for financial reporting, management selects a suitable control criteria against which it may evaluate and report on the effectiveness of the entity's internal controls and procedures for financial reporting.

Control Criteria

Criteria issued by the AICPA, regulatory agencies, and other groups composed of experts who follow due-process procedures, including exposure of the proposed criteria for public comment, usually may be considered suitable criteria for this purpose. For example, the report of the Committee of Sponsoring Organizations (COSO) of the Treadway Commission, *Internal Control—Integrated Framework,* is generally recognized as providing suitable criteria against which management may evaluate and report on the effectiveness of the entity's internal controls for financial reporting.

The COSO publication, though it has not been updated since 1994, arguably provides the most recognizable suitable set of control criteria against which internal controls and procedures for financial reporting may be judged. The COSO criteria provide a fairly broad outline of the components of internal controls and require the exercise of a significant amount of judgment. Issuers should have appropriately skilled persons involved both in implementing internal controls and procedures and in evaluating their effectiveness using a suitable set of control criteria.

Under a suitable set of control criteria, such as that described by COSO, internal controls and procedures for financial reporting consist of control environment, risk assessment, control activities, information and communication, and monitoring. Such a framework considers matters at both the entity level and activity level.

DIFFERENTIATING AN INTERNAL CONTROL EXAMINATION FROM A FINANCIAL STATEMENT AUDIT

An engagement to examine the effectiveness of an entity's *internal controls and procedures for financial reporting* differs from the auditor's consideration of internal controls in an audit of financial statements.

The objective of a financial statement audit is to express an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with GAAP. Thus, the focus in a financial statement audit is on the results of the financial reporting process (the financial statements) rather than on the controls and procedures for the financial reporting process. In the financial statement audit, the auditor's work on internal control is directed toward understanding internal controls and assessing control risk. This work is performed to support the opinion on the financial statements, not to report separately on the effectiveness of internal controls.

The objective of an internal control examination, on the other hand, is to express an opinion about whether the entity maintained, in all material respects, effective internal controls and procedures for financial reporting. In these instances, the auditor obtains an understanding of internal controls that apply to financial reporting and tests the effectiveness of their design and operation.

The concepts of testing the design and operating effectiveness of controls in an audit of financial statements and in an examination of internal controls and procedures for financial reporting are narrowly similar. However, in an internal controls examination, the auditor needs to evaluate the effectiveness of all significant controls in the financial reporting process, from the initiation of transactions all the way through the financial reporting process, including the final assembly, approval, and issuance of the financial statements. In a financial statement audit, the auditor has more discretion as to which controls are evaluated and performs tests of controls only to the degree they are to be relied on to reduce other non-control-related testing.

In summary, the level of effort directed toward internal control performed in an audit of financial statements is not sufficient to support a separate report on the effectiveness of internal controls and procedures for financial reporting—a significant amount of additional audit work will be necessary.

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Auditor's Attestation Report

The issuer should recognize that the types of evaluations and assessments to be conducted (1) by senior officers with respect to disclosure controls and procedures required by section 302 rules, (2) by management with respect to internal controls and procedures for financial reporting under section 404, and (3) by the independent auditor's evaluation in order to attest to management's assertions under section 404 are substantially different from the auditor's consideration of internal controls in connection with a financial statement audit.

The auditor's attestation report required under section 404 will require additional procedures to be performed by the issuer's auditors. Opinions in audit reports on financial statements do not provide assurance on the effectiveness of the reporting entity's internal controls. While the financial statement audit and internal control examination procedures may overlap, only in an internal control examination does the auditor gather sufficient evidence from analysis and testing to evaluate the operating effectiveness of internal controls and procedures for financial reporting.

STEPS IN THE PROCESS OF EVALUATING EFFECTIVENESS OF CONTROLS

Evaluating the effectiveness of controls is an extensive and detailed process. To complete the process, management will need to:

- *Document and gain an understanding of the internal control components relevant to financial reporting.* At a minimum, this process should cover all significant controls relevant to financial reporting within the entity, including its consolidated subsidiaries, and should consider the entity's control environment and activity level controls, as well as information, communication, and monitoring.
- *Select suitable control criteria for evaluation.* To assess internal controls, management must select criteria by which effectiveness can be evaluated (e.g., COSO).
- *Evaluate the design effectiveness of controls.* Based on its understanding and documentation of controls, management needs to evaluate the suitability of the design of internal controls in order to identify potential weaknesses, and then implement appropriate corrective measures.
- *Evaluate the operating effectiveness of controls.* Management should undertake procedures to assess whether or not controls are operating effectively. The nature and extent of procedures performed should be determined by management, based on their determination of evidence required to make an overall assessment regarding the operating effectiveness of controls. Management must support its evaluation with sufficient evidence.
- *Reporting.* Management will be required to report to the independent auditor and to report publicly their conclusions about the effectiveness of controls.

Management's assessment of internal controls and procedures for financial reporting must be completed prior to the independent auditor being able to report on management's assertion regarding the results of its assessment. To the extent an issuer has not already done so, an issuer should immediately establish a process to facilitate management's assessment of the design and operating effectiveness of the issuer's internal controls and procedures for financial reporting.

In some cases, unless management immediately undertakes a process to comprehensively evaluate internal controls and procedures for financial reporting (including documentation and assessment) and to implement actions to correct weaknesses, the independent auditor may be precluded from issuing an unqualified report on the effectiveness of the issuer's internal controls and procedures for financial reporting.

The procedures the independent auditor conducts to support its report on management's assessment of internal controls and procedures for financial reporting, or the procedures that the auditor conducts in connection with the financial statement audit and timely quarterly reviews, may reveal deficiencies in internal controls that may not have been previously identified by management.

The Auditing Standards Board of the AICPA is deliberating a new auditing standard and revisions to the attestation standards to address the audit of internal controls and procedures for financial reporting pursuant to section 404. The revisions are expected to include specific guidance on the "sufficient evidence" required for management to support its evaluation.

COORDINATION WITH SECTION 302

The section 302-certification statement on control evaluation addresses the issuer's disclosure controls and procedures. Disclosure controls and procedures refer to controls and procedures to provide reasonable assurance of fulfilling the issuer's annual, quarterly, and Form 8-K reporting obligations, including requirements to report non-financial information. Disclosure controls and procedures are broader than internal controls and

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PROPOSED RULE 404 CERTIFICATION

In every periodic report filed after the effective date of the SEC's rule on section 404, each principal executive officer or officers and principal financial officer or officers must affirm:

1. He or she has reviewed the report being filed;
2. Based on his or her knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the report;
3. Based on his or her 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 periods presented in the report;
4. He or she and the other certifying officers are responsible for establishing and maintaining disclosure controls and procedures and internal controls and procedures for financial reporting for the issuer and have:
   a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under their supervision, to ensure that material information relating to the issuer, including its consolidated subsidiaries, is made known to them by others within those entities, particularly during the period in which periodic reports are being prepared;
   b) Designed such internal controls and procedures for financial reporting, or caused such internal controls and procedures for financial reporting to be designed under their supervision, to provide reasonable assurances that the registrant's financial statements are fairly presented in conformity with generally accepted accounting principles;
   c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and internal controls and procedures for financial reporting as of the end of the period covered by the report ("Evaluation Date");
   d) Presented in the report their conclusions about the effectiveness of the disclosure controls and procedures and internal controls and procedures for financial reporting, in each case based on their evaluation as of the Evaluation Date;
   e) Disclosed to the registrant's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function):
      (i) All significant deficiencies and material weaknesses in the design or operation of internal controls and procedures for financial reporting which could adversely affect the registrant's ability to record, process, summarize, and report financial information required to be disclosed by the registrant in the reports that it files or submits under the Act (15 U.S.C. 78a et seq.), within the time periods specified in the Commission's rules and forms; and
      (ii) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls and procedures for financial reporting; and
   f) Indicated in the report any significant changes in the registrant's internal controls and procedures for financial reporting or in other factors that could significantly affect internal controls and procedures for financial reporting made during the period covered by the report, including any actions taken to correct significant deficiencies and material weaknesses in the registrant's internal controls and procedures for financial reporting.

procedures for financial reporting, which is the control set cited in the proposed requirement of section 404.

Under the proposed rule to implement section 404, management's required evaluations for the certifications under the Act would be amended to apply to both definitions of controls (internal controls and procedures for financial reporting and disclosure controls and procedures). The evaluations would focus on the effectiveness of the design and operation of the controls and procedures as of the end of the period covered by the quarterly or annual report (in place of being carried out within the 90-day period prior to the filing date of the report as currently required under section 302).

The certification requirements would be modified in two other ways. One would clarify that the certifying officers caused the controls and procedures to be designed under their supervision, and the other would clarify that "material weaknesses" as well as "significant deficiencies" should be disclosed to both the audit committee and independent auditors.

IMPLEMENTATION

The Act does not impose a deadline for rules to implement section 404. However, the Commission proposed rules on October 22, 2002, implementing section 404. The proposing release requests comments on the time needed to make the transition to compliance with its requirements. Under the proposal, the internal control disclosures would apply to issuers whose fiscal years end on or after September 15, 2003. Compliance with the proposed amendments to the certification requirements would be required for the first annual report with an internal control report and all subsequent quarterly and annual reports of such issuers. Until then, the SEC would expect issuers to use the form of certification currently required by section 302.

SECTION 405: EXEMPTION

Section 405, which was effective July 30, 2002, exempts investment companies from the disclosure requirements of several sections under Title IV. Congress believed that existing federal

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securities laws and rules thereunder adequately address investment companies.

Specifically, section 405 states that "nothing in sections 401, 402, or 404, the amendments made by those sections, or the rules of the Commission under those sections shall apply to any investment company registered under section 8 of the Investment Company Act of 1940."

See Appendix A for a discussion of the effect the Act and related SEC rules have on investment companies.

SECTION 406: CODE OF ETHICS FOR SENIOR FINANCIAL OFFICERS

Recent financial scandals have raised concerns about the ethical standards of issuers and their senior management. Section 406 requires issuers to disclose whether they have adopted a code of ethics for their senior financial officers and state the requirements of that code. It also calls for prompt disclosures on Form 8-K or by Internet dissemination "of any change in, or waiver of" an issuer's code of ethics. The final rule implementing section 406 extended the Act's disclosure requirement to include ethics codes applicable to an issuer's principal executive in addition to its senior financial officers.

The rules applicable to investment companies differ somewhat from those for other companies and are described in Appendix A.

DEFINITION OF CODE OF ETHICS

The SEC's rule on the section 406 requirement broadens the Act's definition of "code of ethics." A code under the revised definition includes written standards that are reasonably necessary 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 an issuer files with, or submits to, the Commission and in other public communications made by the issuer
- Compliance with applicable governmental laws, rules, and regulations
- Prompt internal reporting of code of ethics violations to an appropriate person or persons identified in the code
- Accountability for adherence to the code of ethics

A code of ethics for purposes of the rule may be part of a broader document or may consist of separate codes for different types of officers. The rule uses the singular "code of ethics" when setting out disclosure obligations.

CODE OF ETHICS CONTENT

A code of ethics should be issuer-specific. The rule does not specify every attribute of an issuer's code of ethics, nor does it prescribe any standard language.

An issuer that already has a code of ethics should review it and consider what enhancements may be required to incorporate the elements described in the rule.

DISCLOSURE

The rule requires an issuer to disclose whether it has adopted a code of ethics that applies to its principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. If the issuer has not adopted such a code, it must explain why it has not done so. Such disclosure is required in the issuer's annual report filed with the SEC.

Issuers with codes of ethics must make them publicly available by any of the following three methods:

- File a copy as an exhibit to its annual report, including the titles of those to whom it applies
- Post the text of the code on its Internet Web site and disclose its Internet address and intention to provide disclosure in this manner in its annual report filed with the SEC
- Include a statement in its annual report filed with the Commission committing to provide a copy of its code of ethics to any person without charge upon request

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In satisfying the requirement to make its code of ethics publicly available, an issuer need only file, post, or provide the portions of a broader document that constitute a code of ethics and that apply to the persons specified by the rule.

CHANGES TO, OR WAIVERS OF, THE CODE OF ETHICS

An issuer, other than a foreign private issuer or registered investment company, is required to promptly disclose any changes to, or waivers of, the code of ethics to the extent that the change or waiver applies to the issuer's principal executive officer or senior financial officers. An issuer can provide this disclosure on Form 8-K or on its Internet Web site.

The rule adds two items to the list of triggering events that require disclosure on Form 8-K:

- The nature of any amendment to the issuer's code of ethics that applies to its principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions
- The nature of any waiver, including an implicit waiver, of a provision of the code of ethics granted by the issuer to one of these specified officers, the name of the person to whom the issuer granted the waiver, and the date of the waiver

The rule defines the term "waiver" as the approval by the issuer of a material departure from a provision of the code of ethics. An "implicit waiver" is the registrant's tacit approval resulting from failure to take action within a reasonable period of time after acknowledgement of material departure from a provision of the code of ethics.

As an alternative to reporting this information on Form 8-K, an issuer may disseminate this disclosure through its Internet Web site, but only if the issuer previously disclosed in its most recently filed annual report both its intention to disclose these events on its Internet Web site and its Internet Web site address. If an issuer elects to disclose this information on its Web site, it must make the disclosure available for at least 12 months after the initial posting. The disclosure may be removed after 12 months, but the issuer must retain this disclosure for a period of not less than five years and make it available to the Commission upon request.

Under each alternative, disclosure by a domestic issuer must be made within five (5) business days after the issuer amends its ethics codes or grants a waiver. The Commission intends to consider whether to shorten this deadline to two business days when it addresses its proposal to accelerate Form 8-K filing deadlines.

The Commission encourages issuers to retain broad-based business codes of ethics that cover more personnel than prescribed by the rule. However, only amendments or waivers relating to the specified elements of the code of ethics and the specified officers mentioned in the rule require disclosure. For example, if an issuer has a code of ethics that applies to its directors as well as to its principal executive and senior financial officers, an amendment to a provision affecting only directors would not require Form 8-K or Internet disclosure.

FOREIGN PRIVATE ISSUERS

Like a domestic issuer, a foreign private issuer is required to provide the code of ethics disclosure in its annual report filed with the SEC. In contrast, a foreign private issuer is not required to provide in a current report "immediate disclosure" of any change to, or waiver of, the issuer's code of ethics for its senior financial officers and principal executive officer. Instead, a foreign private issuer must disclose in its annual report filed with the SEC any such change or waiver that occurred during the past fiscal year.

A foreign private issuer may disclose on a Form 6-K or its Internet Web site any change to, or waivers of, its code of ethics. In the interest of timely disclosure, the SEC strongly encourages foreign private issuers to use one of these means of timely disclosure.

EFFECTIVE DATES

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

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SECTION 407:
DISCLOSURE OF AUDIT COMMITTEE FINANCIAL EXPERT

The Senate committee that developed the provisions of section 407 believed that the effectiveness of the audit committee in performing its oversight role depends in part on its members' knowledge of and experience in addressing auditing and financial matters. Specifically, the Senate committee believed that a "financial expert" on an issuer's audit committee could serve as a significant resource for the audit committee in performing its oversight function.

In keeping with the Act's provisions, the final rule implementing section 407 requires an issuer to disclose annually in reports filed with the SEC whether at least one member of its audit committee is an "audit committee financial expert." The disclosure must identify the audit committee financial expert and state whether he or she is independent of management. An issuer that does not have an audit committee financial expert is required to disclose this fact and the reasons for it. The issuer's board of directors is responsible for deciding whether its audit committee has at least one member who fits the criteria of an audit committee financial expert.

No penalty is specified for not having an audit committee financial expert. The Senate committee held that investors could benefit from knowing whether an issuer's audit committee has at least one member with sophisticated financial expertise.

STOCK EXCHANGE REQUIREMENTS

The Commission noted that the major U.S. stock exchanges have adopted rules regarding the composition of listed companies' audit committees, but that not all issuers are subject to those requirements. The current stock exchange requirements for audit committee members with financial expertise are less rigorous than the final rule implementing section 407. Therefore, boards of directors evaluating whether their audit committees include one or more audit committee financial experts under the rule cannot assume that compliance with expertise requirements imposed by stock exchanges will satisfy the SEC rule.

DEFINITION OF AUDIT COMMITTEE FINANCIAL EXPERT

The SEC rule substituted the designation "audit committee financial expert" for "financial expert" used in section 407 of the Act. The rule defines an audit committee financial expert to mean a person who has all of the following attributes:

- An understanding of GAAP and financial statements;
- The ability to assess the general application of such principles in connection with the accounting for estimates, accruals, and reserves;
- Experience preparing, auditing, analyzing, or evaluating financial statements that present accounting issues of a breadth and level of complexity generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities;
- An understanding of internal controls and procedures for financial reporting; and
- An understanding of audit committee functions.

A person must have acquired the five necessary attributes through any one or more of the following means:

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

A discussion of some of the key elements of the definition and attributes of an audit committee financial expert follows.

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EXPERIENCE ACTIVELY SUPERVISING

Addressing how a person may have acquired the five attributes of an expert, the board evaluating a person's "experience actively supervising" should consider whether the person participated in and contributed to the process of addressing the same general issues regarding preparation, auditing, analysis, or evaluation of financial statements as those addressed by the person or persons being supervised. "Active supervision" means more than the mere existence of a traditional hierarchical reporting relationship. Accordingly, an executive with considerable operations experience but little financial or accounting involvement would generally not meet the criterion prescribing "active supervision."

NEED FOR SPECIALIZED INDUSTRY KNOWLEDGE.

The release explicitly addresses the limited pool of candidates in certain specialized industries. An audit committee financial expert must be able to assess the general application of GAAP in connection with accounting for estimates, accruals, and reserves. This general attribute provides the necessary background when assessing more detailed industry-specific standards or other topics. Experience with the detailed industry-specific standards is not a required attribute of an audit committee financial expert.

The focus on the "breadth and level of complexity of the accounting issues with which the person has had experience" is not intended to imply that a person must have previous experience in the same industry as the issuer or that the person must have experience with an issuer subject to Exchange Act reporting requirements.

In making the assessment, the board of directors should focus on several factors, including the size of the entity with which the person had experience, the scope of that entity's operations, and the complexity of its financial statements and accounting. Additionally, experience in certain industries where financial analysis is performed, such as investment banking or venture capital investments, may have provided significant exposure to and experience with financial statements and related processes.

UNDERSTANDING OF INTERNAL CONTROLS AND PROCEDURES FOR FINANCIAL REPORTING

It is important for an audit committee financial expert to understand why the internal controls and procedures for financial reporting exist, how they were developed, and how they operate. The audit committee financial expert must understand the purpose of an issuer's internal controls and procedures for financial reporting and be able to evaluate their effectiveness.

OTHER RELEVANT EXPERIENCE

This provision recognizes that an audit committee financial expert can acquire the requisite attributes of an expert in many different ways. However, the Commission has suggested that this expertise should be the product of practical experience and not, for example, merely education.

If the board of directors determines that a person's qualifications as an audit committee financial expert are based on "other relevant experience," the company's disclosure under this rule must briefly list that person's experience.

QUALITATIVE FACTORS

The board of directors needs to consider all of the facts and circumstances available when considering a person's knowledge and experience as a whole. Some candidates experience may be convincingly pertinent and abundant (e.g., recently retired partner of a large accounting firm, former FASB member, or former chief accountant of the SEC), whereas other experience will require judgment calls by the board of directors (e.g., a former accounting firm partner who has been retired for a number of years or former chief executive officers or executives who were more involved in the operating aspects of business than its financial reporting).

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SAFE HARBOR

The rule provides a safe harbor for audit committee financial experts. The safe harbor clarifies that an audit committee financial expert will not be deemed an "expert" for any other purpose. The SEC makes it clear that the designation of a person as an audit committee financial expert does not impose duties, obligations, or liability greater than that borne by a member of the audit committee without the designation. The designation does not affect the duties, obligations, or liability of any other member of the audit committee or board of directors.

The final release specifies that, although other audit committee members may look to the audit committee financial expert as a resource on certain issues that arise, audit committee members should work together to perform the committee's responsibilities. Other audit committee members may not abdicate their responsibilities.

EXEMPTION

Asset-backed issuers are exempt from the rule because they are subject to substantially different reporting requirements, most significantly because such issuers are not required to file financial statements.

DISCLOSURES

The board of directors is responsible for determining whether its audit committee has at least one financial expert. An issuer may not satisfy the disclosure requirements by stating that it has decided not to make a determination or by simply disclosing the qualifications of all of its audit committee members. It is not appropriate for an issuer to disclose that it does not have an audit committee financial expert if its board has determined that such an expert serves on the audit committee.

Once an issuer's board determines that a particular audit committee member qualifies as an audit committee financial expert, it may choose to determine whether additional audit committee members also qualify as experts. The rules permit, but do not require, an issuer to disclose that it has more than one audit committee financial expert on its audit committee.

If the registrant does not have an audit committee financial expert, the disclosure must explain why. If the registrant discloses that it has at least one audit committee financial expert, it must disclose that individual's name and whether that person is independent. A registrant choosing to identify the names of additional audit committee financial experts must indicate whether they are independent.

The rule requires issuers to include the disclosure regarding audit committee financial expert in their annual reports filed with the SEC. A domestic issuer that voluntarily chooses to include this disclosure in its proxy or information statement may incorporate the disclosure by reference into its annual report if it files the proxy or information statement with the Commission no later than 120 days after the end of the fiscal year covered by the annual report.

INDEPENDENCE OF AUDIT COMMITTEE EXPERTS

Issuers must disclose whether the audit committee financial experts they identify are independent. The rules refer to the definition of independence as described in the listing standards of the NYSE, AMEX, or NASD.

The proposed rules under section 301 issued by the SEC will require the national securities exchanges and securities association to change their listing standards. The final rule implementing section 301 is required to be effective by April 26, 2003. Under the section 301 proposal, new listing standards would need to be operative no later than the first anniversary of the publication of the final section 301 rules in the *Federal Register*. Accordingly, the definition of independence will change in the future.

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FOREIGN PRIVATE ISSUERS

A foreign private issuer is required to disclose in its annual report whether it has an audit committee financial expert, but its related obligations differ from those of domestic issuers in the respects described below:

- For a foreign private issuer with a two-tier board of directors, the term "board of directors" means the supervisory or non-management board. Therefore, the supervisory board is responsible for determining whether its audit committee includes an audit committee financial expert.
- In the case of a foreign private issuer, the focus of audit committee financial expertise should be on the generally accepted accounting principles used to prepare the primary financial statements, which may not be U.S. GAAP. Therefore, the board of directors' determination of the audit committee financial expert's "understanding of generally accepted accounting principles" must be based on the individual's understanding of the generally accepted accounting principles used by the foreign private issuer in preparing its primary financial statements filed with the Commission.
- Because foreign private issuers currently are not required to disclose whether their audit committee members are independent, the final rule does not require a foreign private issuer to disclose whether its audit committee financial expert is independent. However, the Commission intends to amend the annual reports for foreign private issuers to require the disclosure in conjunction with the adoption of final rules under section 301, which prescribe new audit committee provisions.

TRANSITION PERIOD

Issuers, other than small business issuers, must comply with the audit committee financial expert disclosure requirements in their annual reports for fiscal years ending on or after July 15, 2003. Small business issuers must comply in annual reports for fiscal years ending on or after December 15, 2003.

SECTION 408: ENHANCED REVIEWS OF PERIODIC DISCLOSURES BY ISSUERS

The Act requires the SEC to review on a "regular and systematic" basis the disclosures and financial statements of issuers that have securities listed on a national securities exchange or are traded on an automated quotation facility of a national securities association.

REVIEW CRITERIA

To determine how often to schedule these periodic reviews, the Commission will consider whether:

- Issuers have issued material restatements of financial results
- Issuers experience significant volatility in their stock price as compared with other issuers
- Issuers are among the largest market capitalization entities
- Emerging companies have disparities in price-to-earnings ratios
- Issuers have operations that significantly affect any material sector of the economy

The Commission may also consider other factors that it deems relevant.

No issuer required to file reports under the Exchange Act will be reviewed less frequently than once every three years.

SECTION 409: REAL-TIME ISSUER DISCLOSURE

Issuers must, as mandated by section 409, disclose information about material changes in their financial condition or operations on a "rapid and current" basis. The Commission is responsible for determining, by rule, what is necessary or useful to disclose. The information must be in "plain English" and may include trend and qualitative information and graphic presentations.

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The Commission has not issued final rules implementing section 409. However, prior to the Act, the Commission proposed rules on reports on Form 8-K that would shorten the filing requirements to within two business days and add 11 events that must be reported.[5] Issuers are now required to file these reports within five (5) business days when hiring a different independent auditor or reporting a director's resignation, within fifteen (15) calendar days for all other required disclosures.

The following additional events would require disclosures:

- A material agreement not made in the ordinary course of business
- Terminating such an agreement
- Terminating or reducing a customer relationship that constitutes 10 percent of the company's revenue
- A transaction or agreement that creates a material direct or contingent financial obligation
- An event triggering a material direct or contingent financial obligation, including a default or acceleration of an obligation
- Exit activities, including any material write-offs or restructurings
- A material impairment
- A change in a rating agency decision, issuance of a credit watch, or change in an issuer's outlook
- A change in the status of the issuer's securities (movement from one exchange or quotation system to another, delisting, or a notice of noncompliance with a listing standard)
- Conclusion or notice that security holders no longer should rely on the issuer's previously issued financial statements or related audit report
- Any material limitation, restriction, or prohibition regarding the issuer's employee benefit, retirement, and stock ownership plans, including the beginning and end of lockout periods

The proposal shifts two disclosures required in periodic reports to Form 8-K:

- Unregistered sales of equity securities by the issuer
- Material modifications to rights of holders of the issuer's securities

The Form 8-K requirement to report the resignation of a director would be expanded under the proposed amendment to require disclosure regarding the departure of the director for reasons other than a disagreement or removal for cause, the appointment or departure of a principal officer, and election of new directors.

5 SEC Release No. 33-8106, 34-46084, Proposed Rule: Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, June 17, 2002.

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APPENDIX A
EFFECTS ON INVESTMENT COMPANIES, ADVISERS, AND AFFILIATES

SEC rules implementing the Sarbanes-Oxley Act have specific provisions for registered investment companies (Funds). This Appendix explains those provisions, their interaction with rules affecting related companies, and differences between the rules applicable to Funds and to non-investment company issuers.

SECTION 202: PRE-APPROVAL REQUIREMENTS

Section 202 requires the issuer's audit committee to pre-approve all services provided by its auditor.

FUND PRE-APPROVAL REQUIREMENTS

The Fund's audit committee is required to pre-approve engagements by the Fund's auditor to provide services to any entity in the investment company complex that provides ongoing services to the Fund audit client, where the nature of the service directly relates to the operations and financial reporting of the Fund audit client.

"Ongoing services" is not a term defined by the SEC but such services would ordinarily be provided by, but not limited to, the following entities:

- Investment adviser
- Distributor
- Administrator
- Custodian

The Fund's audit committee must pre-approve services meeting this definition regardless of whether or not the entity to which the service is provided is a public company.

MULTIPLE PRE-APPROVALS

An entity in an investment company complex (other than a Fund) that is an issuer or a subsidiary of an issuer is subject to pre-approval requirements. Additionally, a consequence of these pre-approval requirements is that, in some cases, more than one audit committee will be required to pre-approve the same services. For example, an accounting firm for the adviser *and* the Fund is engaged by the adviser to perform a benchmarking study of the adviser's trading execution process. The results of this service may have a direct impact on the operations of the adviser and the operations of the Fund, and, therefore, both the adviser's audit committee and the Fund's audit committee are required to pre-approve the service. If different Funds within the same investment company complex have separate audit committees, then each separate audit committee is required to pre-approve the adviser's benchmarking study.

Identifying non-audit services that require pre-approval calls for careful consideration of (1) the nature of the services, (2) the entities in the investment company complex to which the services are provided, and (3) the effect of the services on the Fund's operations. Determination of whether the service has a direct impact on a Fund's operations or financial reporting can be subjective. It is helpful for audit committees, management, and the audit engagement team to establish a method to collectively make these judgments.

The Fund's audit committee is required to be aware of all services the Fund's auditor is providing to the investment company complex prior to filing its annual report with the Commission, including services that do not require pre-approval. The Fund's auditor is required to communicate annually to the Fund's audit committee all non-audit services provided to any entity in the investment company complex.

Because many fund families have several Funds with fiscal year-ends throughout the year, a literal application of the audit committee communication requirement in the Act would result in numerous audit committee meetings to communicate non-audit services. The SEC recognized that this constant communication would be burdensome and would provide little benefit. Therefore, the rule for Funds in investment company complexes with several different fiscal year-ends would require, in most cases, communication of non-audit services annually for the entire

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complex, with an update quarterly of any additional non-audit services provided that were not subject to pre-approval by the Fund's audit committee.

Consistent with the requirements applicable to non-investment companies, Fund audit committees may engage auditors to perform services pursuant to pre-approval policies and procedures established by the audit committee. Fund audit committees also are afforded a de minimis exception for situations where non-audit services are not pre-approved by the audit committee. These requirements are the same as those for non-investment companies except that the 5 percent de minimis exception is based on the aggregate fees paid by entities in the investment company complex for those non-audit services that were subject to pre-approval by the Fund's audit committee. This exception is designed to recognize that most fees for non-audit services are paid for by other entities in the investment company complex and may be subject to pre-approval by the other entities as well.

Funds are required to make the same auditor-fee disclosures in their proxy statements and certified shareholder reports on Form N-CSR that non-investment companies must make, with one additional requirement (for a discussion of Form N-CSR, see Section 302 below). Funds must disclose for each of the past two fiscal years the aggregate non-audit fees billed by their auditors for services provided to the Fund and to any entity in the investment company complex that provides ongoing services to the Fund. This disclosure requirement is consistent with prior disclosure requirements in proxy rules pertaining to all non-audit services.

SECTION 203: AUDIT PARTNER ROTATION

Partner rotation requirements for Fund audit clients are the same as for non-investment companies with two exceptions:

- First, the lead, concurring, and other audit partners defined under the SEC rules are all precluded from serving on any other Fund in the investment complex during the required "time out" period. This includes rotation to or from registered separate accounts funded through variable life insurance or variable annuities that are part of the investment company complex. Partners are precluded from rotating to other Funds in the investment company complex, but may serve non-registered funds in the complex, such as hedge funds or common/collective trust funds. In addition, partners may rotate to other entities in the investment company complex, including the investment adviser, distributor, custodian, or transfer agent.
- Second, the SEC addressed the unique structure of investment company complexes, which allows for many different fiscal year-ends within the same complex and complicates the measurement of the period of service for a partner subject to rotation. The SEC indicated in its commentary on the rule that "consecutive years of service" includes all fiscal year-end audits of Funds in the same complex that are performed in a continuous 12-month period. Consider the case when Fund Family A sponsors 12 Funds (Funds 1–12), each with different fiscal year-ends. If the lead partner on the audit of the engagement for all the Funds has completed five years of service after completing the January 31, 2003, audit of Fund 1, he or she would be allowed to complete the audits of Funds 2 through 12 through years ending December 31, 2003.

SECTION 204: AUDITOR REPORTS TO AUDIT COMMITTEES

The rule requires auditors of Funds to annually communicate specific items to the audit committee, including:

- All critical accounting policies and practices by the Fund
- All material alternative accounting treatments of financial information permitted by GAAP that have been discussed with management, including the ramifications of the use of such alternative treatments and disclosures and the treatment preferred by the accounting firm
- Other material written communications between the accounting firm and Fund management.

The SEC added requirements regarding timely communication with Fund audit committees to address the many fund families whose funds have fiscal year-ends throughout the year. The rule would, in most cases, require no more than quarterly communication of these items with the audit committee of Funds in a complex with several different fiscal year-ends.

Unit investment trusts (UITs) do not have audit committees, thus the rule does not apply to UITs.

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SECTION 206: CONFLICTS OF INTEREST

The final rule for non-investment companies establishes a one-year cooling-off period (commencing on the first day following the filing of the issuer's periodic annual report with the Commission covering the previous fiscal year) before a registered firm's independence is not impaired by a member of the audit engagement team accepting employment in certain designated positions with an audit client. For example, a member of the audit engagement team who participated on any portion of the calender year 2002 audit may not be employed by the audit client in a financial reporting oversight role without impairing independence until after the calender year 2003 audit is completed and the Form N-CSR is filed.

Funds generally have no employees; therefore, the restriction applies to employment in a financial oversight role with any entity in the investment company complex, in which the role is related to the operations and financial reporting of any Fund in the investment company complex.

The rule would not require a cooling-off period for employment with an entity in the investment company complex, such as the adviser, when the employment responsibilities include a financial oversight role related to the operations and financial reporting of the adviser but not related to the operations and financial reporting of Funds in the investment company complex.

SECTION 301: PUBLIC COMPANY AUDIT COMMITTEES—PROPOSED LISTING STANDARDS

Section 301 of the Act requires the SEC to issue rules that would prohibit the listing of an issuer's stock unless the issuer's audit committee meets the Act's requirements covering five different areas, including oversight of auditors, audit committee independence, procedures for complaints, authority to hire staff, and funding. The rules implementing section 301, as proposed, would apply to listed investment companies including listed closed-end funds, exchange-traded funds registered as open-end mutual funds, and many business development companies. The proposed rules would not apply to exchange-traded funds registered as UITs.

Independent Audit Committee Members

The audit committee members of investment company issuers would not be independent under the SEC's proposed rules if they accepted, directly or indirectly, any consulting, advisory, or other compensatory fee from the company apart from their roles as members of the board of directors and its committees. These members would also not be independent if they were "an interested person" as that term is defined in the Investment Company Act of 1940 (1940 Act).

Selection of an Independent Auditor

Section 301 requires the audit committee to select and retain the registered firm. This requirement conflicts with the 1940 Act. The 1940 Act requires that the board of directors or trustees of the registered investment company select and retain the auditor. To resolve this conflict, the SEC has proposed an exemption from the new rule for listed investment company audit committees.

In addition, new rules implementing section 202 provisions of the Act require that the Fund's audit committee be responsible to select the auditor and for the board of directors to ratify the audit committee's selection.

SECTION 302: CERTIFIED SHAREHOLDER REPORTS ON FORMS N-CSR AND N-SAR

Section 302 of the Act requires that the SEC issue rules requiring certification of periodic reports filed under sections 13(a) or 15(d) of the Exchange Act. Unlike Forms 10-K and 10-Q for non-investment companies, Funds and UITs have historically filed Form N-SAR, which is a regulatory reporting form under the Exchange Act, and is not a shareholder report. The form does not include the financial statements included in shareholder reports that are required by section 30 of the 1940 Act.

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CERTIFICATION OF FORM N-SAR

The content required in the certification of Form N-SAR is generally the same for Funds and corporate filers under the Exchange Act. The wording of the certification is stipulated in Rule 30a-2(b) of the 1940 Act. This requires a certifying officer to state that:

(1) He or she has reviewed the report being filed;

(2) Based on his or her knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the report;

(3) Based on his or her knowledge, the financial information included in the report, and the financial statements on which the financial information is based, fairly present in all material respects the financial condition, results of operations, changes in net assets, and cash flows (if the financial statements are required to include a statement of cash flows) of the investment company as of, and for, the periods presented in the report;

(4) He or she and the other certifying officers are responsible for establishing and maintaining disclosure controls and procedures for the investment company and have:

   (i) Designed such disclosure controls and procedures to ensure that material information relating to the investment company, including its consolidated subsidiaries, is made known to them by others within those entities, particularly during the period in which the periodic reports are being prepared;

   (ii) Evaluated the effectiveness of the investment company's disclosure controls and procedures as of a date within 90 days prior to the filing date of the report (the "Evaluation Date"); and

   (iii) Presented in the report their conclusions about the effectiveness of the disclosure controls and procedures based on their evaluation as of the Evaluation Date;

(5) He or she and the other certifying officers have disclosed, based on their most recent evaluation, to the investment company's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function):

   (i) All significant deficiencies in the design or operation of internal controls that could adversely affect the investment company's ability to record, process, summarize, and report financial data and have identified for the investment company's auditors any material weaknesses in internal controls; and

   (ii) Any fraud, whether or not material, that involves management or other employees who have a significant role in the investment company's internal controls; and

(6) He or she and the other certifying officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Rule 30a-2 of the 1940 Act, which was adopted in August 2002, required the principal executive and financial officers of Funds that file periodic reports under sections 13(a) or 15(d) of the Exchange Act to certify the financial information included in the company's Form N-SAR, as well as the financial statements on which the financial information in the Form N-SAR is based. Most Funds and UITs currently are included under these requirements.

Disclosure Controls and Procedures

The August 2002 rule implementing the certification requirements of Rule 30a-2(c) of the 1940 Act required investment companies to maintain disclosure controls and procedures for reports that are filed under the Exchange Act. Therefore, controls and procedures to ensure timely collection and evaluation of information included in the Form N-SAR were required. Disclosure controls and procedures relating to shareholder reports filed under the 1940 Act, including the annual and semi-annual report, were not required.

Consistent with non-investment companies, registered investment companies were required to conduct an evaluation of the effectiveness of the design and operation of their disclosure controls and procedures within 90 days of the date of the filing of the certification. This evaluation was to be performed under the supervision and with participation of their principal executive and financial officers.

A single evaluation for a series or family of Funds could be used in multiple certifications of the Funds in the series or family, as long as the evaluation meets the timing requirements.

Form N-CSR

The SEC amended the 1940 Act to require Funds, other than small business investment companies (SBICs), to file a new certified shareholder report on Form N-CSR rather than Form N-SAR.* In addition, the SEC amended Rule 30d-1 of the 1940 Act to designate these certified shareholder reports as reports that are required under sections 13(a) and 15(d) of the Exchange Act rather than Form N-SAR.

*SEC Release No. 34-47262; IC-25914, Final Rule: Certification of Management Investment Company Shareholder Reports and Designation of Certified Shareholder Reports as Exchange Act Periodic Reporting Forms; Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, January 27, 2003

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In changing the designation of reports filed under the Exchange Act, the SEC replaced the certification requirements of Form N-SAR with the new Form N-CSR requirements with the intent of improving the quality of disclosure that a Fund provides to shareholders. Funds are no longer required to certify Form N-SAR. In addition, SBICs and UITs, which are not required to file Form N-CSR, will not otherwise be required to certify their Forms N-SAR.

Scope of Certification

Form N-CSR includes the annual or semi-annual report distributed to shareholders as well as the officers' certifications. Therefore, while the wording of the certification of Form N-CSR is identical to the previous certification in Form N-SAR, the scope of the certification covers different information, including (1) the financial statements and related footnote disclosures; (2) management's discussion of fund performance, which is typically included in shareholder reports in response to Item 5 of Form N-1A (the Fund's registration statement); and (3) any other disclosures whether voluntarily made or required by Form N-CSR. The SEC has separately adopted rules requiring disclosure in Form N-CSR of information pertaining to codes of ethics and audit committee financial experts. These disclosures are also subject to certification requirements. The rules implementing sections 406 and 407 of the Act are further discussed below.

Disclosure Controls and Procedures: Form N-CSR

Amendments to the certification rules require Funds (other than SBICs and UITs) to maintain and regularly evaluate the effectiveness of disclosure controls and procedures relating to the information included in the Form N-CSR rather than the information in the Form N-SAR. Like the Form N-SAR requirement, the evaluation of disclosure controls must be made within 90 days of the date of the filing of the certification. A single evaluation for a series or family of Funds could be used in multiple Form N-CSR certifications for Funds in a series or family, as long as the evaluation meets the timing requirements.

Transition

All Funds that are required to file Form N-CSR must follow the new rule and form amendments in filings covering fiscal periods ending after April 1, 2003.

Funds with fiscal periods ending on or before March 31, 2003, have an option to file Form N-CSR or to continue to comply with the certification requirements of Form N-SAR. Those Funds that choose to file the Form N-CSR for fiscal annual or semi-annual periods ending on or before March 31, 2003, may omit from their certifications items 4, 5, and 6, which pertain to (1) responsibilities for establishing and maintaining disclosure controls and procedures, (2) disclosures relating to the evaluation of disclosure controls and procedures, (3) disclosures regarding communication of fraud and internal control deficiencies to independent auditors and audit committees, and (4) disclosures pertaining to significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of the evaluation. These transition provisions are designed to give registrants the flexibility to establish disclosure controls covering the elements of the Form N-CSR, while maintaining the requirement for registrants to continue to certify periodic reports.

The effective date of the removal of the certification requirement for Form N-SAR is May 1, 2003, except that SBICs and UITs may discontinue certifying on Form N-SAR immediately.

SECTION 406: CODE OF ETHICS DISCLOSURE

Each Fund is required to disclose in its reports whether it has adopted—and if not, why not—a code of ethics that applies to the Fund's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions, regardless of whether these individuals are employed by the Fund or an affiliated or unaffiliated third party. With the exception of SBICs, which are required to make this disclosure on Form N-SAR, all Funds are required to disclose this information in Form N-CSR. UITs are excluded from code of ethics disclosure requirements.

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The definition of the required code of ethics and the related disclosures are generally the same as those applicable to non-investment companies. Unlike non-investment companies, however, prior to the adoption of the code of ethics rules, Funds were already required to keep codes of ethics pertaining to investment trading practices of certain employees of a Fund's investment adviser. The director of the SEC's Division of Investment Management noted at the open Commission meeting on January 22, 2003, where the code of ethics requirements for Funds were adopted, that such codes of ethics designed to comply with Rule 17j-1 of the 1940 Act could be included as part of a broader code of ethics designed to comply with SEC rules implementing the Act.

A Fund has three options for making the code available to their investors:

- File a copy of the code as an exhibit to its annual report on Form N-CSR or Form N-SAR
- Post the text of the code on the Fund's Internet Web site and disclose in its most recent report on Form N-CSR or Form N-SAR that it has posted the code of ethics on its Web site and citing the Web site address.
- Disclose in the Fund's most recent report on Form N-CSR or Form N-SAR that it will provide a copy of the code to any person without charge upon request, and explaining the manner in which such a request can be made.

A fund has two options relating to the manner and timing of its disclosure of changes to, or waivers of, its code of ethics:

- Disclose on its Web site within five business days. However, if the Fund elects to remove the disclosure from its Web site after the 12-month posting period, the Fund must retain this disclosure for a period of not less than six years, rather than the five-year period required for non-investment companies.
- Disclose changes to or waivers of the code of ethics in each semi-annual report on Form N-CSR or Form N-SAR filed with the Commission. When a Fund elects to include its disclosure in these filings, it otherwise has no current reporting requirement triggered by a change to or waivers of its code of ethics.

Funds will be required to comply with the code of ethics disclosure requirements beginning in periodic reports filed on Form N-CSR or Form N-SAR for fiscal years ending on or after July 15, 2003.

SECTION 407: AUDIT COMMITTEE FINANCIAL EXPERT DISCLOSURE

The annual "audit committee financial expert" disclosure requirements are the same for Funds as for non-investment companies, with two exceptions:

- First, all Funds, with the exception of SBICs, are required to report the "audit committee financial expert" disclosure in their annual certified shareholder reports on Form N-CSR. SBICs are required to report the information in their annual Form N-SAR.
- Second, the definition of when an audit committee financial expert is "independent" of a Fund differs slightly from that for a non-investment company. To be independent, a member of an audit committee of a Fund may not, other than in his or her capacity as a member of the audit committee, board of directors, or any other board committee, accept directly or indirectly any consulting, advisory, or other compensatory fee from the issuer or be an "interested person" of the Fund as defined in section 2(a)(19) of the 1940 Act.

Funds will be required to comply with the audit committee financial expert disclosure requirements beginning in periodic reports filed on Form N-CSR or Form N-SAR for fiscal years ending on or after July 15, 2003.

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APPENDIX B
SUMMARY OF EFFECTIVE DATES AND TRANSITION PROVISIONS

TITLE II: AUDITOR INDEPENDENCE

Topic	Transition and Grandfathering
Conflicts of Interest Resulting from Issuer's Employment of Audit Engagement Team Members (page 16)	• Applies to new employment relationships entered into on or after May 6, 2003. • Employment relationships existing before May 6, 2003, are grandfathered. • Employment relationships involving former audit firm personnel who become employed at the issuer in a financial reporting oversight role as a result of business combinations are grandfathered, provided the audit committee is aware of the prior relationship with the accounting firm and provided the employment is not in contemplation of the business combination.
Prohibited Non-Audit Service Contracts (page 5)	• Applies to contracts entered into on or after May 6, 2003. • Contracts entered into before May 6, 2003, must be completed within 12 months after the Effective Date.
Partners' Rotation (page 11)	• Lead and concurring partners are required to rotate after serving in a combination of either of these roles for five consecutive years. • Lead partner rotation requirements are effective for the first fiscal year beginning after May 6, 2003, and prior years of service as lead or concurring partner are counted. • Concurring partner rotation requirements are effective for the second fiscal year beginning after May 6, 2003, and prior years of service as concurring partner are counted. • Other audit partners are permitted seven consecutive years and prior years of service are not counted. Requirements take effect for an issuer's first fiscal year beginning after May 6, 2003. • For all non-U.S. audit partners, regardless of their role, prior years of service are not counted. Requirements take effect for an issuer's first fiscal year beginning after May 6, 2003, or one year later for concurring review partners.
Requirements for Pre-Approval of Services by Audit Committees (page 9)	• Applies to new engagements entered into after May 6, 2003. • Engagements in progress at May 6, 2003, are exempt from pre-approval requirements.
Limitations on Partner Compensation (page 13)	• Applies to the next fiscal year of an accounting firm beginning after May 6, 2003.
Required Auditor Communications with the Audit Committee (page 13)	• Applies at May 6, 2003. • Communications must occur prior to filing of audited financial statements with the SEC.
Issuer Disclosure of Fees Paid to the Auditor (page 10)	• Applies to issuers' fiscal years ending after December 15, 2003. • Early adoption is encouraged.

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TITLE III: CORPORATE RESPONSIBILITY

Topic	Transition and Grandfathering
Public Company Audit Committee Responsibilities (page 19)	• Proposed rule was issued January 8, 2003. • Final rule is required to be effective by April 26, 2003. • As proposed, the new listing requirements would need to made operational by the exchanges and associations no later than the first anniversary of the publication of the final rule in the Federal Register.
Officer Certification Requirements (page 22)	• Effective since August 29, 2002. • Subject to amendment upon enactment of the SEC's proposed rule implementing section 404.
Improper Influence on Conduct of Audits by Officers and Directors (page 25)	• Proposed rule was issued October 18, 2002. • Final rule is expected to be issued by April 26, 2003.
Forfeiture of Bonuses and Profits by Executives as a Result of a Restatement (page 27)	• Effective July 30, 2002.
Bars and Penalties for Misconduct by Officers and Directors (page 27)	• Effective July 30, 2002.
Notices to Insiders and the Commission Regarding Pension Fund Blackout Periods (page 27)	• Effective for blackout periods commencing on or after January 26, 2002. • Blackout periods that commenced before January 26, 2003, and remain in effect are not affected. • Notice to directors and officers is required as soon as reasonably practicable for blackout periods commencing between January 26, 2003, and February 25, 2003. • Notices in accordance with the rule to directors and officers and the Commission are effective for blackout periods beginning on March 31, 2003.
Rules of Professional Responsibility for Attorneys Appearing and Practicing Before the Commission (page 30)	• Effective August 5, 2003. • "Noisy withdrawal" issue is currently the subject of a separate SEC proposal.
Collection and Administration of Funds for Victim Investors (page 32)	• Effective July 30, 2002.

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TITLE IV: SUMMARY OF EFFECTIVE DATES AND TRANSITION PROVISIONS

Topic	Transition and Grandfathering
Disclosures of Off-Balance-Sheet Arrangements (page 33)	• Not effective until issuer files an annual report, registration statement, proxy, or information statement that includes financial statements for an annual period ending on or after June 15, 2003. • For calendar-year issuers, the new rule will take effect for reports or filings that include the December 31, 2003, financial statements.
Disclosures of Contractual Obligations (page 35)	• Effective for fiscal years ending after December 15, 2003. • Early adoption is permitted.
Disclosures and Reconciliation of Non-GAAP Financial Measures (page 36)	• Regulation G applies to all public disclosures, including earnings releases and filings with the SEC, made as of March 28, 2003. • Additional provisions applicable only to SEC filings will be effective for filings that include periods ending after March 28, 2003. • 10-K reports filed on or after March 28, 2003, for periods prior to that date that contain a non-GAAP financial measure must include a reconciliation. • Reports filed on 10-Q on or after March 28, 2003. • Form 8-K will apply to earnings and similar announcements after March 28, 2003.
Restrictions on Providing Certain Loans to Officers and Directors (page 40)	• Effective July 30, 2002. • Any loans that were outstanding on July 30, 2002, are unaffected by the prohibition, provided they are not materially modified or renewed after that date.
Disclosures of Transactions Involving Management and Principal Stockholders (page 40)	• Effective August 30, 2002. • Electronic filing of reports and availability on Web sites required by July 30, 2003.
Certification of Management's Assessment of Internal Controls and Auditor's Attestation of Such Controls (page 40)	• Proposed rule issued October 22, 2002. • Proposal suggests requirements would apply to fiscal years ending on or after September 15, 2003.
Disclosure of Code of Ethics and Amendments to, and Waivers of, the Code of Ethics (page 44)	• Effective for fiscal years ending on or after July 15, 2003.
Disclosure of Audit Committee Financial Expert (page 46)	• Effective for fiscal years ending on or after July 15, 2003 (December 15, 2003, for small business issuers).
Requirements for More Timely and Additional Form 8-K Disclosures (page 49)	• Proposed rule issued June 17, 2002.

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APPENDIX C
SUMMARY OF SEC RELEASES

SECTION OF THE SARBANES-OXLEY ACT	RELATED SEC RELEASE
Section 103: Auditing, Quality Control, and Independence Standards and Rules—Retention of Audit Work Papers	No. 33-8180; 34-47241, IC-25911; FR-66, Final Rule: Retention of Records Relevant to Audits and Reviews, January 24, 2003
Section 201: Services Outside the Scope of Practice of Auditors Section 202: Pre-Approval Requirements Section 203: Audit Partner Rotation Section 204: Auditor Reports to Audit Committees Section 206: Conflicts of Interest	No. 33-8183; 34-47265; 35-27642; IC-25915; IA-2103, FR-68, Final Rule: Strengthening the Commission's Requirements Regarding Auditor Independence, January 28, 2003
Section 301: Public Company Audit Committees	No. 34-47137; 33-8173; IC-25885, Proposed Rule: Standards Relating to Listed Company Audit Committees, January 8, 2003
Section 302: Corporate Responsibility for Financial Reports	No. 33-8124, Final Rule: Certification of Disclosure in Companies' Quarterly and Annual Reports, August 29, 2002 No. 34-47262; IC-25914, Final Rule: Certification of Management Investment Company Shareholder Reports and Designation of Certified Shareholder Reports as Exchange Act Periodic Reporting Forms; Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, January 27, 2003
Section 303: Improper Influence on Conduct of Audits	No. 34-46685; IC-25773, Proposed Rule: Improper Influence on Conduct of Auditors, October 18, 2002
Section 306: Insider Trades During Pension Fund Blackout Periods	No. 34-47225; IC-25909, Final Rule: Insider Trades During Pension Fund Blackout Periods, January 22, 2003
Section 307: Rules of Professional Responsibility for Attorneys	No. 33-8185, 34-47276; IC-25919, Final Rule: Implementation of Standards of Professional Conduct for Attorneys, January 29, 2003
Section 401(a): Off-Balance-Sheet Transactions	No. 33-8182; 34-47264; FR-67, International Series No. 1266 Final Rule: Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, January 27, 2003
Section 401(b): Non-GAAP Financial Measures	No. 33-8176; 34-47226; FR-65, Final Rule: Conditions for Use of Non-GAAP Financial Measures, January 22, 2003
Section 403: Disclosures of Transactions Involving Management and Principal Stockholders	No. 34-46421, Final Rule: Ownership Reports and Trading by Officers, Directors, and Principal Security Holders, August 27, 2002
Section 404: Management Assessment of Internal Controls	No. 33-8138; 34-46701; IC-25775, Proposed Rule: Disclosure Required by Sections 404, 406, 407 of the Sarbanes-Oxley Act of 2002, October 22, 2002
Section 406: Code of Ethics for Senior Financial Officers Section 407: Disclosure of Audit Committee Financial Expert	No. 33-8177; 34-47235, Final Rule: Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, January 23, 2003 No. 34-47262; IC-25914, Final Rule: Certification of Management Investment Company Shareholder Reports and Designation of Certified Shareholder Reports as Exchange Act Periodic Reporting Forms; Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, January 27, 2003
Section 409: Real Time Issuer Disclosure	No. 33-8106; 34-46084, Proposed Rule: Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, June 17, 2002

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GLOSSARY

This glossary presents definitions from the Sarbanes-Oxley Act, from proposed and final SEC rules, and from commentary in SEC releases. The definitions from the Act and from SEC releases are either verbatim or near verbatim. Since many of these terms have definitions for other purposes, the identity the origin of the definitions is cited parenthetically. The glossary also contains explanations of abbreviated terms, such as "Commission" for Securities and Exchange Commission and "GAAP" for generally accepted accounting principles. In those cases, the source is identified. The Act is always the Sarbanes-Oxley Act. The securities acts are identified more specifically.

accountant (SEC rule)
A registered public accounting firm, certified public accountant, or public accountant performing services in connection with an engagement for which independence is required. References to the accountant include any accounting firm with which the certified public accountant or public accountant is affiliated.

accounting role (SEC rule)
A position to exercise or that does exercise more than minimal influence over the contents of the accounting records or anyone who prepares them.

affiliate (of the audit client) (SEC rule)

- An entity that (1) has control over the audit client, or (2) over which the audit client has control, or (3) that is under common control with the audit client, including the audit client's parents and subsidiaries
- An entity over which the audit client has significant influence, unless the entity is not material to the audit client
- An entity that has significant influence over the audit client, unless the audit client is not material to the entity
- Each entity in the investment company complex when the audit client is an entity that is part of an investment company complex

appropriate state regulatory authority (Act)
The state agency or other authority responsible for the licensure or other regulation of the practice of accounting in the state or states having jurisdiction over a registered public accounting firm or associated person thereof, with respect to a matter in question.

audit (Act)
An examination of the financial statements of any issuer by an independent public accounting firm in accordance with the rules of the Public Company Accounting Oversight Board or the Securities and Exchange Commission (or for the period preceding the adoption of applicable rules of the Public Company Accounting Oversight Board under section 103, in accordance with then-applicable generally accepted auditing and related standards for such purposes), for the purpose of expressing an opinion on such statements.

audit client (SEC rule)
The entity whose financial statements or other information is being audited, reviewed, or attested and any affiliates of that entity.

audit committee (Act)
Committee, or equivalent body, established by 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. If no such committee exists with respect to an issuer, the entire board of directors of the issuer is the audit committee.

audit committee financial expert (SEC rule)
A person who has the following attributes:

- An understanding of generally accepted accounting principles and financial statements;
- The ability to assess the general application of such principles in connection with the accounting for estimates, accruals, and reserves;
- Experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities;
- An understanding of internal controls and procedures for financial reporting; and
- An understanding of audit committee functions.

A person must have acquired such attributes through any one or more of the following:

- 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;
- Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;

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- Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; and
- Other relevant experience.

audit engagement period (SEC rule)
For purposes of the Conflicts of Interest rule, audit procedures are deemed to have commenced for the current audit engagement period the day after the prior year's periodic annual report (e.g ., Form 10-K, 10-KSB, 20-F, or 40-F) is filed with the Commission. The audit engagement period for the current year is deemed to conclude the day the current year's periodic annual report (for example, Form 10-K, 10-KSB, 20-F or 40-F) is filed with the Commission.

audit engagement team (SEC rule)
All partners, principals, shareholders, and professional employees participating in an audit, review, or attestation engagement of an audit client, including audit partners and all persons who consult with others on the audit engagement team during the audit, review, or attestation engagement regarding technical or industry-specific issues, transactions, or events.

audit and professional engagement period (SEC rule)
Includes both the period covered by the financial statements being audited or reviewed and the period of engagement to audit or review the client's financial statements or to prepare a report filed with the Commission. The period of engagement begins when the auditor signs an initial engagement letter or begins audit, review or attest procedures, and ends when the client or the auditor notifies the Commission that the client is no longer the auditor's audit client.

audit partner (SEC rule)
A partner or persons in an equivalent position, other than a partner who consults with others on the audit engagement team during the audit, review, or attestation engagement regarding technical or industry-specific issues, transactions, or events, who is a member of the audit engagement team who has responsibility for decision making on significant auditing, accounting, and reporting matters that affect the financial statements, or who maintains regular contact with management and the audit committee and includes the following:

- The lead or coordinating audit partner having primary responsibility for the audit or review (the "lead partner");
- The partner performing a second level of review to provide additional assurance that the financial statements subject to the audit or review are in conformity with generally accepted accounting principles and the audit or review and any associated report are in accordance with generally accepted auditing standards and rules promulgated by the Commission or the Public Company Accounting Oversight Board (the "concurring or reviewing partner");
- Other audit engagement team partners who provide more than ten hours of audit, review, or attest services in connection with the annual or interim consolidated financial statements of the issuer or an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8); and
- Other audit engagement team partners who serve as the "lead partner" in connection with any audit or review related to the annual or interim financial statements of a subsidiary of the issuer whose assets or revenues constitute 20 percent or more of the assets or revenues of the issuer's respective consolidated assets or revenues.

audit report (Act)
A document or other record report prepared following an audit performed for purposes of compliance by an issuer with the requirements of the securities laws and in which a public accounting firm either sets forth the opinion of that firm regarding a financial statement, report, or other document or asserts that no such opinion can be expressed.

Board (Act)
See Public Company Accounting Oversight Board.

code of ethics (SEC rule)
Written 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 Commission and in other public communications made by the registrant
- Compliance with applicable governmental laws, rules, and regulations
- The prompt internal reporting to an appropriate person or persons identified in the code of violations of the code
- Accountability for adherence to the code

Commission (Act)
Securities and Exchange Commission (SEC)

disclosure controls and procedures (SEC rule)
This term, used in the certification process, refers to controls and other procedures that are designed to ensure that information required to be disclosed in the reports an issuer files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized, and reported within the time periods specified in the Securities Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in reports filed or submitted under the Securities Exchange Act of 1934 is accumulated and communicated to management, including its principal

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executive officer or officers and principal financial officer or officers, or persons performing similar functions, as appropriate to allow timely decision regarding required disclosure.

Exchange Act (SEC rule)
Refers to the Securities Exchange Act of 1934, which created the Securities and Exchange Commission. The Exchange Act outlawed manipulative and abusive practices in the issuance of securities; required registration of stock exchanges, brokers, dealers, and listed securities; and required disclosure of certain financial information and insider trading.

financial reporting oversight role (SEC rule)
A role in which a person is in a position to or does exercise influence over the contents of the financial statements or anyone who prepares them, such as when the person is a member of the board of directors or similar management or governing body, chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, or any equivalent position.

GAAP
generally accepted accounting principles

GAAS
generally accepted auditing standards

internal controls (GAAS)
A process—affected 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: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with applicable laws and regulations.

Internal control consists of five interrelated components:

a. *Control environment* 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.

b. *Risk assessment* is the entity's identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how the risks should be managed.

c. *Control activities* are the policies and procedures that help ensure that management directives are carried out.

d. *Information and communication* systems support the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.

e. *Monitoring* is a process that assesses the quality of internal control performance over time.

internal controls and procedures for financial reporting (SEC rule)
Controls that pertain to the preparation of financial statements for external purposes that are fairly presented in conformity with GAAP as addressed by the GAAS or any superseding definition or other literature that is issued or adopted by the Public Company Accounting Oversight Board.

investment company complex (1940 Act)
An investment company complex is a group of related entities that includes:

a) An investment company and its adviser or sponsor

b) Any entity controlled by or controlling an investment adviser or sponsor in (a) above, or any entity under common control with an investment adviser or sponsor in (a) above, if the entity is:

(1) An investment adviser or sponsor or

(2) Engaged in the business of providing administrative, custodian, underwriting, or transfer agent services to any investment company adviser or sponsor

c) Any investment company or entity that would be an investment company but for the exclusions provided by section 3(c) of the Investment Company Act of 1940 that has an investment adviser or sponsor included in this definition by either paragraph (a) or (b) above (e.g., hedge funds)

issuer (Act)
For these purposes, 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.

non-audit services (Act)
Any professional services provided to an issuer by a registered public accounting firm, other than those services provided to an issuer in connection with an audit or a review of the financial statements of an issuer.

person associated with a public accounting firm (Act)
The terms "person associated with a public accounting firm" (or "with a registered public accounting firm") and "associated person of a public accounting firm" (or "of a registered public accounting firm") mean any individual proprietor, partner, shareholder, principal, accountant, or other professional employee of a public accounting firm, or any other independent contractor or entity that, in connection with the preparation or issuance of any audit report:

- Shares in the profits of, or receives compensation in any other form from, that firm, or

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- Participates as agent or otherwise on behalf of such accounting firm in any activity of that firm

professional standards (Act)
Accounting principles that are:

- Established by the standard-setting body described in section 19(b) of the Securities Act of 1933, as amended by the Sarbanes-Oxley Act of 2002, or prescribed by the SEC under section 19(a) of that Act (15 U.S.C. 17a(s)) or section 13(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78a(m))
- Relevant to audit reports for particular issuers, or dealt with in the quality control system of a particular registered public accounting firm
- Auditing standards, standards for attestation engagements, quality control policies and procedures, ethical and competency standards, and independence standards (including rules implementing title II) that the Public Company Accounting Oversight Board or the SEC determines:
  - Relate to the preparation or issuance of audit reports for issuers
  - Are established or adopted by the Public Company Accounting Oversight Board under section 103(a), or are promulgated as rules of the SEC

Public Company Accounting Oversight Board (PCAOB) (Act)
The body established by the Sarbanes-Oxley Act of 2002 to oversee the audit of public companies that are subject to the securities laws and related matters. The Public Company Accounting Oversight Board is directed to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for public companies.

public accounting firm (Act)
A proprietorship, partnership, incorporated association, corporation, limited liability company, limited liability partnership, or other legal entity that is engaged in the practice of public accounting or preparing or issuing audit reports and to the extent so designated by the rules of the Public Company Accounting Oversight Board, any associated person of any of these entities.

registered public accounting firm or "registered firm" (Act)
A public accounting firm registered with the Public Company Accounting Oversight Board in accordance with the Sarbanes-Oxley Act of 2002.

rules of the board (Act)
The bylaws and rules of the Public Company Accounting Oversight Board (as submitted to, and approved, modified, or amended by the Commission, in accordance with section 107), and those stated the policies, practices, and interpretations of the Public Company Accounting Oversight Board that the Securities Exchange Commission may deem to be rules of the Public Company Accounting Oversight Board, as necessary or appropriate in the public interest or for the protection of investors.

SEC Practice Section (AICPA)
Self-regulatory group within the AICPA whose objective is to improve the practice of CPA firms before the SEC. The bylaws of the American Institute of Certified Public Accountants (AICPA) require that all members who engage in the practice of public accounting with a firm that audits one or more SEC clients are required to join the SEC Practice Section.

Securities Exchange Act of 1933 or "Securities Act" (SEC rule)
The federal law that regulates the securities industry. It requires registration of securities and includes measures to discourage fraud and deception.

work papers (SEC rule)
Documentation of auditing or review procedures applied, evidence obtained, and conclusions reached by the accountant in the audit or review engagement, as required by the Securities and Exchange Commission or the Public Company Accounting Oversight Board.

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