

Client Alert: Sarbanes-Oxley Act of 2002 Amends Securities Laws to Crack Down on Corporate Fraud

A. Introduction

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002 (the “Act”), which is aimed at restoring investor confidence in U.S. securities markets. The Act amends the Securities Exchange Act of 1934 and other securities laws to require expanded and more frequent disclosure, creates a Public Company Accounting Oversight Board (the “Board”) to register and regulate accounting firms and accounting practices and enhances the SEC’s power to monitor and investigate compliance with securities laws, adding stiff penalties for violations by corporations, their officers and their accountants. This sweeping legislation will substantially change securities law reporting and compliance practices, although the full scope of new regulations will only become clear over the next year as the SEC and the Board establish rules to implement the Act. We will be providing updates as these new rules are issued.

B. Corporate Responsibility

CEO and CFO certification. The Act requires the SEC to adopt rules requiring that the CEO and CFO of a 1934 Act reporting company certify the company’s annual and quarterly reports (*e.g.*, Forms 10-K and 10-Q). These officers will be required to certify that they have reviewed the report and that, based on their knowledge:

- the report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which the statements were made, not misleading; and
- 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.

The officers must also certify that they:

- are responsible for and have established internal controls to ensure that any material information relating to the issuer is made known to them;

- have evaluated and presented in the report their conclusions on the effectiveness of these internal controls; and
- have disclosed to the issuer’s auditors and audit committee (i) all significant deficiencies in the issuer’s internal controls and (ii) any fraud involving employees with a significant role in such internal controls.

These SEC rules are to be effective within 30 days.

Separately, the Act requires that each “periodic report containing financial statements” filed with the SEC be “accompanied” by a written statement by the issuer’s CEO and CFO that the report “fully complies with the requirements” of Section 13(a) or 15(d) of the 1934 Act. A CEO or CFO who provides this certification knowing that the report does not comply with the requirements of the applicable securities laws faces a fine of up to \$1 million and up to 10 years in prison. Willful violations carry fines of up to \$5 million and up to 20 years imprisonment. Although there is some uncertainty as to whether this second certification requirement was intended merely to provide an enforcement mechanism for the first certification, the provision appears on its face to create an independent certification requirement that is effective for all reporting companies immediately.¹

Audit committees. The Act requires the SEC to issue rules directing national securities exchanges and national securities associations to prohibit the listing of securities of any company that does not comply (following an opportunity to cure defects) with specified standards related to their audit committees. These standards require that:

- the audit committee be directly responsible for the appointment, compensation and oversight of the work of any registered public accounting firm employed by the issuer, and that each registered public accounting firm report directly to the audit committee;
- all members of the audit committee be independent directors (as defined in the Act);
- the audit committee establish procedures to receive and consider complaints received by the issuer or made by its employees (including anonymous submissions) regarding accounting or auditing matters; and

¹ Note that the foregoing certifications are in addition to those to be provided under the SEC’s recent order requiring CEOs and CFOs of large public companies to certify as to the accuracy of the company’s most recent Form 10-K and Forms 10-Q, Forms 8-K and proxy statements filed subsequent to that Form 10-K.

- the audit committee have the authority to engage independent counsel and other advisers, as it deems necessary.

These SEC rules are to be effective within nine months.

In addition, within six months the SEC is required to adopt rules requiring that issuers disclose whether at least one member of their audit committee is a “financial expert” (as defined by the SEC), or disclose why this is not the case.

Loans to directors and executive officers. The Act prohibits loans by issuers to their directors and executive officers, with certain limited exceptions not applicable to most issuers. The prohibition will not apply retroactively to loans outstanding on July 30, 2002, provided that there is no material modification to any term or any renewal of such loans on or after that date.

Disgorgement of CEO and CFO compensation and profits preceding a restatement. Under the Act, if an issuer is required to restate its financials due to material noncompliance with financial reporting requirements as a result of misconduct, the issuer’s CEO and CFO must reimburse the issuer for (i) any bonus or other incentive-based or equity-based compensation he or she received from the issuer during the 12-month period after the relevant financial document was filed or otherwise made public and (ii) any profits he or she realized from the sale of the issuer’s securities during that 12-month period.

Improper influence on conduct of audits. The Act requires the SEC to issue final rules within nine months prohibiting officers and directors from fraudulently influencing or misleading the auditors of an issuer for the purpose of rendering the financial statements being audited materially misleading.

Prohibition of officer and director trading during employee plan blackout periods. The Act prohibits transactions in issuer equity securities by directors and executive officers during “blackout periods” if the director or executive officer acquires the equity securities in connection with his or her service or employment with the issuer; profits from such transactions can be recovered (regardless of intent) by or in the name of the company in a manner similar to the way short-swing profits are recovered under Section 16(b) of the 1934 Act (although a matching transaction during the blackout period is not required). A blackout period is any period of more than 3 consecutive business days during which at least 50% of the participants or beneficiaries under all of the issuer’s individual account 401(k) or profit sharing plans are temporarily suspended from purchasing or selling issuer equity securities held in an issuer’s plan. Issuers are required to provide at least 30 days notice to directors and executive officers, as well as the SEC, of applicable blackout periods. The Act sets forth a number of exceptions to

blackout periods and authorizes SEC rulemaking in this area. The Act also amends ERISA to, among other things, require notice of blackout periods to plan participants.

C. Attorney Conduct

The Act requires the SEC to issue rules within six months establishing minimum standards of professional conduct for attorneys practicing before the SEC. These rules will include a requirement that attorneys (i) report to the chief legal counsel or CEO of a company any evidence of a material violation of securities laws or breach of duty or similar violation by the company or any agent thereof and (ii) if the chief legal counsel or CEO fails to respond appropriately to the evidence, report such evidence to the company's audit committee, to another board committee comprised of independent directors, or to the board of directors.

D. Disclosure Requirements

Section 16 reporting of transactions by directors, officers and principal stockholders.

The Act amends Section 16(a) of the 1934 Act to require directors, officers and beneficial owners of more than 10% of an issuer's equity securities to report beneficial holdings of the issuer's securities **within two business days** of any transaction in such securities. **This provision is effective in 30 days**. Within one year, Section 16 reports will be required to be filed electronically with the SEC, and the filings will have to be made available on the issuer's website, if it maintains one, by the end of the next business day.

"Real time" disclosure of material changes. Under the Act, issuers reporting under Section 13(a) or 15(d) of the 1934 Act are required to disclose to the public "on a rapid and current basis" such additional information concerning material changes in the financial condition or operations of the issuer as the SEC determines, by rule, "is necessary or useful for the protection of investors and in the public interest." This information must be in plain English and may include trend and qualitative information and graphic presentations, as determined by the SEC.

Pro forma information. The SEC must issue final rules within six months requiring that all *pro forma* financial information included in SEC filings or in any other public disclosure (*e.g.*, press release) be presented in a manner that:

- does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the *pro forma* financial information, in light of the circumstances under which it is presented, not misleading; and
- reconciles the *pro forma* information with the financial condition and results of operations of the issuer under GAAP.

Off-balance sheet transactions. The SEC will also issue final rules within six months mandating disclosure in annual and quarterly financial reports of all material off-balance sheet transactions, arrangements, obligations and other relationships with unconsolidated entities or other persons that may have a material current or future effect on the financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources or significant components of revenues or expenses of the issuer.

Increased SEC review of issuers. The SEC will review disclosures made by 1934 Act reporting issuers at least once every three years and more frequently for certain issuers, such as:

- those that have issued material restatements of their financial results;
- issuers experiencing significant volatility in their stock price;
- issuers with large market capitalization;
- emerging companies with disparities in price to earning ratios; and
- issuers whose operations significantly affect any material sector of the economy.

Code of ethics for senior financial officers; internal controls. Under the Act, the SEC must issue final rules within six months requiring issuers to disclose whether or not they have adopted a code of ethics for senior financial officers applicable to their principal financial officer and comptroller or principal accounting officer. If they have not adopted such a code, they will need to disclose why they have not done so.

The Act also requires the SEC to adopt rules (with no specific deadline) requiring annual reports to contain an “internal control report”, acknowledging management’s responsibility for establishing adequate internal control structures and procedures for financial reporting and containing an assessment of the effectiveness of those controls and procedures. Auditors will attest to and report on management’s assessment.

E. Public Company Accounting Oversight Board

The Act establishes a new non-governmental agency, called the Public Company Accounting Oversight Board, to oversee public accountants in their auditing of public companies. The Board’s duties will include registering public accounting firms, establishing auditing, quality control, ethics and independence standards and rules for auditors and inspecting, investigating and imposing appropriate sanctions upon public accounting firms and persons associated with such firms.

The Board will have five members, each appointed by the SEC for five-year staggered terms. Two of the Board’s members will be certified public accountants, past or present, and all Board members will be independent of public accounting firms. The

SEC must determine the composition of the Board within nine months of enactment of the Act, after which all public accounting firms will have six months to register with the Board. The SEC will oversee the Board's activity and have the power to increase or reduce any sanctions issued by the Board. The Board's activities will be funded by fees on all publicly traded companies to be determined by the SEC.

F. Auditor Independence

Preapproval of auditor's services. Under the Act, an issuer's audit committee must preapprove all services, whether auditing or otherwise, to be provided to the issuer by its auditor.

Prohibition on non-audit services. The Act prohibits a registered public accounting firm performing audit services for an issuer from providing to the issuer, contemporaneously with the audit, any non-audit services, including:

- bookkeeping services;
- financial information systems design and implementation;
- appraisal or valuation services, fairness opinions or contributions-in-kind reports;
- actuarial services;
- internal audit outsourcing services;
- management functions or human resources;
- broker or 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.

An issuer may engage its auditor for tax or other non-audit services (other than those listed above) following preapproval by the issuer's audit committee and must disclose the engagement in its 1934 Act reports.

Audit partner rotation. The Act effectively mandates rotation of lead audit partners at least every five years by making it unlawful for a registered public accounting firm to audit a client if the lead audit partner has performed audit services for that issuer in each of the five previous years. Note that this rule is effective immediately.

G. Criminal and Civil Enforcement

The Act codifies several new crimes related to fraudulent activities and increases criminal penalties for a number of existing white collar crimes. For example, the Act makes it a crime to knowingly execute, or attempt to execute, a scheme or artifice (i) to defraud any person "in connection with any security" of a 1934 Act reporting company

or (ii) to obtain, by means of false or fraudulent pretenses, representations or promises, any money or property in connection with the purchase or sale of any such security.

Crimes related to the destruction, alteration or falsification of corporate audit records and records in Federal investigations and bankruptcy cases are also codified under the Act. In addition, maximum penalties for mail and wire fraud are increased from five to 20 years imprisonment, and the statute of limitations for private securities fraud actions is extended to five years after commission of the fraud (or two years after its discovery). Civil penalties levied by the SEC as a result of judicial or administrative action will be directed to a fund for the benefit of harmed investors (the “FAIR Funds” account).

H. Miscellaneous

The Act authorizes the SEC to address matters of analyst independence by enhancing the separation between investment bankers and research analysts.

The Act protects corporate whistleblowers from retaliation by their employers.

Much of the Act applies to non-U.S. companies listed in the United States.

The Act also commissions various studies and reports, including a study of the factors that have led to the consolidation of public accounting firms since 1989, a study of the role and function of credit rating agencies in the operation of the securities market, a study of recent violators and violations of securities laws, a study of SEC enforcement actions, a study of the role of investment banks in public companies' manipulations of earnings and a study of off-balance sheet transactions.

Noteworthy in its absence, the Act does not address accounting treatment for stock options and other equity compensation.

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For Additional Information

This client alert can be found, together with other recent Chadbourne & Parke LLP client alerts, at http://www.chadbourne.com/publications/sub_Publications.html. If you have any questions regarding the Sarbanes-Oxley Act of 2002, please contact any of the following:

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