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MEMORANDUM

November 6, 2002

TO: Clients and Friends

FROM: Graubard Miller

SUBJECT: Newly Proposed SEC Rules under the Sarbanes-Oxley Act Relating to Financial Experts on Audit Committees, Codes of Ethics, Internal Controls and Prohibitions on Improper Influence of Auditors

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General

The SEC has proposed rules to implement Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002 ("Act"). These rules would require public companies to disclose in their annual reports information about audit committee financial experts, company codes of ethics and internal disclosure controls. Additionally, proposed rules dealing with Section 303 of the Act would prohibit actions designed to improperly influence auditors.

The SEC invites comments on the proposed rules prior to November 29, 2002.

The Act requires the SEC to adopt final rules regarding the code of ethics and the "financial expert" disclosure by January 26, 2003 and final rules regarding prohibitions against improper influence of auditors by April 26, 2003.

There is no deadline for the rules regarding internal controls. 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.

Disclosure Requirements

The proposed rules would require companies to make the following new disclosures:

- Pursuant to Section 407, a company would be required to (i) disclose in its annual report on Form 10-K or 10-KSB the number and names of the "financial experts" serving on its audit committee and (ii) include a statement in such report that such financial experts are independent of management (as determined by the company's board of directors).

- If no person sitting on the audit committee qualifies as a financial expert, the company would be required to disclose this fact, as well as the reasons why, in its annual report on Form 10-K or 10-KSB.

- If the Board concludes that a person is a financial expert by virtue of experience other than as a public accountant, auditor, principal financial officer, principal accounting officer, controller or position with similar functions, then the company must disclose the board's basis for such a determination.

- Pursuant to Section 406, a company would be required to (i) disclose in its annual report on Form 10-K or 10-KSB whether it has adopted a code of ethics for its principal executive officer and senior financial officers, or if it has not, why it has not and (ii) disclose on a current basis (*i.e.*, in 8-K filings) all amendments to, and waivers from, the code of ethics relating to any of those officers.

- Pursuant to Section 404, a company would be required to file an "internal control report" of management in its annual report on Form 10-K or 10-KSB.

Definition of "Financial Expert"

Background

It is the SEC's position that a financial expert sitting on an audit committee would be a valuable resource for the audit committee as a whole in carrying out its functions. The SEC has stated that the mere designation of an audit committee member as a "financial expert" will not impose a higher degree of individual responsibility or obligation on that member. At the same time, the SEC has noted that the existence of a financial expert on the audit committee will not decrease the duties and obligations of other audit committee members or the board of directors. The SEC has stated that it does not intend for a person serving as a financial expert for audit committee purposes to be considered an expert for purposes of Section 11 of the Securities Act of 1933 solely as a result of such designation.

Proposed Rules

As proposed by the SEC, 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 involving the 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), all of the following attributes:

- An understanding of generally accepted accounting principles and financial statements;

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

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

- Experience with internal controls and procedures for financial reporting; and

- An understanding of audit committee functions.

In determining whether a potential financial expert has all of the requisite attributes, the instructions to the proposed rules identify a number of non-exclusive factors that a board should consider to evaluate the totality of an individual's education and experience. This is not intended to be an exhaustive list of the factors that the board should consider in assessing whether a person qualifies as a financial expert. Rather, it should help the board make a qualitative assessment of a potential candidate's level of knowledge and experience:

- 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 publicly reporting company, 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 by publicly reporting companies;

- The level and amount of the person's direct experience reviewing, preparing, auditing or analyzing financial statements that must be included in reports filed by publicly reporting companies;

- 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 publicly reporting companies;

- 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 company'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.

In the case of a foreign private issuer, the board of directors also should consider the person's experience with public companies in the foreign private issuer's home country, generally accepted accounting principles used by the issuer, and the reconciliation of financial statements with U.S. generally accepted accounting principles.

Codes of Ethics

Background

A comprehensive code of ethics should set forth guidelines requiring avoidance of conflicts of interests and material transactions or relationships involving potential conflicts of interests without proper approval. Moreover, an effective code of ethics should describe the company's system for the internal reporting of code violations. The code also should state clearly the consequences for non-adherence to code provisions.

Proposed Rules

The SEC has proposed new Item 406 to Regulations S-B and S-K (and new Item 15(c) to Form 20-F and new Instruction B.(9) to Form 40-F) to require SEC reporting companies (including foreign private issuers) to disclose in their annual reports:

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

- If the company has not adopted such a code of ethics, the reasons it has not done so.

The proposed rules would define a code of ethics as a codification of standards that is 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;

- 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;

- full, fair, accurate, timely, and understandable disclosure in SEC reports other public communications made by the company;

- compliance with applicable governmental laws, rules and regulations;

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

- accountability for adherence to the code.

The SEC has stated that it expects ethics codes to vary and that each company must design compliance and disciplinary measures appropriate to its business. A copy of a company's code of ethics would be required to be filed as an exhibit to its annual report.

Any change to, or waiver of, a 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 companies could use their websites in lieu of Form 8-K disclosure would be available only to companies that had disclosed in their most recent annual report that they intend to disclose such events on their website and listed the website address. Foreign private issuers would make such disclosure as exhibits to their Forms 20-F or 40-F, or

could do so earlier on Form 6-K or their website. The SEC also has proposed requiring companies that post such disclosure on their websites to leave the disclosure posted for a 12-month period. Also, the SEC seeks comment on whether companies that disseminate such disclosure via their websites must retain the disclosure for five years and make it available to the SEC upon request.

Graubard Miller is working with its clients to draft and adopt appropriate codes of ethics.

Internal Control Reports

Background

The proposed rules would require SEC reporting companies to include in their annual reports an "internal control report." This report would address management's responsibility to establish internal controls and procedures for financial reporting and require management to evaluate the effectiveness of those controls and procedures as of the last day of the company's fiscal year. Under Section 404(b) of the Act, the company's auditor must attest to, and report on, management's assertions in the internal control report. The company must state this fact and file the auditor's attestation in its annual report.

Proposed Rules

The SEC proposes to amend Item 307 of Regulations S-K and S-B (and Forms 20-F and 40-F) to require a company's annual report to include an internal control report of management that includes:

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

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

The proposed amendments do not specify the exact content of the proposed management report, as this likely would result in boilerplate responses. The SEC believes that management should tailor the report to the company's circumstances.

The SEC believes that the purpose of internal controls and procedures for financial reporting is to ensure that companies have processes designed to provide reasonable assurance that:

- the company's transactions are properly authorized;

- the company's assets are safeguarded against unauthorized or improper use; and

- the company's transactions are properly recorded and reported to permit the preparation of the registrant's financial statements in conformity with generally accepted accounting principles.

The SEC believes that these objectives are embodied in the definition of the term "internal controls" set forth in the AICPA's Codification of Statements on Auditing Standards (AU) Section 319. Accordingly, the SEC has proposed the formal definition be that contained in AU Section 319, pending action by the Public Company Accounting Oversight Board ("PCAOB"). The proposed definition would state that the term "internal controls and procedures for financial reporting" means controls that pertain to the preparation of financial statements for external purposes that are fairly presented in conformity with generally accepted accounting principles as addressed by AU Section 319 or any superseding definition or other literature that is issued or adopted by the PCAOB.

Section 404(b) of the Act 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 issuer's internal controls and procedures for financial reporting. The attestation and report required by Section 404(b) must be made in accordance with standards for attestation engagements "issued or adopted" by the PCAOB. The SEC is proposing amendments to Regulation S-X to reference the attestation report that will be prepared by registered public accounting firms and to require a company to file the attestation in their annual reports.

The SEC expects that companies and their auditors will require substantial time to develop processes under relevant standards and to train appropriate personnel to ensure compliance with the foregoing requirements. Similarly, companies and accounting firms likely will need additional time to actually perform these activities. Accordingly, the SEC proposes to delay the effectiveness of its rules under Section 404 to enable the PCAOB to act and other relevant parties to prepare for compliance.

Specifically, the SEC proposes that the rules under Section 404, if adopted, would apply to companies whose fiscal years end on or after September 15, 2003.

Prohibitions of Improperly Influencing Auditors

Under proposed Exchange Act Rule 13b2-2(b), it would be unlawful for any officer or director of an issuer, or any other person acting under their direction, to take any action, directly or indirectly, to fraudulently influence, coerce, manipulate or mislead any independent public or certified accountant engaged in the performance of an audit or review of the financial statements of an issuer that are required to be filed with the SEC if

that person knew, or was unreasonable in not knowing, that such action could, if successful, result in rendering such financial statements materially misleading.

Actions that "could, if successful, result in rendering such financial statements materially misleading" include those to improperly influence an auditor to:

- issue a report on an issuer's financial statements that is not warranted in the circumstances (due to material violations of GAAP, GAAS or other standards);
- not perform audit, review or other procedures required by GAAS or other professional standards;
- not withdraw an issued report; or
- not communicate matters to an issuer's audit committee.

The release makes clear that the SEC regards the group of "persons acting under the direction thereof" who could potentially be liable under the rule as having broad scope, beyond directors and officers and people who report to them, and also potentially including customers, vendors, creditors, other partners or employees of the accounting firm, attorneys, securities professionals and other advisers who act under the direction of an officer or director. The SEC explains in the release that their intention is that no "specific direction" by an officer or director that a person improperly influence an auditor is required for a violation.

In the release, the SEC also states that the rule could be violated by conduct "that did not succeed in affecting the audit or review" and offers a non-exclusive list of conduct that could fraudulently influence, coerce, manipulate, or mislead an auditor for purposes of this rule:

- 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;
- Canceling or threatening to cancel existing engagements if the auditor objects to the issuer's accounting;
- Seeking to have a partner removed from an audit engagement because he or she objects to the issuer's accounting; or
- Blackmailing and making physical threats.

The release also clarifies that the rule would be effective during any time the auditor is called upon to make decisions regarding the issuer's financial statements, including after the end of the engagement when issuing a consent.

Additional Information

If you have any questions, please call Brian Ross at (212) 818-8610 or Marci J. Frankenthaler at (212) 818-8892. We intend to provide updates to this memorandum and our previous memoranda regarding the implementation of the provisions of the Sarbanes-Oxley Act of 2002 as warranted at our website www.graubard.com. When visiting our website for updates, please review the section entitled "Articles."