

# CLIENT ALERT

## The Sarbanes-Oxley Act of 2002 – What will this mean to your business?

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**IN THE WAKE OF** the severe bear market and the wave of recent corporate accounting scandals, Congress passed and President Bush on July 30 signed a major piece of securities and accounting reform legislation, the “Sarbanes-Oxley Act of 2002” (referred to in this Client Alert as the “Act”). The Act covers a wide range of matters related to accounting, financial reporting and corporate governance. The Act creates a new Public Company Accounting Oversight Board (PCAOB) to regulate accounting firms, requires accounting firms doing public company audits to register with the PCAOB, adds new requirements and restrictions on accounting firms designed to ensure auditor independence, and expands the oversight and enforcement mechanisms of the SEC and establishes such mechanisms for the new PCAOB. In addition, it makes a number of major changes to the rules governing public companies aimed at improving corporate governance, particularly the role of the audit committee, increasing company disclosures, and requiring corporate officers to certify that they have in place internal structures and procedures to ensure accurate accounting. Criminal penalties for a variety of corporate abuses are significantly increased.

Brown Rudnick will provide a more detailed summary of the new law shortly, but the purpose of this Client Alert is to bring to your attention some of the changes made by the Act that will affect public companies immediately and in the very near term.

### Certification of Financial Statements of All Public Companies by CEO and CFO

As has been widely reported in the press, the SEC recently required the principal executive officer and the principal financial officer of approximately 950 of the largest public companies to file a personal certifica-

tion as to the correctness of the company's financial statements by August 14, 2002.

The Act now codifies and extends the certification requirement to ALL public companies. Unfortunately, the Act contains two separate, differing sections addressing certification, which have caused confusion.

First, under Section 302, the SEC must adopt rules to be effective by August 29, 2002, requiring that the principal executive officer and the principal financial officer (or persons who perform similar functions) of ALL public companies certify in each annual or quarterly report filed after that date:

- That they have reviewed the report;
- That, based on their knowledge, the report does not contain any untrue statement of a material fact, or omit a material fact, so as to make it not misleading;
- That, based on their knowledge, the financial information fairly presents the financial condition and results of operations for the period reported;
- That they acknowledge they are responsible for establishing and maintaining internal controls to ensure that material information is made known to them;
- That they have evaluated the effectiveness of these internal controls within 90 days prior to the report and have presented in the report their conclusions about the effectiveness of the internal controls;
- That they have disclosed to their auditors and audit committee all significant deficiencies in the design or operation of the internal controls which could adversely affect the issuer's ability to record, process, summarize, and report financial data, and any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's controls; and
- Whether there were significant changes in internal control or other factors that could significantly affect internal controls, including any corrective action with regard to significant deficiencies and material weaknesses.

Second, Section 906 contains a shorter certification requirement that does not explicitly address internal controls matters. Section 906 requires that each periodic report filed under Section 13(a) or 15(d) of the Securities Exchange Act containing financial statements (such as a Form 10-K or 10-Q) be accompanied by a written certification of the CEO and the CFO that the financial statements fully comply with the requirements of those sections and fairly present, in all material respects, the financial condition and results of operations of the company. Certification of a periodic report with knowledge that it does not meet all of the requirements of Section 906 exposes the individual to criminal sanctions of up to 10 years in prison, a \$1 million fine, or both. A willful violation could result in up to 20 years in prison, a \$5 million fine, or both.

However, because there is no specific effective date with respect to Section 906, even though it overlaps Section 302, SEC and Congressional staff members have taken the position that it means what it says: Section 906 is effective immediately. That means that Form 10-Qs for the second calendar quarter due by August 14, 2002 will have to be accompanied by this certification.

In the absence of official guidance on Section 906, companies need to consider how to respond to the Section 906 requirement. One practice emerging is to submit the certifications separately to the SEC (for example, as correspondence either electronically, by fax or physical delivery) but not as part of the publicly

filed report. Another approach is to include the certifications on the report's signature page or to file the certifications as an exhibit to the report. Others are considering whether to include a disclaimer limiting the purpose of the certification to the requirement of the statute. Some have considered whether, based upon a variety of arguments, it is appropriate to add a knowledge qualifier, either to the certificate or through explanatory language in the report itself, since the criminal penalties are premised on knowledge. This is an area that is evolving on a daily basis, and there is some question whether the SEC will give definitive guidance on this issue by August 14. Therefore, all issuers with reports due by August 14 should work closely with their counsel over the next couple weeks.

### Accelerated Filing of Form 4s

Section 403 of the Act, effective August 29, 2002, requires directors, officers, and beneficial owner of more than 10% of a registered class of stock to file their Form 4s reporting a change in ownership of the issuer's equity securities before the end of the second business day following the day on which the transaction was executed. The old rule required a Form 4 to be filed within 10 days after the end of the month in which the transaction occurred.

The Act does permit the SEC to extend the period for filing if it determines that the two day rule is not feasible. It is possible that the SEC will provide for a longer period until it has in place the capability to receive and process the Form 4s electronically through EDGAR, which the Act mandates that it do within one year.

This shorter time frame for filing will make it more imperative than ever that company officials closely monitor trades by officers and directors. Combined with pending SEC rule proposals, it may increase the already substantial extent to which the company may have to control the process of purchase or sale of company stock by insiders.

### Prohibition on Extension of Credit to Directors and Officers

Effective as of the date of enactment (July 30, 2002), an issuer will no longer be able to extend or maintain credit, arrange for the extension of credit, or renew an extension of credit in the form of a personal loan to any director or executive officer. This prohibition extends to indirect extensions of credit as well. Extensions of credit in place on July 30, 2002 may remain, provided that there is no material modification to or extension of the credit after that date. There also are exceptions to the rule to address credit cards issued by businesses to their employees, margin loans for personal securities brokerage accounts held by employees of a brokerage firm, and loans by financial institutions to their employees that are already subject to regulation by the Federal Reserve.



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