



**JAECKLE
FLEISCHMANN &
MUGEL, LLP
ATTORNEYS AT LAW**

ALERT!

SEC Proposes Rules under the Sarbanes-Oxley Act of 2002

The Securities and Exchange Commission ("SEC") continues to propose rules implementing provisions of the Sarbanes-Oxley Act of 2002 (the "Act"). These rules have been mandated by Sections 401, 404, 406, 407 and 409 of the Act, and set out new requirements with respect to:

- management assessment of internal controls;
- codes of ethics;
- the identity of "financial experts" on a company's audit committee;
- use of non-GAAP financial measures;
- real-time disclosure of material information regarding a company's financial condition or operations; and
- disclosure of off-balance sheet transactions, arrangements, obligations and other relationships.

Each of these proposed rules are discussed more fully below.

Management's Internal Control Reports

To comply with Section 404 of the Act, the SEC has proposed rules that would require a company to include in its Form 10-K a report regarding the adequacy of the company's internal controls. This "internal control report" would be required to include:

- a statement of management's responsibilities for establishing and maintaining adequate internal controls and procedures for financial reporting;

November 11, 2002

- conclusions about the effectiveness of the company's internal controls and procedures for financial reporting based on management's evaluation as of the end of the company's most recent fiscal year; and
- a statement that the company's auditors have attested to, and reported on, management's evaluation (with the attestation being filed with the Form 10-K).

The proposed rules do not specify the exact content of the annual internal control report, rather, the exact content should be tailored by each company.

The SEC has previously adopted final rules in connection with Section 302 of the Act requiring public companies to maintain, and their CEOs and CFO certify as to the effectiveness of, disclosure controls and procedures. The proposed rules require a comparable evaluation of internal controls for financial reporting. According to the SEC, internal controls are procedures designed to assure that transactions are properly authorized, that assets are safeguarded and that transactions are properly recorded for financial reporting purposes. Disclosure controls are procedures designed to ensure that information required to be disclosed is recorded, processed, summarized and reported on a timely basis.

In an attempt to create "symmetry" with the existing disclosure controls rules, the SEC is proposing to require quarterly evaluations of internal controls. In addition, the SEC is proposing to expressly require that evaluations of both disclosure controls and procedures and internal controls be made as of the end of the period covered by the quarterly or annual report rather than within 90 days of the date that the report is filed.

Other proposed changes to the existing Section 302 certifications would:

- require management, with the participation of the principal executive and financial officers, rather than the company itself, to evaluate the company's internal controls and disclosure controls and procedures;
- require management to disclose "material weaknesses," in addition to "significant deficiencies," in the company's internal controls to both the independent auditors and audit committee; and
- clarify that the CEO and CFO may arrange to have the company's disclosure controls and procedures designed under their supervision rather than personally design them.

Code of Ethics

The proposed rules, if adopted in their current form, would require public companies to disclose in their annual reports whether they have adopted a code of ethics applicable to their CEO, CFO, principal accounting officer, controller or persons performing similar functions (and

if not, why not). If a company has a code of ethics, it would be required to file a copy of the code as an exhibit to its Form 10-K.

As proposed by the SEC, a company's "code of ethics" would be a codification of standards reasonably designed to deter wrongdoing and to promote:

- honest and ethical conduct (including treatment of conflicts of interest between personal and professional conduct);
- avoidance of conflicts of interest;
- full, fair, accurate, timely, and understandable disclosure in the company's SEC filings and other public communications;
- compliance with governmental laws, rules and regulations;
- prompt internal reporting of violations of the code to identified persons; and
- accountability for adherence to the code.

Any change to, or waiver of, the company's code of ethics would be required to be disclosed in a Form 8-K or on the company's website within two business days. The proposal that allows companies to use their websites in lieu of Form 8-K disclosure would be available only to companies which had disclosed in their most recent annual report that they intend to disclose such events on their website and listed the website address.

Although the SEC's proposed rules do not require a company to adopt a code of ethics, the New York Stock Exchange, NASDAQ and the American Stock Exchange have each proposed rules requiring listed companies to adopt a code of ethics. A company will need to make certain that its code of ethics complies with the listing standards of the appropriate stock exchange as well as the criteria set forth in the proposed SEC rules.

Audit Committee "Financial Experts"

To comply with Section 407 of the Act, the proposed rules would require each public company to disclose in its annual report the number and names of audit committee members whom the board of directors has determined to be "financial experts," or to explain why the audit committee has no financial experts.

The term "financial expert" is defined more narrowly than stock exchange rules regarding the financial expertise of audit committee members. As proposed by the SEC, to be a "financial expert," a public company director must possess, 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 a position involving similar functions or that, in the board's judgment, results in the person having similar expertise and experience):

- an understanding of GAAP and financial statements;
- experience in applying GAAP in accounting for estimates, accruals, and reserves that is generally comparable to the accounting for those items in the company's financial statements;
- experience preparing or auditing financial statements that present accounting issues generally comparable to the issues raised by the company's financial statements;
- experience with internal controls and financial reporting procedures; and
- an understanding of audit committee functions.

The SEC release makes clear that the members of the audit committee who are "financial experts" will have "no higher degree of individual responsibility or obligation" than other members of the audit committee and will not be "experts" for purposes of liability under the Securities Act of 1933.

Use of Non-GAAP Financial Measures

As required by Section 401(b) of the Act, the SEC has proposed rules that would (1) prohibit material misstatements or omissions that would make the presentation of a material non-GAAP financial measure, under the circumstances in which it is made, misleading, and (2) require a quantitative reconciliation (by schedule or other clearly understandable method) of the differences between the non-GAAP financial measure presented and the comparable financial measure or measures calculated and presented in accordance with GAAP.

The SEC used the term "non-GAAP financial measure" for this rulemaking to avoid confusion with the "pro forma" terminology that already exists in the SEC's rules. For this purpose, a "non-GAAP financial measure" would be a numerical measure of a company's financial performance, financial position or cash flows that: (1) excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the comparable measure calculated and presented in accordance with GAAP in the company's statement of income, balance sheet or statement of cash flows (or equivalent statements); or (2) includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the comparable measure so calculated and presented.

An example of a non-GAAP financial measure would be a measure of operating income that excludes one or more expense or revenue items that are identified as "non-recurring," or funds from operations, a measure currently used in real estate investment trust financial reports. Another example would be EBITDA (earnings before interest, taxes, depreciation and amortization), which could be calculated using elements derived from GAAP financial presentations but, in any event, is not presented in accordance with GAAP.

Real-Time Disclosures

Section 409 of the Act requires the SEC to conduct rulemaking to require companies to disclose "on a rapid and current basis such additional information concerning material changes in the financial condition or operations of the issuer . . . as the Commission determines, by rule, is necessary or useful for the protection of investors and in the public interest." To meet this requirement, the SEC proposed to amend Form 8-K to require companies to file a Form 8-K within two business days of any public announcement or release disclosing material non-public financial information regarding a company's results of operations or financial condition for an annual or quarterly fiscal period that has ended.

This "real-time" disclosure proposal would not require the issuance of earnings releases or similar announcements. However, such releases and announcements would trigger the new proposed filing requirement. The proposed filing requirement would apply regardless of whether the release or announcement included disclosure of a non-GAAP financial measure. The proposed rule would also require the filing of the press release, which might discourage companies from making forward looking statements in such press releases, as under many circumstances they would be incorporated by reference into Securities Act filings.

A company would not be required to file a Form 8-K if the presentation of non-public information was made orally, telephonically, by webcast, broadcast or similar means and (1) the presentation occurs within 48 hours of a related release or announcement that is filed on Form 8-K; (2) the presentation is accessible to the public; (3) the information in the webcast is posted on the company's website; and (4) the presentation was announced by a widely disseminated press release.

Off-Balance Sheet Arrangements

As required by Section 401(a) of the Act, the SEC proposed rules relating to off-balance sheet arrangements. Although the Act directed the SEC to require the off-balance sheet arrangement disclosure only in a company's annual and quarterly reports, the SEC proposed to also require a company to include this disclosure in the MD&A section of its Securities Act registration statements. While current MD&A rules already require a company to provide disclosure about its off-balance sheet arrangements to the extent necessary to an understanding of the company's financial condition, changes in financial condition and results of operations, the proposed rules would more specifically address the types of disclosure that companies must provide.

The proposals would require a public company to provide, in a separately captioned subsection of the MD&A, a comprehensive explanation of its off-balance sheet arrangements. The proposed rules would require a company (other than small business issuers) to provide an overview of its aggregate contractual obligations in a tabular format and contingent liabilities and commitments in either a textual or tabular format.

Timing

The Act requires the SEC to issue final rules by January 26, 2003 regarding the code of ethics, "financial expert" disclosure, use of non-GAAP financial measures and off-balance sheet arrangements. There is no deadline for the rules regarding internal controls or real-time disclosures. As proposed, the rules regarding internal controls would, if adopted, include a transition period – applying only to annual reports for fiscal years ending on or after September 15, 2003.

* * * * *

The information in this Alert is intended for general information purposes only and should not be considered legal advice or opinion on any specific facts or circumstances. You are urged to contact a professional advisor concerning any specific question you may have relating to your own situation.

If you would like to discuss the matters presented in this Alert you may contact:



James J. Tanous
Joseph P. Kubarek
William I. Schapiro
Kayla E. Klos
Michael C. Donlon

(716-843-3905; jtanous@jaeckle.com)
(716-843-3862; jkubarek@jaeckle.com)
(716-843-3896; wschapiro@jaeckle.com)
(716-843-3858; kklos@jaeckle.com)
(716-843-3881; mdonlon@jaeckle.com)