SEC Adopts Final Rules Regarding Audit Committee Financial Experts
Under Section 407 of the Sarbanes-Oxley Act of 2002

February 2003

Introduction

On January 23, 2003, the SEC approved final rules under Section 407 of the Sarbanes-Oxley Act of 2002 requiring public reporting companies to disclose whether their audit committees include at least one member who is an “audit committee financial expert” and, if so, the name of the expert and whether the expert is independent of management (see SEC Release No. 33-8177). A company that does not have an audit committee financial expert must disclose this fact and explain why it has no such expert.

Time Frame for Compliance

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

Disclosure Requirements

The SEC rules (which expand the current Item 401 of Regulations S-K and S-B, and create a redesignated Item 16A of Form 20-F and a new Instruction B.(8) of Form 40-F) will require public reporting companies to disclose whether or not the company has at least one audit committee financial expert serving on its audit committee, as determined by the board of directors.

In addition to this disclosure, the SEC rules will also require that:

- if the company discloses that it does not have at least one audit committee financial expert, it must explain why it does not have one; and
- if the board of directors has determined that it has more than one audit committee financial expert serving on its audit committee then it may, but is not required to, disclose the names of those additional persons, but if it does disclose the names, it must indicate whether they are independent.

The independence standard used in the new rules is contained in Item 7(d)(3)(iv) of Schedule 14A of the Exchange Act and currently references the NYSE, AMEX or Nasdaq definitions of independence, as applicable. The definitions are contained in Sections 303.01(B)(2)(a) and (3) of the NYSE listing standards, Section 121(A) of the AMEX listing standards, and Rule 4200(a)(15) of the Nasdaq listing standards.

However, in the adopting release the SEC mentions in a footnote that the current references in Item 7(d)(3)(iv) of Schedule 14A may be amended as a result of the recently proposed rules under Section 10A of the Exchange Act. Those proposed rules direct the national securities exchanges and associations to prohibit the listing of any security of an issuer that, among other things, does not have an independent audit committee, as that term is used in Section 10A(m)(3) of the Exchange Act.

Definition of “Audit Committee Financial Expert”

The SEC rules define “audit committee financial expert” as a person who has each of 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 company’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.

The audit committee financial expert must have acquired such attributes through at least one of the following ways:

• education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions;

• 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.

The SEC release states that the fact that a person previously has served on an audit committee does not, by itself, justify a company’s board of directors in “grandfathering” that person as an audit committee financial expert under the audit committee financial expert definition. In addition, the SEC release states that the fact that a person has experience as a public accountant or auditor, a principal financial officer, controller or principal accounting officer or experience in a similar position would not, by itself, justify the board of directors in deeming the person to be an audit committee financial expert.

The SEC release also states that, in addition to determining that a person possesses an appropriate degree of knowledge and experience, the board must ensure that it names an audit committee financial expert who embodies the highest standards of personal and professional integrity and that therefore a board should consider any disciplinary actions to which a potential expert is, or has been, subject in determining whether that person would be a suitable audit committee financial expert.

**Will a CEO, Venture Capitalist or Investment Banker qualify?**

The final SEC rules do not expressly refer to a CEO, but they provide that experience actively supervising a person who prepares, audits, analyzes or evaluates financial statements would satisfy the requirement of “preparing or auditing” financial statements. The SEC cautioned, however, that the mere existence of a traditional hierarchical reporting relationship between supervisor and those being supervised would not necessarily satisfy this standard. For example, a principal executive officer with considerable operations involvement, but little financial or accounting involvement, would not have “active supervision” under this standard. The supervisor must have general expertise to prepare, audit, analyze or evaluate financial statements at least comparable to the general expertise of the person being supervised. Therefore, a CEO could qualify as a financial expert presuming that he or she met the “active supervision” standard.

The SEC release also recognizes that a broader group of people, expressly including investment bankers and venture capitalists, may have the qualities necessary to act as an audit committee financial expert. A company’s board is encouraged to consider all the available facts and circumstances in determining whether an individual qualifies as an audit committee financial expert, not a mechanical checklist of factors.
Safe Harbor

The requirements of Section 407 of the Sarbanes-Oxley Act are entirely disclosure-based, and the SEC release states that it would not be in the public interest if the designation and identification of the audit committee financial expert affected the duties, obligations or liabilities to which any member of the company’s audit committee or board is subject. To this end, the final rules contain a safe harbor to clarify that:

• a person who is determined to be an audit committee financial expert will not be deemed an “expert” for any other purpose, including without limitation for purposes of the director liability provisions Section 11 of the Securities Act, as a result of being designated or identified as an audit committee financial expert pursuant to the new disclosure item;

• the designation or identification of a person as an audit committee financial expert pursuant to the new disclosure item does not impose on such person any duties, obligations or liability that are greater than the duties, obligations and liability imposed on such person as a member of the audit committee and board of directors in the absence of such designation or identification; and

• the designation or identification of a person as an audit committee financial expert pursuant to the new disclosure item does not affect the duties, obligations or liability of any other member of the audit committee or board of directors.

In other words, the SEC believes that there should be no heightened exposure to liability for an audit committee financial expert. Whether or not this is in fact true remains to be seen.

Location of Disclosure

The SEC rules require companies to include the new disclosure in Part III of their annual reports on Forms 10-K and 10-KSB. However, companies will not be required to include this disclosure in their quarterly reports. Consequently, a company may incorporate this information by reference from its definitive proxy or information statement that involves an election of directors if the company voluntarily chooses to include this information in its proxy or information statement and then files such statement with the SEC no later than 120 days after the end of the fiscal year covered by the Form 10-K or 10-KSB.

Changes from Proposed Rules

Please note that this final release differs significantly from the proposed rules which were issued by the SEC in October 2002.

The term audit committee financial expert has replaced the originally proposed term of financial expert. The definition of independence has shifted from the definition contained in Section 10A(m)(3) of the Exchange Act to that contained in Item 7(d)(3)(iv) of Schedule 14A of the Exchange Act. In the attributes required for a financial expert, the second and third factors have been broadened so that an individual does not necessarily have to have acquired direct experience preparing or auditing financial statements but could have acquired the necessary skills through analyzing or evaluating financial statements or actively supervising others. In its commentary, the SEC specifically recognized that persons actively engaged in industries such as investment banking and venture capital often have relevant experience evaluating financial statements and may be eligible to qualify as a financial expert.

The proposed rules provided an extensive list of factors to be considered in evaluating whether an individual qualifies as an audit committee financial expert, and those factors have been eliminated. The final rules add a section for the clarification of the means by which an audit committee financial expert must have acquired the relevant experience. The SEC also eliminated the proposed requirement that an audit committee financial expert must have gained the relevant experience with a company that, at the time the person held such position, was a public company.

The proposed rules contemplated locating the required disclosure in a new Item 309 of Regulations S-K and S-B, but the final proposal
moves the location to existing Item 401 of Regulations S-K and S-B. Finally, the enumeration of the safe harbor contained in the final rules was not contained in the proposed rules.

This memorandum is intended only as general information about the matters discussed, and should not be construed as legal advice. For more information about these matters, please contact your Wilson Sonsini Goodrich & Rosati partner.