

October 29, 2002

SEC Issues Proposed Rules Implementing Provisions of the Sarbanes-Oxley Act

On October 22, 2002, the SEC proposed rules to implement Sections 404, 406, and 407 of the Sarbanes-Oxley Act (the "Act"). In connection with the proposed rule implementing Section 404 of the Act, the SEC also proposed making revisions to its recently adopted rules requiring a company's principal executive and financial officers to certify quarterly and annual reports.

The comment period on the proposed rules ends November 29, 2002

The full text of the rules proposals is available on the SEC's website at <http://www.sec.gov/rules/proposed/33-8138.htm>

Management's Internal Controls and Procedures for Financial Reporting

Section 404 of the Act directs the SEC to issue rules requiring a company to include in each annual report an internal control report: (1) stating management's responsibilities for establishing and maintaining adequate internal control structure and procedures for financial reporting; and (2) containing an assessment, as of the company's most recent fiscal year, of the effectiveness of the company's internal controls and procedures for financial reporting.

The SEC's proposed rule would require a company's annual report to include an internal control report of management setting forth the following:

1. A statement of management's responsibilities for establishing and maintaining adequate internal controls and procedures for financial reporting;
2. Conclusions about the effectiveness of the company's internal controls and procedures for financial reporting based on management's evaluation of those controls and procedures in accordance with Exchange Act Rule 13a-15 or 15d-15, as of the end of the company's most recent fiscal year; and
3. A statement that the registered public accounting firm that prepared or issued the company's audit report relating to the financial statements included in the company's annual report has attested to, and reported on, management's

evaluation of the company's internal controls and procedures for financial reporting.

The SEC stated that the proposed rule does not specify the exact content of the proposed management report and that management should tailor the report to the company's circumstances.

The proposed rule would define the term "internal controls and procedures" to mean controls that pertain to the preparation of financial statements for external purposes that are fairly presented in conformity with generally accepted accounting principles.

Section 404 of the Act also requires every registered public accounting firm that prepares or issues an audit report for an issuer other than a registered investment company to attest to, and report on, management's assessment of the company's internal controls and procedures for financial reporting. The SEC rule proposal would require a company to file the attestation in its annual reports.

On August 29, 2002, the SEC adopted new Securities Exchange Act rules to implement Section 302 of the Act. These rules require the principal executive and financial officers of a company to certify the veracity of each annual or quarterly report filed with the SEC. Among other items, each of these officers must disclose that they: (1) are responsible for establishing and maintaining "disclosure controls and procedures" for the company; (2) have designed these disclosure controls to ensure that material information is made known to them; (3) have evaluated the effectiveness of the company's disclosure controls and procedures; and (4) have presented in their report their conclusions regarding the effectiveness of the disclosure controls and procedures. In addition, the officers must certify that they have disclosed whether or not there were significant changes in internal controls, including any corrective actions with respect to significant deficiencies and material weaknesses.

Section 404 of the Act directs the SEC to adopt rules that would require management to assess annually the company's internal control structure and procedures for financial reporting. A company's officers, however, are already required to certify to significant changes to internal controls as required by Section 302 of the Act. In order to provide a basis for the quarterly disclosure about changes to the company's internal controls and procedures for financial reporting and to conform the requirements for periodic evaluations of both the company's disclosure controls and procedures and its internal controls and procedures, the

SEC has proposed to require a company's management to evaluate the effectiveness of the design and operations of the company's internal controls and procedures for financial reporting, as well as its disclosure controls and procedures, with respect to each annual and quarterly report it files. In addition, the SEC proposes to amend its prior rules that the evaluation be conducted within the 90-day period prior to the filing date of the quarterly or annual report, to require that the evaluation be made as of the end of the period covered by the report. The SEC also proposed conforming changes to the form of certification that must be filed pursuant to these rules. A form of the proposed amended certification is attached as Appendix A.

The SEC has also proposed a transition period for compliance with the rules regarding evaluations of, and reports and attestations on, the internal controls and procedures. The SEC stated its belief that Congress did not intend for the provisions of Section 404 to take effect until the Public Company Accounting Oversight Board ("PCAOB") has established the relevant attestation standards. The SEC therefore proposed to delay the effectiveness of the rules under Section 404 of the Act to enable the PCAOB to act and other relevant parties to prepare for compliance. Accordingly, the SEC proposed that the rules under Section 404, if adopted, would apply to companies whose fiscal years end on or after September 15, 2003.

Code of Ethics

Section 406 of the Act directs the SEC to issue rules requiring a company to disclose whether or not the company has adopted a code of ethics for senior financial officers and requiring companies that have not adopted a code of ethics to explain why they have not done so. Section 406 further directs the SEC to issue rules requiring a company to disclose immediately on Form 8-K or by posting on their website, any change in, or waiver of, a provision of its code of ethics.

In its proposed rule, the SEC has extended the scope of Section 406 to include a company's principal executive officer and has broadened the definition of "code of ethics" used in Section 406 to include three additional factors. The SEC is seeking comment on whether the rule should cover an even broader group of officers and whether the general counsel should be covered.

Under the proposed rule, a company must disclose: (1) whether it has adopted a written code of ethics that applies to the company's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions; and (2) if the company has not adopted a code of ethics, the reasons it has not

done so.

The proposed rule defines the term “code of ethics” to mean a codification of standards reasonably designed to deter wrongdoing and to promote:

1. Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
2. Avoidance of conflicts of interest, including disclosure to an appropriate person or persons identified in the code of any material transaction or relationship that reasonably could be expected to give rise to such a conflict;
3. Full, fair, accurate, timely, and understandable disclosure in reports and documents that a company files with, or submits to, the SEC and in other public communications made by the company;
4. Compliance with applicable governmental laws, rules and regulations;
5. The prompt internal reporting to an appropriate person or persons identified in the code of violations of the code; and
6. Accountability for adherence to the code.

In addition to providing the required disclosure, the proposed rule would require the company to file a copy of its code of ethics as an exhibit to its annual report.

The proposed rule would not require a company to adopt a code of ethics if it has not already done so, nor would the rules require a company to amend its existing code, but the rules would require a company that does not have a code of ethics that meets the definition in the rule for the specified officers to explain why it does not have such a code. The SEC has stated that a pre-existing code of ethics may satisfy the requirements of the proposed rules, but that a company should review its code upon adoption of the final rule to determine whether the code meets all of the standards set forth in the rule.

The SEC also proposes to add an item to the list of Form 8-K triggering events to require disclosure of a change to a company’s code of ethics that applies to the specified officers or a grant of a waiver of a code provision to a specified officer. If a company chooses to provide the required disclosure on Form 8-K, the company would have to file the report within two business days after making the change or granting the waiver. The proposed rule would also allow a company to use its

website as an alternative means of disseminating the required disclosure. Under the proposed rules, however, a company would only be able to use its website to disseminate the disclosure if it has disclosed in its most recently filed annual report that it intends to disclose these events on its website and the website's address. Moreover, if a company chooses to disclose information regarding changes to or waivers from its code, it would have to do so within the same two-business day time period proposed for Form 8-K filings and would have to make the disclosure available on its website for at least 12 months after it initially posts the disclosure.

Audit Committee Financial Experts

Section 407 of the Act requires the SEC to adopt rules requiring a company to disclose whether at least one member of its audit committee is a "financial expert," and defining the term "financial expert." Pursuant to Section 407 of the Act, the SEC has proposed to require companies to disclose: (1) the number and names of persons that the board of directors has determined to be the financial experts serving on the company's audit committee; and (2) whether the financial expert or experts are "independent," as that term is used in Section 10A(m)(3) of the Securities Exchange Act, and, if not, an explanation of why they are not. If the company does not have a financial expert serving on its audit committee, the company must disclose that fact and explain why it has no financial expert. The Act did not require disclosure of the number or names of the financial experts; however, the SEC deems this appropriate because, in their view, investors would be interested in this information.

The Act also requires the SEC to define "financial expert." Under the proposed rules, the term "financial expert" would mean a person who has, through education and experience as a public accountant or auditor or a principal financial officer, controller, or principal accounting officer of a publicly reporting company, or experience in one or more positions that involve performance of similar functions (or that results, in the judgment of the company's board of directors, in the person's having similar expertise and experience), the following attributes:

1. An understanding of generally accepted accounting principles and financial statements;
2. Experience applying such generally accepted accounting principles in connection with the accounting for estimates, accruals, and reserves that are generally comparable to the estimates, accruals and reserves, if any, used in the registrant's financial statements;
3. Experience preparing or auditing financial statements that

present accounting issues that are generally comparable to those raised by the registrant's financial statements;

4. Experience with internal controls and procedures for financial reporting; and
5. An understanding of audit committee functions.

Although not explicitly required by Section 407 of the Act, the SEC rule proposal would require the financial expert's experience to be related to companies that were, at the time he or she held the position, publicly reporting companies. The SEC rule proposal also provides that the board of directors in its entirety is the best equipped to make the decision as to whether any of the audit committee members is a financial expert. In making this determination, the rule proposal states that the board must evaluate the totality of an individual's education and experience and should consider a variety of factors in making this determination, including:

- The level of the person's accounting or financial education, including whether the person has earned an advanced degree in finance or accounting;
- Whether the person is a certified public accountant, or the equivalent, in good standing, and the length of time that the person actively has practiced as a certified public accountant, or the equivalent;
- Whether the person is certified or otherwise identified as having accounting or financial experience by a recognized private body that establishes and administers standards in respect of such expertise, whether that person is in good standing with the recognized private body, and the length of time that the person has been actively certified or identified as having this expertise;
- Whether the person has served as a principal financial officer, controller or principal accounting officer of a company that, at the time the person held such position, was required to file reports pursuant to Section 13(a) or 15(d) of the Exchange Act, and if so, for how long;
- The person's specific duties while serving as a public accountant, auditor, principal financial officer, controller, principal accounting officer or position involving the performance of similar functions;
- The person's level of familiarity and experience with all applicable laws and regulations regarding the preparation of financial statements that must be included in reports filed under Section 13(a) or 15(d) of the Exchange Act;

- The level and amount of the person's direct experience reviewing, preparing, auditing or analyzing financial statements that must be included in reports filed under Section 13(a) or 15(d) of the Exchange Act;
- The person's past or current membership on one or more audit committees of companies that, at the time the person held such membership, were required to file reports pursuant to Section 13(a) or 15(d) of the Exchange Act;
- The person's level of familiarity and experience with the use and analysis of financial statements of public companies; and
- Whether the person has any other relevant qualifications or experience that would assist him or her in understanding and evaluating the registrant's financial statements and other financial information and to make knowledgeable and thorough inquiries as to whether:
 - the financial statements fairly present the financial condition, results of operations and cash flows of the company in accordance with generally accepted accounting principles; and
 - The financial statements and other financial information, taken together, fairly present the financial condition, results of operations and cash flows of the company.

Finally, the SEC proposal would require companies to include this new disclosure in their annual reports on Forms 10-K and 10-KSB, but not in their quarterly reports.

This document is intended as an informational reminder and does not constitute legal advice. If you have any questions or would like to discuss a particular situation, you should contact your usual W&D attorney or one of us.

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