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The Sarbanes-Oxley Act of 2002

On July 30th 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002. The Act is a response to recent accounting issues that have arisen at large public companies and the subsequent calls for legislation to prevent the recurrence of these types of issues. The Act seeks to promote corporate responsibility by, among other things, creating a new oversight board for the accounting industry, requiring faster and more extensive financial disclosure, imposing new restrictions on accounting firms and research analysts, placing new corporate responsibilities on executives and attorneys, and imposing stiffer criminal and civil penalties for corporate wrongdoers. The law also extends the statute of limitations for shareholders to bring securities fraud actions. This law applies to publicly owned U.S. companies as well as to foreign issuers ("Companies"). The new law will not apply retroactively. Cases against Enron, WorldCom, Adelphia and Tyco, for example, will be filed under the laws that existed when the alleged violations took place.

Several key provisions of the Act overlap with corporate governance reform proposals of the New York Stock Exchange ("NYSE") and the NASD, as well as the recent Securities and Exchange Commission ("SEC") rule proposals to enhance corporate disclosure.

This alert explains some of the key provisions of the new law that will have an impact on Companies and their top executives. The complete text of the Act is available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_cong_bills&docid=f:h3763enr.txt

Executive Certification Requirements

Under the new law, chief executive officers and chief financial officers of all SEC registered Companies must attest to the veracity of their financial filings. They are required to make two certifications, one criminal and one civil, with respect to periodic financial reports filed with the SEC. These certifications are in addition to the recently issued SEC order requiring the CEOs and CFOs of over 900 of the largest U.S. companies to file sworn certifications by August 14 attesting to the accuracy of their recent filings. Notably, the SEC has also recently proposed that CEOs and CFOs at all public companies file sworn certifications, and this new law effectively requires the SEC to adopt that proposal in the next 30 days.[1]

[1] *See* Our Memorandum, dated July 30, 2002 entitled "Recent SEC Rule Proposals to Enhance Corporate Disclosure."

Under the criminal certification requirement, which is effective immediately, the CEO and CFO must file a written statement with each periodic report containing financial statements stating that the report fully complies with the requirements of the Securities Exchange Act of 1934 and the disclosures in the report fairly present, in all material aspects, the operations and financial condition of the Company. If an executive files a certification knowing that the results are false, he or she will face fines of as much as $5 million or as many as 20 years in prison, or both.

The civil certification requirement, subject to SEC rulemaking within 30 days following the enactment of this law, requires the CEO and CFO to certify the veracity of each annual or quarterly report filed with the SEC. Signing officers are required to certify that, among other things:

- based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading;

- based on such officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report;

- the signing officers have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report; and

- the signing officers have disclosed to the issuer's auditors and the audit committee of the board of directors any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls.

The criminal certification provision appears to be broader than the civil. The criminal certification requires the signing officers to certify that "the periodic report fully complies with the requirements of Section 13(a) or 15(d) of the Securities and Exchange Act of 1934" while similar language is absent in the civil provision.

Prohibition on Insider Trading During Pension Fund Blackout Periods

Except to the extent permitted by SEC rules, directors and officers are prohibited from trading any equity security of their Company during a blackout period if the security was acquired in connection with his or her employment as a director or officer. For purposes of this section, a pension fund blackout period is any period of more than three consecutive days during which not less than 50% of participants or beneficiaries under all individual account plans (401(k) and similar plans) are precluded from buying or selling their interests in equity securities. Any profit earned by an officer or director in violation of this provision, regardless of their intent or knowledge, can be recovered by the Company. This provision takes effect 180 days after enactment.

Disclosure of Material Changes

The Act will require issuers to disclose "on a rapid and current basis" and "in plain English" any material changes to their financial condition or operations as may be required by future SEC rules. This provision appears consistent with the pending SEC rule proposal to add 11 new items that a Company would be required to file on Form 8-K.[2]

Accelerated Reporting of Securities Transactions by Insiders

Beginning on August 29, 2002, insiders, defined as directors, officers and greater-than-10% beneficial owners of securities, must file their Form 4 reports "before the end of the second business day following the day on which the subject transaction has been executed." Form 4 reports are currently due 10 days after the end of the month in which a transaction takes place. Under this provision, the SEC is permitted to make an exception in circumstances where it determines that the 2-day reporting period is not feasible. Additionally, within one year of enactment, insiders will be required to file reports electronically and the SEC will in turn, within one day of receipt, be required to post the reports on a publicly accessible website. Similarly, the recent SEC rule proposals would require that this information be reported on Form 8-K no later than two business days following any insider transaction with an aggregate value of $100,000 or more.

Disclosure of Off-Balance-Sheet Transactions and Pro-Forma Information

Within 180 days of enactment, the SEC must issue rules that require Companies to disclose all material off-balance-sheet transactions. In the same timeframe, the SEC must also issue rules prohibiting the presentation of pro-forma financial information included in any periodic or other report that is misleading or does not reconcile with the financial condition and results of operations of the Company in accordance with generally accepted accounting principles ("GAAP").

Prohibition of Loans to Directors and Officers

Effective immediately, Companies are prohibited from directly or indirectly extending personal loans, maintaining credit or giving an extension of credit, to any director or executive officer. Companies are still permitted, however, to make loans to officers that are also offered to the public in the ordinary course of a Company's consumer credit business, such as home improvement and credit card loans, provided they are on market terms or terms no more favorable than are offered to the general public. Personal loans already in existence as of the passage of this law are not subject to this provision but may not be modified, extended, or renewed.

Forfeiture of Certain

In the event a Company is required to file an accounting restatement due to "material noncompliance of the issuer, as a result of misconduct," with any

[2] *See* Our Memorandum, dated July 30, 2002 entitled "Recent SEC Rule Proposals to Enhance Corporate Disclosure" at pages 8-9.

Bonuses and Profits

financial reporting requirement under the securities laws, the CEO and CFO must reimburse the Company for:

- any bonus or other incentive or equity-based compensation received during the 12-month period following the first public release of the document containing the financials that were later restated; and,
- any profits realized from the sale of securities of the Company during that 12-month period.

Reimbursement is required whether or not the CEO or CFO engaged in or knew of the misconduct. This provision takes effect immediately.

Codes of Ethics

Within 180 days following enactment, the SEC must issue final rules requiring Companies to disclose in their periodic reports whether they have established corporate codes of ethics for senior financial officers, and, if not, why not. The code of ethics must include standards reasonably necessary to promote ethical conduct; full, accurate and timely disclosure in SEC periodic reports; and, compliance with applicable governmental rules. In addition, a Company must immediately disclose any change in or waiver of the code on Form 8-K or by dissemination on the Internet or other electronic means.

Audit Committees

The new law further defines the composition and role of a Company's audit committee and the relationship of the auditor to the audit committee and the Company. Subject to definitive SEC rulemaking within 270 days of enactment, Companies will be required to have an audit committee that will be responsible for the appointment, compensation and oversight of the Company's outside auditors, who must report directly to the audit committee. If a Company does not establish an audit committee, it appears that the entire board will be considered the audit committee and subject to these rules.

Under the new rules, there are several requirements for audit committees, with two in particular worth highlighting. First, committee members must be "independent," meaning they cannot accept any compensation from the Company other than for services as a director, and they cannot be affiliated with the company or any of its subsidiaries. Second, Companies will be required to disclose in their periodic reports whether at least one member of the committee is a "financial expert", and if not, explain why. Again, subject to definitive rulemaking, a financial expert is someone who has, through education and experience as a public accountant, auditor, principal financial officer, comptroller, or principal accounting officer of an issuer, or from a position involving the performance of similar functions:

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

- experience in the preparation or auditing of financial statements of generally comparable issuers;
- experience in the application of such principles in connection with the accounting for estimates, accruals, and reserves;
- experience with intemal accounting controls; and
- an understanding of audit committee functions.

Although they have received much less attention than the Sarbanes-Oxley Act, the recent NYSE corporate governance rule proposals have similar requirements for audit committees.

Attorney Professional Responsibility

Corporate lawyers, who have been largely exempt from securities suits, also face potential new liabilities under the Act. Within 180 days of enactment, the SEC must establish rules setting forth the minimum standards of professional conduct for attorneys representing Companies. Under the new rules, attorneys will, for the first time, be required to report evidence of material violations of securities laws or the breach of a fiduciary duty by any agent of the Company to the chief legal counsel or the CEO. If the counsel or CEO does not respond "appropriately," the attorney must report the evidence to the audit committee of the board of directors or another committee of the board of directors comprised solely of non-employees or the board itself.

Stiffer Penalties

Several new sections have been added to Title 18 of the United States Code and others have been changed to increase the penalties for fraud and obstruction of justice. The law creates a new crime, entitled Securities Fraud, that imposes a prison term of up to 25 years and substantial fines for executing or attempting to execute a scheme to defraud any person in connection with any security of an issuer or to obtain money by fraudulent means in connection with the purchase or sale of a security. There are also significant increased penalties for already existing crimes. The maximum sentence for willful violations of the Securities Exchange Act of 1934 is increased from 10 to 20 years, and the maximum fine was increased from $1 million to $5 million. The mail and wire fraud statutes have both been amended to increase the maximum prison time from 5 years to 20 years. The law also expands the federal criminal prohibitions against mail and wire fraud to include conspiracy and attempts to commit these offenses. The maximum sentence for defrauding a pension fund has been increased from 1 to 10 years.

The new law also imposes stiffer penalties and increased exposure for document destruction. Section 1512 has been amended to make document destruction with the intent to impair an object's availability or use in an official proceeding or impede an official proceeding punishable by up to 20 years in prison, a twofold increase. New section 1519 has been added to Title

18 making it illegal to knowingly alter or destroy an object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States. Section 1519 clearly lowers the standard for convictions based on document destruction by removing the official proceeding requirement. Violations under Section 1519 are also punishable by up to 20 years in prison. The law also requires certain audit documents and e-mails to be preserved for five years and creates a 10-year felony for destroying such records. Finally, the law directs the United States Sentencing Commission to review and amend the sentencing guidelines for these crimes.

The law amends the federal bankruptcy code to prohibit the discharge in bankruptcy of debts arising under claims relating to the violation of any federal or state securities laws or any securities fraud or manipulation.

Whistleblower Protection

The new law provides protection for employees of public companies who, in good faith, provide information about securities violations or fraud to a federal regulatory or law enforcement agency, Congress, or a supervisor who has the authority to investigate misconduct. Employees whose rights are violated under this provision are entitled to seek reinstatement, back pay with interest and compensation for any special damages such as attorney fees and other litigation costs. This provision takes effect immediately.

Accounting Oversight Board

One of the primary goals of the legislation is to prevent deceptive accounting and management practices. To this end, a central provision of the law is the establishment of the Public Company Accounting Oversight Board (the "Board"). The five-member Board will be constituted not later than 270 days after enactment and will oversee the audit of public companies by establishing audit report standards and rules, investigating registered public accounting firms and enforcing compliance with this law. The Board will have the power to impose disciplinary and remedial sanctions including, but not limited to, license suspension and fines of up to $750,000 for an individual and $15 million for a Company for intentional, reckless, or repeated negligent conduct that results in a violation. The Board can also sanction supervisors where a violation results from inadequate supervision.

The SEC will have oversight authority over the Board and the power to modify or rescind Board authority. The SEC must also approve any standards adopted by the Board. The new law also amends the Securities Act of 1933 to allow the SEC to recognize as "generally accepted" for purposes of the securities laws, any accounting principles established by a standard setting body.

Starting 180 days after the establishment of the Board, Registration with the Board will be required for all accounting firms that audit Companies. In registering, accounting firms agree to comply with any requests by the Board or the SEC for testimony or document production.

Auditor Independence

The law also restricts the services that accounting firms can provide to Companies. To ensure auditor independence, a Company's auditors will be prohibited from performing any of the following non-audit services contemporaneous with an audit:

- bookkeeping or other services related to the accounting records or financial statements of the audit client;
- financial information systems design and implementation;
- appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- actuarial services;
- internal audit outsourcing services;
- management functions or human resources;
- broker-dealer, investment adviser, or investment banking services;
- legal services and expert services unrelated to the audit; and
- any other service that the Board determines, by regulation, is impermissible.

Auditors will still be permitted to provide non-audit services not prohibited above, such as tax services, if the audit committee of the Company approves the activity in advance.

Auditors will be required to rotate the audit partner, or the partner responsible for reviewing the audit, on each engagement at least every five years. Additionally, auditors will be prohibited from providing any audit service under this law if the CEO, CFO, CAO, or any person in an equivalent position at the Company was employed by the auditor and was involved in that Company's audit during the previous year.

This provision takes effect 180 days after the Board commences operations.

Research Analyst Conflicts of Interest Rules

To combat conflicts of interests affecting research analysts employed by brokerage firms, the law requires the SEC, or at the SEC's direction, the NYSE or the NASD, to adopt a set of rules to address these conflicts. Many of the suggested rules mirror the rules recently adopted by the NYSE and the

NASD and approved by the SEC in May. The proposals include the following:

- restricting the pre-publication clearance or approval of research reports by persons employed by the brokerage firm who are engaged in investment banking activities, or persons not directly responsible for investment research, other than legal or compliance staff;

- limiting the supervision and compensatory evaluation of research analysts to officials employed by the brokerage firm who are not engaged in investment banking activities; and,

- prohibiting a brokerage firm and any of its employees who are involved with investment banking activities from directly or indirectly retaliating against or threatening to retaliate against any research analyst employed by that brokerage firm or its affiliates as a result of an adverse, negative, or otherwise unfavorable research report that may adversely affect the present or prospective investment banking relationship of the brokerage firm with the issuer that is the subject of the research report, except that such rules may not limit the authority of a brokerage firm to discipline an analyst for causes other than such research report in accordance with the policies and procedures of the firm.

The new law requires the SEC to define periods during which brokerage firms involved in a public offering as underwriters or dealers may not publish research reports relating to the Company or its securities. It also mandates rules that require analysts and brokerage firms to disclose publicly conflicts of interest. The NYSE and NASD rules appear to comply with most of these requirements.

These rules must be adopted within one year of enactment.

Extension of Statute of Limitations

The new law lengthens the statute of limitations for securities fraud lawsuits by shareholders to the earlier of two years after the discovery of the violation or five years after the violation. Under the previous law, securities fraud lawsuits had to be filed within one year from discovery or three years from the violation.

Increased SEC Review of Financial Reports

Effective immediately, the SEC is required to review the filings of public companies on a regular and systematic basis and not less than every three years.

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As noted above, the Act's provisions will become effective at different times. A number of the provisions are effective immediately, thereby requiring Companies and their management and directors to take immediate affirmative steps. Companies should consult with counsel as to compliance with those issues requiring immediate attention. Other provisions of the Act depend on the SEC and the various stock exchanges implementing rules, some of which will be adopted almost immediately and others of which will be adopted over the next year. We will continue to monitor all rules that are implemented as a result of the Act and will provide additional alerts.

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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