GODFREY & KAHN S.C.
ATTORNEYS AT LAW

780 NORTH WATER STREET
MILWAUKEE, WI 53202-3590
TEL 414-273-3500
FAX 414-273-5198
www.gklaw.com

GODFREY & KAHN, S.C.
MILWAUKEE
APPLETON
GREEN BAY
WAUKESHA

LAFOLLETTE GODFREY & KAHN
MADISON

MEMORANDUM

TO: Our Clients and Friends

FROM: Godfrey & Kahn, S.C.

DATE: November 1, 2002

RE: Recent Rule Proposals by the SEC

As mandated by the Sarbanes-Oxley Act of 2002 (the "Sarbanes Act") and as part of its ongoing initiative to improve the quality of disclosures by public companies, the Securities and Exchange Commission (the "SEC") recently published a release (the "Release") proposing new rules relating to:

- *disclosure regarding financial experts serving on a company's audit committee, in response to Section 407 of the Sarbanes Act;*
- *disclosure regarding a company's adoption (or non-adoption) of a code of ethics for senior financial officers (as well as the chief executive officer), in response to Section 406 of the Sarbanes Act; and*
- *the presentation of a report, in a company's annual report on Form 10-K, relating to the company's internal controls and procedures for financial reporting, in response to Section 404 of the Sarbanes Act.*

This memorandum is intended to provide a summary of the rules proposed by the SEC in the Release. The rules are subject to a 30 day comment period, after which the SEC will issue final rules. We expect the final rules to be substantially similar to the proposed rules.

I. Proposed Disclosure About Financial Experts Serving on a Company's Audit Committee

In response to Section 407 of the Sarbanes Act, the SEC has proposed to add a new disclosure item, applicable to annual reports on Form 10-K, requiring companies to disclose:

- 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

- whether the financial expert or experts are "independent," and if not, an explanation as to why they are not.

If a company has no financial experts serving on its audit committee, the proposed rule would require the company to disclose that fact and explain why it has no financial expert.

The Sarbanes Act did not direct the SEC to require disclosure of the number or names of financial experts, but the proposed rule reflects the SEC's belief that investors would be interested in knowing how many financial experts a company's board has determined are serving on its audit committee. According to the Release, disclosure of the names of the financial expert or experts is intended to assist investors in evaluating the company's annual report or proxy statement disclosure that describes the background and business experience of the company's directors.

Under the proposed rules, the term "financial expert" would be defined to mean a person who possesses all of the following attributes:

- an understanding of generally accepted accounting principles ("GAAP") and financial statements;

- experience applying GAAP 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.

The person may have obtained these attributes through any of several means, including through (i) education and experience as a public accountant/auditor or a chief financial officer, controller, or principal accounting officer of a company which, at the time a person held such position, was a public company, or (ii) experience in one or more positions that involve the performance of similar functions (or that results, in the judgment of the company's board of directors, in the person having similar expertise and experience).

An instruction to the proposed rule would set forth a number of factors that the board of directors should consider in evaluating an individual's education and experience. These factors include:

- 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 the chief financial officer, controller or principal accounting officer of a company that, at the time the person held such position, was a public company, and if so, for how long;

- the person's specific duties while serving as a public accountant, auditor, chief 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 periodic reports filed with the SEC;

- the level and amount of the person's direct experience reviewing, preparing, auditing or analyzing financial statements that must be included in periodic reports filed with the SEC;

- 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 public 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 whether (i) the financial statements fairly present the financial condition, results of operations and cash flows of the company in accordance with GAAP, and (ii) the financial statements and other financial information, taken together, fairly present the financial condition, results of operations and cash flows of the company.

This list of factors is not meant to be exhaustive, and the proposed rules do not specify the number of listed factors that a financial expert should satisfy. According to the Release, the fact that a person has previously served on an audit committee would not, by itself, justify the board of directors in "grandfathering" that person as a financial expert under the proposed definition. Similarly, the fact that a person has experience as a public accountant or auditor, or as a chief financial officer, controller or principal accounting officer, or experience in a similar position, would not, by itself, justify the board of directors in deeming that person to be a financial expert.

Based on the foregoing, even financially literate, sophisticated and experienced business persons, including former CFOs of public companies, may not necessarily qualify as "financial experts." If the board of directors cannot make the determination that the persons serving on the company's audit committee are so qualified, disclosure that the audit committee does not contain any financial experts will be required.

In order to be considered "independent" under the proposed rules, an audit committee member may not—other than in his or her capacity as a member of the audit committee, the board of directors or any other board committee—accept any consulting, advisory or other compensatory fee from the company, or be an affiliate of the company or any of its subsidiaries.

II. Proposed Code of Ethics Disclosure

The Release also contains proposed rules in response to Section 406(a) of the Sarbanes Act, in which the SEC was directed to issue rules requiring all public companies to make disclosures relating to the company's adoption of (or failure to adopt) a code of ethics for its senior financial officers.

The focus of the Sarbanes Act directive was solely on whether a company has adopted a code of ethics applicable to its senior financial officers, including its chief financial officer and controller, or persons performing similar functions. According to the Release, however, the SEC believes it is appropriate to propose rules that would also apply to a company's chief executive officer. As a result, the proposed rule would require the company to disclose whether it has adopted a written code of ethics that applies to its chief executive officer, chief financial officer, controller or principal accounting officer, or persons performing similar functions. The proposed rule would also require that a company that has not adopted such a code of ethics disclose the reasons why it has not done so. The SEC's code of ethics rule proposals are in addition to the New York Stock Exchange and Nasdaq rule proposals which would require companies to adopt a code of conduct covering directors, officers and employees (as discussed in one of our prior memoranda).

The proposed definition of "code of ethics" is broadened slightly from that set forth in the Sarbanes Act. The proposed rule would define "code of ethics" as a codification of standards that is reasonably designed to deter wrongdoing and to promote:

- honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interests 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 reports and documents that a company files with, or submits to, the SEC and in any other public communications made by the company;

- compliance with applicable government laws, rules and regulations;

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

- accountability for adherence to the code.

In addition to providing the required disclosure, a company would have to file a copy of its code of ethics as an exhibit to its annual report on Form 10-K.

The proposed rules do not specify every detail that a company must address in its code of ethics, nor do they specify the procedures that a company should develop or the types of sanctions that a company should impose to ensure compliance with its code of ethics. According to the Release, a pre-existing ethics code may satisfy the requirements of the proposed rule, but a company should review its code after the final rules are adopted to determine whether the code meets all the standards included in the definition of a "code of ethics." If a pre-existing code does not satisfy all parts of that definition, the company would not be able to affirm that it has the type of code contemplated by the rules.

The proposed rules would also require current disclosure regarding changes to, or the company's grant of a waiver from, any provision of its code of ethics. Companies would be permitted to disclose these events in one of two ways. Specifically, a company could disclose these events by filing a current report on Form 8-K under a new item which would be added to the list of events triggering the obligation to file a Form 8-K, or the company could use its Internet web site, if it has a web site, to disseminate the required disclosure. Under the proposed rules, a company would be able to take advantage of the Internet dissemination option only if it had disclosed in its most recently filed annual report on Form 10-K that it intends to disclose these events on its Internet web site (and includes its Internet web site address in the report). If a company elected to disclose this information on its web site under the new rules, it would have to do so within the same two-business day time period that is currently proposed for Form 8-K filings. In addition, the proposed rules would require a company electing this option to make the disclosure available for a period of at least twelve months after the initial posting of the information. Although the proposed rules would permit a company to remove information from its web site after the twelve month posting period, the company would be required to retain the disclosure for a period of at least five years and make it available to the SEC upon request.

III. Management's Internal Controls and Procedures for Financial Reporting

New Rule Proposals. In response to Section 404 of the Sarbanes Act, the SEC proposed a rule that would require a company's annual report on Form 10-K to include an internal control report of management that provides:

- 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 "registered public accounting firm," which refers to a firm that has registered with the Public Company Accounting Oversight Board, that issued the company's audit report has attested to, and reported on, management's evaluation of the company's internal controls and procedures for financial reporting (note that the auditor's attestation would need to be filed in the Form 10-K).

In an effort to avoid boilerplate responses, the SEC's proposed rules do not specify the exact content of the management report; rather, the Release states that management should tailor the report to each company's circumstances.

According to the Release, 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 company's financial statements in conformity with GAAP. To meet those objectives, the SEC proposes to define the term "internal controls and procedures for financial reporting" as controls that pertain to the preparation of financial statements for external purposes that are fairly presented in conformity with GAAP, as addressed by the Codification of Statements on Auditing Standards ("AU") Section 319. Generally, AU Section 319 defines the term "internal controls" as a process in which a company's board of directors, management and other personnel engage to attempt to ensure the reliability of financial reporting, efficiency of operations and compliance with applicable laws and regulations.

Effect of New Rule Proposals on CEO/CFO Certifications. Recently, the SEC adopted rules to implement Section 302 of the Sarbanes Act which require a company's chief executive officer and chief financial officer to make certain certifications in the company's quarterly reports on Form 10-Q and annual reports on Form 10-K (as discussed in one of our prior memoranda). These certifications include statements as to the officers' evaluation of the company's "disclosure controls and procedures," as well as disclosures as to any significant changes in the company's "internal controls" subsequent to the date of their evaluation. The term "disclosure controls and procedures" is a new term which reflects the concept of controls and procedures that are designed to ensure that information required to be disclosed in a company's periodic reports are recorded, processed, summarized and reported within the required time periods. The term "internal controls" is a pre-existing term relating to a company's

internal controls regarding financial reporting. While the current rules require quarterly evaluations of a company's disclosure controls and procedures, they do not require quarterly evaluations of a company's internal controls.

The proposed rules would require quarterly evaluations of not only a company's disclosure controls and procedures, but also the company's internal controls and procedures for financial reporting. However, a company's "internal controls," as defined above, would not need to be evaluated periodically.

The proposed rules differ from the Sarbanes Act directive, which requires only annual evaluations of internal controls and procedures for financial reporting. According to the Release, the SEC added the requirement with respect to quarterly reports to create symmetry between its requirements for periodic evaluations of both a company's disclosure controls and procedures and its internal controls and procedures for financial reporting. Under the proposed rules, the evaluation must be made as of the end of the period covered by the report, amending the current rule requiring that the evaluation be conducted within the 90-day period prior to the filing date of the quarterly or annual report.

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We will continue to monitor the SEC rule proposals and keep you apprised of any new developments. In the meantime, please do not hesitate to contact us if you have any questions.

Godfrey & Kahn Securities Team

Kenneth C. Hunt, kchunt@gklaw.com
Christopher B. Noyes, cbnoyes@gklaw.com
Larry D. Lieberman, llieber@gklaw.com
Pamela M. Krill, pmkrill@gklaw.com
Dennis F. Connolly, dconnoll@gklaw.com
Ellen R. Drought, edrought@gklaw.com
Michelle M. Nelson, mnelson@gklaw.com
Jake C. Blavat, jblavat@gklaw.com
C.J. Wauters, cwauters@gklaw.com

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