

SEC Adopts Final Rules Under Title II and Section 401(a) of Sarbanes-Oxley

The SEC yesterday adopted final rules under Title II (auditor independence) and Section 401(a) (MD&A discussion of off-balance sheet arrangements and contractual obligations) of Sarbanes-Oxley. We have previously sent Securities Alerts that describe each of the proposed rules previously adopted by the Commission. These Securities Alerts are also available on our web site at www.ropesgray.com under “News & Events”. We have summarized below the major changes from the previously proposed rules that were discussed at yesterday’s SEC open meeting. The text of the new, final rules has not yet been made available.

Auditor Independence

Rotation of Audit Partners:

Partners Subject to Rotation Requirements. The proposed rules would have subjected audit partners to a five year rotation and five year cooling-off period. Recognizing that the proposed rules may have resulted in increased costs, loss of expertise and diminished quality of audits, the Commission modified the proposed rules to subject only the lead audit partner and the concurring audit partner to the five year rotation and five year cooling-off period. Audit partners on the engagement team who have responsibility for decision making on significant audit matters, including the lead partner on the audit engagement teams for any significant subsidiaries of the issuer, will be subject to a seven year cooling-off period.

Transition Period. Applicable transition periods will be specified in the final rule when it is published. The final rules will provide that time served as lead audit partner or concurring audit partner prior to the adoption of the rules will apply toward calculating the five year rotation period. For audit partners subject to the seven year rotation period, however, time served prior to the adoption of the rules will not apply toward calculating the seven year rotation period.

Services Outside the Scope of the Practice of Auditors:

Tax Services. In response to comments, the final rules clarify that auditors are not prohibited from providing tax services, except to the extent that providing certain tax services to an audit client would impair the auditor’s independence, such as representing the audit client in the tax court. The final rules classify tax services as non-audit services which must be preapproved by the Audit Committee.

Expert Services Not Related to the Audit. The final rules clarify that auditors are prohibited from providing expert services in connection with advocating an audit client’s interest in litigation or in administrative or regulatory proceedings. Auditors are permitted to conduct internal investigations on their own initiative or at the direction of the Audit Committee, and to report their factual findings to the Audit Committee. Auditors are prohibited from conducting investigations or internal reviews at the direction of the issuer’s legal counsel or as part of the team advocating the issuer’s interests in a proceeding.

Legal Services Not Related to the Audit. The proposed rules, in accordance with Section 201(a) of Sarbanes-Oxley, provided that legal services unrelated to the audit are prohibited nonaudit services. Acknowledging

that many services considered to be audit services in the U.S. are considered to be legal services in foreign jurisdictions, and that it would be inconsistent to permit an accounting firm to provide certain services in the U.S. that it was prohibited from providing in foreign jurisdictions, the final rules clarify that services characterized as legal services in foreign jurisdictions that would be characterized as audit services in the U.S. are not expressly prohibited and may be provided by an auditor to an audit client if pre-approved by the Audit Committee.

Principal Accountants' Fees:

The final rules require issuers to disclose audit fees, audit-related fees, tax fees and all other fees paid by an issuer to its principal accountants. In response to comments, the release will clarify that fees for audit services include the audit and review of the issuer's financial statements, as well as services required to be performed in connection with statutory or regulatory filings, such as review of subsequent events necessary for the auditor to consent to the inclusion of its audit report in the issuer's '34 Act filings.

Effective Dates and Transition Periods:

The rules will be effective 90 days after their publication in the Federal Register. Transition periods for various provisions will be specified in the final rule when it is published.

Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations.

The Commission adopted rule amendments that will require each annual and quarterly financial report required to be filed with the SEC to disclose and explain in MD&A certain material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities or other persons. The amendments will also require companies to provide an overview of certain known contractual obligations in a tabular format.

Definition of Off-Balance Sheet Arrangements. In response to concerns that the proposed rule's definition of "off-balance sheet arrangements" was too vague and risked capturing unintended activities, the revised rule employs concepts in accounting literature to define more precisely the categories of such arrangements, primarily targeting the means through which companies typically structure off-balance sheet transactions or otherwise incur risks of loss not fully transparent to investors. Generally, the new rule's definition includes the following categories of contractual arrangements:

- certain guarantee contracts defined by reference to FASB Interpretation No. 45;
- retained or contingent interests in assets transferred to an unconsolidated entity;
- derivative instruments that are classified as equity; or
- material variable interests, defined by reference to FASB Interpretation No. 46, in unconsolidated entities that conduct certain activities.

"Reasonably Likely" Disclosure Threshold. The new rule requires disclosure of off-balance sheet arrangements that either have, or are reasonably likely to have, a current or future effect on the company's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors. This disclosure threshold is consistent with the

existing threshold governing MD&A disclosure generally, under which information must be included that would be reasonably likely to have a material effect on financial condition, changes in financial condition or results of operations. This threshold standard is narrower than the one initially suggested in the proposed rule which required that the likelihood of an effect's occurrence or its materiality only be higher than "remote."

Required Disclosure. Concerned that the proposed rule's approach to disclosure was overly prescriptive, the Commission adopted final rules employing a more flexible, principles based approach consistent with existing MD&A concepts. The new rule requires the following specified disclosure to the extent necessary to understand the company's off-balance sheet arrangements and their material effects:

- the nature and business purpose of the company's off-balance sheet arrangements;
- their importance to the company for liquidity, capital resources, market risk or credit risk support or other benefits;
- the financial impact on and exposure to risk for the company; and
- known events, demands, commitments, trends or uncertainties that implicate the company's ability to benefit from its off-balance sheet arrangements.

Also consistent with existing MD&A requirements, the new rule contains a principles-based requirement that a company provide such other information that it believes is necessary for an understanding of its off-balance sheet arrangements and their specified material effects.

Contractual Obligations. The new rule, like the initial proposal, requires companies (other than small business issuers) to disclose, in tabular format, the amounts of payments due under specified contractual obligations, aggregated by category of contractual obligation, for specified time periods. The categories of contractual obligations are defined more clearly in the final rule than in the previous proposal by referencing to applicable accounting literature.

Contingent Liabilities and Commitments. The new rule does not contain the initially proposed table of the company's aggregated contingent liabilities and commitments. The Commission believes that the effect of its newly adopted rules and of recent FASB and other accounting disclosure requirements, which already address contingent liabilities and commitments, should be assessed before implementing further requirements.

Effective Date. Companies must comply with the off-balance sheet arrangements disclosure requirements in SEC filings required to include financial statements for fiscal years ending on or after June 15, 2003. Companies must comply with the contractual obligations table disclosure requirement in SEC filings required to include financial statements for fiscal years ending on or after December 15, 2003.

Contact Information

If you have any questions or would like to learn more about the final rules, please contact the lawyer who normally represents you.