

KEY PROVISIONS OF THE SARBANES-OXLEY ACT OF 2002

On July 30, 2002, President Bush signed into law a lengthy set of corporate governance changes contained in the Sarbanes-Oxley Act of 2002. The new law:

- dramatically changes the regulation of public accountancy;
- sets new standards for corporate governance;
- enhances enforcement authority for the Securities and Exchange Commission; and
- adds criminal statutes and increases penalties for illegal conduct by corporate executives, accountants and lawyers.

The Act mandates a flurry of rulemaking by the SEC and requires that reporting companies – those public entities that file periodic reports under the Securities Exchange Act of 1934 – must establish new corporate procedures in response to the legislation and the coming SEC regulations.¹

OVERVIEW

The Act covers 7 major areas of interest:

1. **Corporate Responsibility** – Public companies must adopt new corporate governance standards for public boards of directors (especially audit committee members), corporate officers, and attorneys.
2. **Enhanced Financial Disclosures** – The Act sets higher standards for public company financial disclosure, mandates ethical codes for corporate officers and increases emphasis on "real time" disclosure of insider transactions and changes in financial condition.
3. **Public Accounting Oversight** – A new agency, the Public Company Accounting Oversight Board (PCAOB), will license and regulate independent auditors of public companies, under the SEC's supervision.

¹ Most statutory provisions of the law are effective immediately. Where SEC rulemaking is mandated, the SEC generally is required to adopt rules within 180 days (by January 26, 2003).

4. **Auditor Independence** – Federally mandated minimum requirements will govern the relationship between independent auditors and their publicly held clients.
5. **Analyst Conflicts of Interest** – The SEC must adopt new rules restricting conflicts of interest by financial analysts, such as analysts working for major underwriting firms.
6. **Commission Resources** – The SEC receives new resources and new enforcement powers to tackle wrongdoing by public company executives, accountants and lawyers.
7. **Enhanced Penalties and New Criminal Statutes** – New criminal statutes provide additional tools to punish fraud and obstruction of justice by both public and private companies, including criminalization of aiding and abetting type of offenses for executives, accountants and lawyers.

The Act mandates several studies, by the SEC and General Accounting Office, of the effectiveness of corporate governance and of the SEC's enforcement program. It contains a "sense of the Senate" recommendation (not a statutory requirement, but a signal to the IRS) that all corporate CEOs should be required to sign the corporation's federal income tax returns.

ANALYSIS OF KEY PROVISIONS

Corporate Responsibility

- *Public Audit Committees.* All members of audit committees of public companies must be independent directors. Nasdaq has recently sent new rules to the SEC which provide detailed standards for director independence.
- *Audit Committee Financial Expert.* The Commission must adopt rules requiring each company to disclose whether it has on its audit committee at least one "financial expert" – someone with education or experience in preparing or reviewing financial statements.
- *Certification of Financial Reports.* CEOs and CFOs will be required to certify that they have read their company's periodic reports and that they know of no material misstatements or omissions. They must also certify that they have disclosed to the auditors and audit committee:
 - All significant deficiencies in the company's internal controls.

- Any fraud that involves management or employees responsible for internal controls.
- Any changes or other factors that could affect the quality of internal controls.
- *Unlawful Influence of Audits.* It is unlawful for any corporate insider to influence, coerce, manipulate or mislead any public accountant in the performance of their audit functions. The SEC is instructed to adopt rules governing such misconduct.
- *Penalties for Restatements.* If an issuer is required to restate its financial statement as a result of any misconduct by a corporate official, the offending officer must reimburse the issuer for any bonus or other incentive compensation received within the 12 month period following the misstatement, plus any profits from the sale of the issuer's securities during that period.
- *Insider Trades During Blackout Periods.* In an obvious response to allegations regarding Enron, insiders are prohibited from buying or selling company securities during the period of any blackout period imposed on purchases and sales by company pension or profit-sharing plans. This provision contains a lengthy set of technical definitions, qualifications and exceptions.
- *Loans to Executives Prohibited.* The Act prohibits making loans to corporate insiders except in limited circumstances where the issuer is in the business of making similar loans to the general public. Existing loans may continue but their terms may not be materially modified.
- *Attorneys Must Report Violations to Company.* The SEC must adopt rules requiring attorneys to report evidence of material violations of securities laws or breach of fiduciary duties to the corporate general counsel or CEO. If the receiving officer does not "appropriately respond," the evidence must be reported to the audit committee or another committee of independent directors.²

Enhanced Financial Disclosures

- *Corporate Codes of Ethics.* The SEC must adopt rules requiring each public company to disclose whether it has adopted a code of ethics for senior management and financial officers, and if not, why not. If a company grants a waiver of its ethical code, the waiver must be immediately disclosed in a public report. (A logical, but unstated, implication is that a violation of the code must also be immediately reported.) Nasdaq and NYSE have already announced the

² An American Bar Association Task Force is considering amendments to the Model Rules of Professional Responsibility that would not only require reporting misconduct to corporate officials but also would permit a lawyer to publicly disclose information relating to the representation to the extent necessary to prevent the client from committing a crime or fraud reasonably certain to result in substantial economic loss, if the lawyer's services have been or are being used in furtherance of the crime or fraud.

adoption of rules to be submitted to the SEC, requiring Nasdaq and NYSE issuers to adopt ethics codes.

- *Annual Report on Internal Controls.* The Management's Discussion and Analysis section of annual reports must report on the issuer's internal controls and procedures for financial reporting. The independent auditor must report on management's assessment of the company's internal controls.
- *Off-Balance Sheet Transactions.* The Commission must adopt rules requiring prompt financial reporting of off-balance sheet transactions (another response to Enron) and other arrangements with unconsolidated affiliates and entities that could affect the company's financial condition.
- *Material Adjusting Entries.* A public company's periodic reports must disclose any material adjusting entries to its financial statements that the company's auditors required it to make.
- *Pro Forma Information.* The SEC must adopt rules establishing uses of *pro forma* information which can be reconciled with GAAP financial statements and which, of course, are not materially misleading.
- *Securities Transactions by Insiders.* The short-swing trading section, Section 16 of the Exchange Act, is amended to require that, beginning August 29, 2002, officers, directors and 10% shareholders to report any purchases or sales of securities within 2 business days. Beginning July 2003, all of these reports must be filed electronically, so they can be instantly disseminated on the SEC's EDGAR system.
- *Regular and Systematic Review* The SEC is mandated to establish a procedure to periodically review the public filings of all public companies, at least once every three years. The SEC is given discretion to establish criteria for its periodic review procedures. The new law changes current SEC practice of seldom reviewing some public filers at all, absent a new public offering or a definite reason for a review.
- *Real Time Disclosure.* Material changes in financial condition must be disclosed "on a rapid and current basis" and in "Plain English." The SEC must adopt implementing rules and may require issuers to include trend and qualitative information and to use graphic presentations. This suggests a move away from the traditional quarterly/annual report cycle, toward more nearly instantaneous disclosure, akin to the SEC's current rule proposals to greatly expand the use of Form 8-K for current event reporting.

Public Accounting Oversight – the Public Company Accounting Oversight Board

- *Board Composition.* The PCAOB will be a five-member board with licensing, investigative and disciplinary powers. The Act contemplates that the board will be established and functioning within 270 days (by April 26, 2003). Two members may be accountants; the remaining three must be from outside the profession. Members will be appointed by the SEC in consultation with the Treasury Department and Federal Reserve Board. The board has rulemaking authority, subject to approval by the SEC.
- *Registration of Public Accountants.* All accounting firms who audit public companies must register with the board. The board has broad authority to require reports from, inspect and discipline registered accounting firms and accountants. The statute requires disclosure in the registration application of the fees paid to accounting firms for their audit and non-audit services.
- *Inspections.* The board must inspect registered public accounting firms on the following schedule:
 - annually if the firm regularly audits more than 100 public companies.
 - at least every 3 years for firms auditing 100 or fewer public companies.
- *Setting Auditing Standards.* The board must adopt rules governing auditing standards, independence standards, quality control standards, and professional ethics standards in preparation of audit reports. The board must consult with professional accounting groups in setting standards but is not required to follow recommendations from those groups.
- *SEC Oversight.* The SEC has authority to approve or reject board rules, orders, and disciplinary actions, similar to its current oversight over securities self-regulatory organizations. The SEC specifically may approve generally accepted accounting principals proposed by the board.
- *Funding.* The board will be funded by fees levied on public companies. The fees will be set annually by the board, with the approval of the SEC. The board may create classes or categories of issuers and set different fee levels among categories.
- *State Authority.* States retain authority to set separate standards for accounting firms not registered with the board. However, all accountants who audit public companies will be subject to the board's federal standards. As a practical matter, state accountancy agencies may feel a need to uphold local standards of best practices by moving toward the federal rules.

Auditor Independence

- *Non-Audit Services Restricted.* Accounting firms will be prohibited from providing 9 types of auditing services to audit clients:
 1. bookkeeping services.
 2. financial information systems design.
 3. appraisal or valuation services.
 4. actuarial services.
 5. internal audit outsourcing services.
 6. management functions or human resources.
 7. broker-dealer, investment adviser or investment banking services.
 8. legal and expert services unrelated to the audit.
 9. other services that the board determines to be impermissible.
- *Audit Partners Rotation.* Accounting firms must rotate the lead partner and the reviewing partner from each client assignment every 5 years at most.
- *Audit Committee Approval.* All substantial auditing and non-auditing services must be approved by the public company's audit committee. Any non-auditing services must be reported to investors in the company's periodic reports.
- *Reports to the Audit Committee.*³ The auditors must report to the public company's audit committee on critical accounting policies, alternative accounting treatments and principles and other communications with management, such as management letters.
- *Conflicts of Interest.* Auditors may not provide audit services to a public company whose top management or financial officers were employed by the accounting firm to audit the issuer during the past year.

Analyst Conflicts of Interest

- *Disclosure of Conflicts.* The SEC and/or SROs must, within one year, adopt rules governing conflicts of interest and disclosure of relationships between financial analysts who cover securities, the underwriters or brokerage firms who employ analysts, and the issuers on whom analysts report.

³ The SEC must adopt new rules governing the membership and responsibility of audit committees of companies listed on Nasdaq and the national securities exchanges within 270 days (by April 26, 2003).

Commission Resources

- *New Staff and Resources.* The SEC's budget has been increased to:
 - provide for hiring 200 additional professionals for audit oversight and enforcement.
 - dedicate an additional \$102 million to increasing compensation to SEC employees, to slow its loss of trained personnel to private industry.
 - spend an additional \$108 million for new technology and security systems.

Enhanced Penalties and New Criminal Statutes

- *Bankruptcy.* Liabilities for violations of any state or Federal securities laws⁴ are no longer dischargeable in bankruptcy. This appears to include sales of securities in violation of federal or state securities registration laws.
- *Civil Statute of Limitations.* The limitations statute for private rights of action for fraud in violation of any Federal securities laws is lengthened to the earlier of 2 years after discovery or 5 years after the violation. Prior to the amendment, the applicable periods were 1 and 3 years.
- *Bars on Director and Officer Service.* The SEC may, in administrative proceedings, bar securities law violators from service as corporate officers or directors. Prior to this amendment, the SEC was required to obtain a court order to bar individuals from board or officer service.
- *Destruction of Documents.* It is a criminal offense to alter, destroy, mutilate, conceal, cover up, falsify or make a false entry in any record or object with intent to impede any investigation by any department or agency of the government, or in any bankruptcy proceeding.
- *Relief Funds for Fraud Victims.* In enforcement suits, the SEC may use civil penalties or disgorgement from defendants to establish funds to benefit victims of the violation. (Prior to this amendment, the SEC could seek payment to the government of penalties and disgorgement of profits, but could not seek payments to investors.)
- *Enhancement of Penalties.* The maximum penalty for defrauding any person in connection with any security registered under the Exchange Act is increased to

⁴ "Federal securities laws" are defined in Section 3(a)(47) of the Exchange Act to include the Securities Act of 1933, Exchange Act of 1934, Public Utility Holding Company Act of 1935, Trust Indenture Act of 1939, Investment Company Act of 1940, Investment Advisers Act of 1940, and Securities Investor Protection Act of 1970.

25 years in prison. The U.S. Sentencing Commission is directed to revise the Federal Sentencing Guidelines to increase penalties for fraudulent conduct.

- *Conspiracy.* Conspiracies and attempts to commit criminal fraud offenses, such as the ones described in the preceding paragraph, are punished at the same level as the primary offense itself. The new conspiracy statute may be seen as subjecting executives, accountants and lawyers to criminal penalties for aiding and abetting conduct.
- *Freezing Compensation.* The SEC is given authority, in enforcement suits, to freeze payments to corporate executives where the SEC has reason to believe that a corporate defendant may seek to make extraordinary payments to an executive by a corporation after the SEC files its lawsuit.

ADDITIONAL INFORMATION

In addition to the Act (and perhaps in anticipation of it), the New York Stock Exchange and Nasdaq Stock Market have submitted new corporate governance regulations to the SEC which will be published in the near future. Recent rule proposals by the SEC also anticipate the provisions of Sarbanes-Oxley. The rulemaking initiatives in the next six months will present a host of new challenges for public companies and the accountants and attorneys who advise them.

We provided this bulletin for the information of our clients, to keep you abreast of the new law. However, this bulletin is not legal advice, and it should not be used to make legal decisions about any particular facts or circumstances. If you have legal questions, we encourage you to consult one of us regarding the specific situation in question.

Our firm regularly advises corporations on ethical as well as regulatory issues, including the development of the corporate codes of conduct which are mandated by this legislation and new SRO rules. If you would like more information on the provisions of Sarbanes-Oxley or the rulemaking initiatives by the SEC, Nasdaq and NYSE, please call your Strasburger attorney or one of the lawyers from our Corporate and Securities Practice Group, listed below.

Donald Patrick Owens	214.651.4976	patrick.owens@strasburger.com
Carol Glendenning	214.651.4660	carol.glendenning@strasburger.com
Mark E. Golman	214.651.4478	mark.golman@strasburger.com
W. Garney Griggs	713.951.5613	garney.griggs@strasburger.com
Jane Woods La Franchi	202.756.3619	jane.lafranchi@strasburger.com
David K. Meyercord	214.651.4525	david.meyercord@strasburger.com
Lee Polson	512.499.3626	lee.polson@strasburger.com
John E. Rogers	011.52.55.5520.8514	john.rogers@strasburger.com