

CLIENT ALERT

## THE SARBANES- OXLEY ACT OF 2002

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**RECENTLY**, we sent out a Client Alert advising of the enactment on July 30 of the Sarbanes-Oxley Act of 2002 (referred to in this Client Alert as the "Act"). That Client Alert discussed certain changes in the law which required the most immediate attention. This Client Alert will discuss the Act more generally. However, given the breadth of the Act, this is only a summary of the key provisions and does not address all aspects of the Act. In addition, because the Act is new and there are not yet any regulations or judicial or administrative interpretations of it, there are some unanswered questions about its meaning.

The Act imposes new obligations and limitations on corporate directors and executive officers, imposes significant new disclosure obligations on public companies, creates a new body to regulate auditors of public companies, increases the responsibilities of the audit committee, imposes various limitations on services provided by audit firms, and increases the penalties for violations of the securities laws.

## **A** PPLICABILITY AND EFFECTIVE DATES

The Act generally applies to all companies that are required to file periodic reports under Sections 12 and 15(d) of the Securities Exchange Act of 1934. In other words, the Act generally applies to "public companies." Most of the Act's provisions apply to foreign private issuers that are subject to the reporting requirements of the Securities Exchange Act. The Act does not apply to private companies unless they are in registration with the SEC for a public offering.

Parts of the Act were effective immediately on July 30, 2002, but many of its particular provisions require the SEC, the stock exchanges, or other regulators to adopt rules to implement the Act within various periods after enactment.

## **M** ATTERS AFFECTING EXECUTIVE OFFICERS AND DIRECTORS OF PUBLIC COMPANIES

### Certification of Financial Statements

In the last Client Alert, we brought to your attention the provisions of Sections 302 and 906 of the Act

related to the personal certification of financial statements by CEOs and CFOs. It now appears that the SEC will not be providing additional guidance on the Section 906 certification, and there are a number of unresolved issues related to that certification. It is important that you consult with your counsel on the procedures to be utilized in preparing any financial statements for filing as part of periodic reports until such time as the SEC adopts regulations under Section 302.

#### **Accelerated Filing of Form 4s**

We also noted in the last Client Alert that, effective August 29, 2002, the deadline for filing of Form 4s has been shortened. They will now be due within two business days after the transaction, unless the SEC extends the deadline. The SEC announced on August 6 that it expects to adopt amendments to the Form 4 and related rules by the August 29 deadline. Those rules will require most transactions, including issuances, exercises, cancellations and re-grants of stock options under employee benefit plans, to be filed within the two business day period. The only transactions the SEC is considering giving more time for are:

- those pursuant to a single market order executed over several days;

- those under a pre-existing arrangement (such as a Rule 10b5-1 plan) where the actual timing is outside the knowledge of the corporate insider; and
- certain employee benefit plan transfers.

Given the practical problems of filing Form 4s within this shortened timeframe, we urge you to immediately send a notice to all executive officers and directors advising them of the new, shortened time frame and telling them to notify you before doing anything which would change their ownership of company stock. You should also before August 29 adopt streamlined reporting procedures, including obtaining electronic filing codes in advance for insiders, that will increase the chances of being able to make timely filings of Form 4s. Brown Rudnick will be happy to help you design procedures to help you comply with these new rules.

#### **Ban on Personal Loans**

As noted in the last Client Alert, the Act provides that effective immediately, public companies may not make, extend, renew or modify any loan to their executive officers or directors, although arrangements in place on July 30, 2002 may remain in place. There 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 Board.

#### **No Transactions by Executive Officers or Directors during Pension Fund Blackout Period**

Effective January 26, 2003, officers and directors are prohibited from trading in the company's stock during any blackout period under a company 401(k) plan or other profit sharing or retirement plan. A blackout period generally is defined as any period (other than a regularly-scheduled and disclosed period) of more than three consecutive business days during which the ability of 50% or more of the participants in the plans to trade is temporarily suspended by the company or by a plan fiduciary. Any profit realized by the officer or director trading in violation of this rule can be recovered by the company for up to two years after the profit was realized.

#### **CEO/CFO May Have to Give Back Compensation and Profits**

Effective immediately, if a public company is required to restate its financial statements due to material noncompliance with financial reporting rules, its CEO and CFO each must reimburse the company for:

- any bonus or other incentive-based or equity-based compensation he or she received; and
  - any profit realized from the sale of securities of the company, in each case during the 12-month period following the first public issuance or filing with the SEC (whichever occurs first) of the financial document embodying such financial reporting requirement.<sup>1</sup>
- Please note that the Act does not require that the CEO or CFO be aware of the material noncompliance for this give-back rule to apply.

## **ENHANCED PUBLIC COMPANY DISCLOSURES**

### **Rapid and Current Disclosure**

The Act requires that any public company must disclose to the public “on a rapid and current basis” such information concerning material changes in their financial condition or operations as the SEC may by rule require. This is intended to move the legal framework for public company periodic reporting closer to continuous disclosure and will significantly reduce a company’s ability to defer disclosure until the next Form 10-Q under the “disclose or abstain from trading” theory.

### **Off Balance Sheet Transactions and Pro Forma Earnings Disclosure**

By January 26, 2003, the SEC must issue rules that require annual and quarterly financial reports filed with it to disclose certain matters which have recently become controversial. The SEC must adopt rules that:

- require companies to disclose all material off-balance sheet transactions, obligations (including contingent obligations) and other relationships with unconsolidated entities or others that may affect the company’s financial condition, changes in financial condition, results of operation, liquidity, capital expenditures, capital resources, or significant components of revenue or expenses;
- ensure that “pro forma” financial information included in reports filed with it, or in a press release or other public disclosure, does not contain any untrue statement of material fact or omit any material fact necessary to make the pro forma information not misleading; and
- require reconciliation of pro forma information with the financial condition and results of operations of the company under generally accepted accounting principles.

### **Internal Control Reports**

The SEC is required to adopt rules requiring the inclusion in public company annual reports of a report on the company’s internal controls which includes:

- an acknowledgement of management’s responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting;
- an assessment of the effectiveness of the internal control structure and procedures for financial reporting, as of the end of the most recent fiscal year of the issuer; and
- a report from the registered public accounting firm which prepares the audit report for a company which must attest to, and report on, management’s assessment of the internal control structure.

### **Codes of Ethics**

By January 26, 2003, the SEC must adopt rules requiring companies to disclose in their periodic reports whether or not they have adopted a code of ethics for senior financial officers (i.e., CFO and comptroller or principal accounting officer) and if not, why not. As a practical matter, this means that all companies that have not already done so will need to adopt a code of ethics. Codes of

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<sup>1</sup> The SEC can exempt individuals from this rule.

ethics will be required to establish such standards as are reasonably necessary to promote:

- honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
- full, fair, accurate, timely and understandable disclosure in the periodic reports required to be filed by the issuer; and
- compliance with applicable governmental rules and regulations.

Any change in or waiver of the code of ethics must be immediately disclosed on a Form 8-K (or Form 6-K for foreign issuers), by dissemination on the Internet, or by other electronic means. Brown Rudnick can work with you to formulate a Code of Ethics compliant with the new requirements but tailored to your particular company's situation.

## **R**EGULATORY OVERSIGHT OF INDEPENDENT ACCOUNTANTS

The Act creates a new Public Company Accounting Oversight Board (the "PCAOB") responsible for regulating accounting firms that prepare audits for public companies. The PCAOB will be a private non-profit corpora-

tion, with a five member board chosen by the SEC. Two of the five members must be certified public accountants; the other three must not be accountants. The SEC will have oversight and enforcement authority over the PCAOB. Effective January 26, 2003, no accounting firm will be able to audit a public company without first registering with the PCAOB. The PCAOB is directed to establish audit and ethics standards, conduct a program of continuing periodic inspections of the audit operations of registered accounting firms, conduct investigations of and disciplinary proceedings against registered public accounting firms, and enforce compliance with the Act and the securities laws related to the audit. Accounting firms that violate the rules of PCAOB may be subject to sanctions which include:

- temporary suspension or permanent revocation of registration;
- temporary or permanent barring of a person from association with any registered public accounting firm;
- temporary or permanent limitation on the activities, functions or operations of a firm or person;
- civil monetary penalties;
- censure;

- required additional professional training; and
- any other sanctions provided for in the rules of the PCAOB.

## **A**UDIT COMMITTEES AND THEIR RELATIONSHIP TO OUTSIDE AUDITORS Powers and Responsibilities of Audit Committees

The Act establishes the authority of audit committees to appoint, compensate and oversee the work of any firm performing an audit of the company. The audit committee is also responsible for resolving disagreements between a company and its auditors. The audit committee must establish procedures for the receipt, retention and treatment of complaints received by the company regarding accounting, internal accounting controls or accounting matters and the confidential anonymous submission by employees of the company of concerns regarding questionable accounting or auditing matters.

Registered public accounting firms will report directly to the audit committee. They will be required to inform the audit committee of the types of accounting policies and practices the company will use,

including alternative treatments of financial information under GAAP that have been discussed with management, the ramifications of such alternative treatments, and the treatment preferred by the accounting firm. The accounting firm must also disclose to the audit committee any material written communications between management and the accounting firm.

### **Composition of Audit Committees**

The Act also requires that each member of the audit committee must be a member of the board of directors who “shall otherwise be independent.” This means that, except in his or her capacity as a member of the board of directors or a board committee, an audit committee member may not accept any consulting, advisory or other compensatory fee or be an affiliated person of the company.<sup>2</sup> In one respect, this rule is more restrictive than existing or proposed stock exchange rules, which have dollar or materiality thresholds. However, the Act does not expressly address indirect financial interests such as being an officer of a customer or supplier of the public company, which are addressed by the proposed stock exchange rules. The Act also requires that the audit committee have

the authority to hire independent counsel and other advisors at company expense if it determines necessary.

By January 26, 2003, the SEC must adopt rules requiring a company to disclose whether or not there is at least one financial expert on its audit committee and, if not, why not. Again, as a practical matter this will create heavy pressure on almost all companies to ensure that they have a financial expert on their board if they do not already have one. A financial expert is defined in the Act as someone who has, through education or experience as a CPA, CFO, controller, or as the SEC by rule otherwise provides:

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

Interestingly, unlike the Nasdaq and NYSE proposals, experience as a CEO is not listed in the Act as evidence of financial expertise.

### **Preapproval of Services; Prohibition on Certain Services**

The Act requires pre-approval by the audit committee (or a designated member) of all audit services and non-audit services provided to a public company by its auditors. There is a *de minimis* exception to the prior-approval requirement *if*:

- the aggregate amount of the non-audit service constitutes no more than 5% of the total amount paid to the auditor that year;
- the non-audit services were *not* recognized as such at the time of engagement; and
- the services are subsequently approved by the audit committee.

(The non-audit services will still need to be disclosed to investors under the *de minimis* exception.)

However, the Act further provides that without regard to approval, registered public accounting firms will not be allowed to provide certain enumerated non-audit services “contemporaneously with the audit”. The services prohibited by the statute are:

- bookkeeping or other services related to accounting records or financial statements;
- financial information systems design and implementation;
- appraisal or valuation services,

<sup>2</sup> The SEC can exempt a member from these requirements.

fairness opinions or contribution-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 PCAOB determines, by regulation, is impermissible.<sup>3</sup>

The Act directs the SEC to issue final rules to implement these provisions by no later than January 26, 2003.

#### **Auditor Partner Rotation and One Year Cooling Off Period**

The Act prohibits any person from being a lead auditor or reviewing partner on an audit of a public company for more than five consecutive years. The Act also prohibits a registered public accounting firm from performing any audit service if the chief executive officer, chief financial officer, controller or chief accounting officer of the company, or a person serving in an equivalent position, was employed by the accounting firm or participated in any capacity in an audit of the company in the year preceding the current audit.

#### **No Misleading of Auditor**

The SEC is required to adopt final rules by April 26, 2003 making it illegal for any officer, director or person under their direction to take any action to fraudulently influence, coerce, manipulate or mislead an independent public accountant performing an audit of the company in order to make the company's financial information materially misleading.

#### **INCREASED PENALTIES AND ADDITIONAL REMEDIES**

Several criminal penalties and additional remedies are added or increased under the Act. These penalties and remedies include:

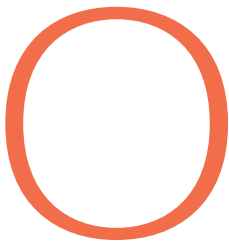
- Up to 20 years in prison, fines or both for trying to obstruct or influence any Federal case or investigation (including any bankruptcy case or investigation) by knowingly altering, destroying, concealing or falsifying any document or tangible object;
- Maximum jail terms for wire fraud and mail fraud increased from five years to 20 years;
- Jail term for pension law violations increased from one year to ten years; and, fines for such a violation increased from \$5,000 to \$100,000;

- Prison term of up to 25 years, a fine or both for knowingly defrauding any person in connection with any security of a registered public company;
- Sentences of up to 20 years for Securities Exchange Act violations;
- No bankruptcy protection to avoid judgments related to violations of securities laws;
- Up to 10 years in prison, a fine or both for knowingly violating rule that accountant must keep all audit or review papers for five years from the end of the fiscal period in which the audit of review was conducted; and
- Whistleblower protections, including criminal penalties for retaliation and right of whistleblower to sue.

If an issuer is under investigation for securities violations, the SEC will be authorized to petition for a temporary freeze on extraordinary payments to officers and employees. The initial order to freeze payments will remain in effect for 45 days, unless set aside, limited or suspended by a court. An extension of an additional 45 days may be granted upon good cause, so long as the combined period of the freeze does not exceed 90 days. The SEC will now have authority to commence a cease and desist proceeding to

<sup>3</sup>The PCAOB may make exceptions to this rule on a case-by-case basis.

temporarily or permanently bar officers and directors who violate Section 10(b) or the rules thereunder, including Rule 10b-5, from serving as an officer or director of a public company. Further, the standard for a bar from serving as an officer or director of a public company has been changed from “substantial unfitness” to simply “unfitness”.



## **OTHER PROVISIONS**

### **SEC Review of Periodic Filings**

The SEC is directed to conduct an enhanced review of every company's periodic reports at least once every three years. In determining which issuers to review first, the SEC is to consider several factors:

- companies that have issued material restatements of financial results;
- companies that experience significant volatility in their stock price as compared to other companies;
- companies with the largest market capitalization;
- emerging companies with disparities in price to earning ratios;
- companies whose operations significantly affect any material sector of the economy; and

- any other factors that it may consider relevant.

### **Whistle Blower Provisions**

New whistleblower protections in the Act provided that no officer, employee or agent of a public company may harass, fire, demote, suspend or otherwise discriminate against an employee because of a lawful act by the employee in providing information to regulators, members of Congress, or his supervisors regarding any conflict the employee reasonably believes constitutes a violation of the Federal securities laws or Federal antifraud laws. Proceedings may be brought by an employee for violation of this provision by filing a complaint with the Department of Labor or, if it does not make a decision within 180 days, bringing a civil suit in Federal District Court. An attempt to retaliate against a whistleblower can carry a jail term of up to ten years, fines or both.

### **Statute of Limitations for Civil Suit for Securities Fraud**

The basic statute of limitations for a private suit for securities fraud or contravention of a regulatory requirement is increased to the earlier of two years after discovery of the violation or five years after such violation.

### **Further Studies**

In addition to all of the changes mandated by the Act, there were several issues that Congress considered, but chose to study further rather than legislate on at this time. It therefore directed the SEC and the GAO to conduct one year studies on a number of topics, including the roles of credit rating agencies and investment banking firms, the implications of the consolidation of the accounting profession, the desirability of mandating public company rotation of auditing firms, the extent of securities law violations by various categories of market participants and regulated professionals, and other matters.



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PROUDLY ANNOUNCES**

the addition of our newest Partner, William C. Mutterperl. Mr. Mutterperl is a recognized authority on all aspects of corporate governance, including board

structure and processes, privacy, risk oversight, corporate ethics and insider trading and other transactions. Previously, Mr. Mutterperl was General Counsel and Secretary to FleetBoston Financial Corporation, one of the largest banking companies in the U.S., and Executive Director to the Independent Oversight Board for Arthur Anderson chaired by former Federal Reserve Chairman Paul Volcker.

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