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SARBANES-OXLEY ACT OF 2002: CEO/CFO CERTIFICATIONS, CORPORATE RESPONSIBILITY AND ACCOUNTING REFORM

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On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002 (the "Act"). The Act is a sweeping package of reforms intended to remedy many of the accounting, disclosure, mismanagement and self-dealing issues that have commanded headlines since the Enron debacle. The Act contains provisions designed to instill greater corporate responsibility among senior management of public companies, to enhance disclosures, to improve auditor independence, to introduce regulatory oversight of the auditing profession and to remedy perceived conflicts of interest of equity analysts while increasing substantially the penalties and other sanctions associated with corporate and criminal fraud and white-collar crimes.

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Executive Summary

The following is a summary overview of the Act:

CEO/CFO Certifications and Corporate Responsibility

- CEOs and CFOs of public companies are required to certify each periodic report containing financial statements filed with the Securities and Exchange Commission on or after July 30, 2002. The certification must state that the report fully complies with the reporting requirements of the Securities Exchange Act of 1934, as amended, and that the information contained in the report fairly presents, in all material respects, the financial condition and results of operations of the company. We believe this "fairly presents" certification requirement introduces a new higher reporting standard that covers more than technical compliance with form requirements and generally accepted accounting principles and an absence of fraud.

- The Act also requires the SEC to adopt final rules on or before August 29, 2002 requiring that the CEO and CFO of each public company provide additional certifications regarding their company's annual and quarterly reports filed with the SEC. These certifications will be significantly more detailed than those required by the SEC's June 27, 2002 order requiring certifications to be made on the first date an annual or quarterly report is required to be filed on or after August 14, 2002.

- The Act prohibits new loans by public companies to directors and executive officers, subject to limited exceptions.

- If a public company makes an accounting restatement due to misconduct, its CEO and CFO will be required to reimburse the company for their bonuses and other incentive-based or equity-based compensation received from the company in the one-year period after the error as well as any profits from sales of the company's securities during that period.

- Attorneys will be required to report evidence of a material violation of securities laws or breach of fiduciary duty or similar violations by a company or its agents to its CEO or chief legal counsel and, should such officer not respond appropriately, to the company's board of directors or its audit committee.

- All audit committee members of listed companies will be required to be independent, and all authority regarding audit-related matters must be vested in the committee.

- The Act provides new protections for employee "whistleblowers" by prohibiting public companies, their officers and their agents from discharging, demoting, suspending, threatening, harassing or in any way discriminating against any employee in his or her employment because of any lawful act done by the employee to assist in an investigation into specified types of fraud.

Enhanced Disclosure

- The Act requires the SEC to review, at least once every three years, the annual reports and other periodic reports of public companies.

- Directors, officers and persons owning 10% or more of any class of registered equity securities of a public company must report a change in their ownership of the company's equity securities before the end of the second business day after the occurrence of the change.

- The Act requires new periodic disclosure of material correcting adjustments, off-balance sheet transactions and internal controls and effectively requires public companies to adopt codes of ethics for senior financial officers.

- The Act directs the SEC to require "real time" disclosure of material changes in financial condition or operations and requires the SEC to issue new rules in relation to the use of pro forma financial information.

Public Company Accounting Oversight Board

- The Act subjects public accounting firms and accounting professionals to significant supervision by a new Public Company Accounting Oversight Board. The Oversight Board will be subject to SEC supervision and function as a self-regulating body.

- The Oversight Board is required to adopt auditing, quality control, ethics and independence standards for registered public accounting firms to use in performing audits of public companies.

- The Oversight Board is required to conduct periodic inspections of registered public accounting firms and has the authority to conduct investigations and disciplinary proceedings.

Auditor Independence

- The Act limits the scope of non-audit and consulting services that accounting firms can perform for their public audit clients.

- The audit committee of a public company must pre-approve all non-audit services performed by the company's auditors.

Research Analyst Independence

- The Act requires that the SEC, or self-regulatory organizations such as the National Association of Securities Dealers, Inc. and the New York Stock Exchange, Inc., adopt rules requiring firewalls to insulate analysts from pressure from investment banking personnel and disclosure of an analyst's conflicts of interest with regard to companies on which an analyst prepares research.

Private Civil Litigation Statute of Limitations

- The Act lengthens the statute of limitations for certain securities claims to the earlier of two years after the discovery of the facts constituting the violation and five years after the violation (as compared with the prior statute of limitations of the earlier of one year after the date of discovery of the facts constituting the violation and three years after the violation).

Criminal Sanctions

- The Act establishes new criminal offenses, including for securities fraud, tampering with and destruction of records and conspiracy, and increases criminal penalties under certain existing statutes.

Applicability to Reporting Companies and Pre-IPO Issuers

- In general, the Act imposes requirements on all companies that file periodic reports with the SEC, including, for example, subsidiary issuers of utility holding companies and companies whose common equity is not publicly traded, but which nonetheless file periodic reports because they have recently completed a registered public offering of debt securities. Some provisions also apply to

companies that have filed a registration statement that has not yet become effective under the Securities Act and that has not been withdrawn.

Applicability to Foreign Private Issuers

- The Act generally applies to U.S. and non-U.S. companies alike. However, the Act raises significant issues regarding the extraterritorial application of U.S. law to non-U.S. companies and their directors and officers. In addition, the requirements of the Act may conflict with the home country laws or practices of non-U.S. companies. We anticipate that application of some of the provisions of the Act to non-U.S. companies may be relaxed by rules to be issued by the SEC or, possibly, amendments or technical corrections to the Act. Until such time as any such relaxation, amendments or corrections are adopted, non-U.S. companies and their directors and officers will need to comply fully with the provisions of the Act.

Applicability to Officers

- Certain of the provisions of the Act apply to "executive officers" and others to "officers". Under the regulations that apply to the Exchange Act, "executive officers" include an issuer's president, vice presidents in charge of principal units, divisions or functions and other officers performing a policy- making function, as well as any other person (including, for example, executive officers of subsidiaries) who performs similar policy- making functions for the issuer. For purposes of Section 16 of the Exchange Act, "officers" are the same persons as "executive officers," except that the issuer's principal financial officer and principal accounting officer (or controller) are expressly included.

Effective Date and Future Actions

- Some provisions of the Act applicable to issuers, directors and officers became effective upon enactment of the Act (which was July 30, 2002). Other provisions require rulemaking by the SEC before they can become effective. The SEC has already proposed rules covering, in whole or in part, some of the matters for which the Act requires additional rulemaking. The SEC may finalize these rules or repropose them in light of the Act. We have attached as Annex A a chart setting forth the effective time of the major provisions of the Act and by when the Act requires the SEC (or a self-regulatory organization or other body) to provide rules, if applicable. We believe that errors and inconsistencies contained in the Act may lead to the adoption of a technical corrections bill.

- The NYSE and the Nasdaq Stock Market have adopted or are expected to adopt new listing standards with respect to some of the governance and disclosure matters covered by the Act, including CEO certifications and audit committee independence. The NASD has also adopted rules to increase the objectivity and independence of securities analysts. None of the NYSE, the Nasdaq Stock Market or the NASD has announced whether or how they will harmonize their proposals or rules with the Act.

We plan to issue additional memoranda as the SEC, the NYSE, the Nasdaq Stock Market and the NASD propose and adopt additional rules, including any required or made necessary by the Act, and when significant ambiguities in the Act are clarified.

CEO/CFO CERTIFICATIONS AND CORPORATE RESPONSIBILITY

Certification of Annual and Quarterly Reports

The Act contains two new certification requirements for periodic reports filed with the SEC under the Exchange Act. Because only one of these requirements became effective immediately, it is discussed below at some length. The second certification requirement will not become effective until after the SEC adopts new rules required by the Act. Accordingly, a detailed discussion of this requirement will be deferred until these rules have been adopted.[1]

Both of the new certification requirements are applicable to all companies that file periodic reports with the SEC, including, for example, subsidiary issuers of utility holding companies and companies whose common equity is not publicly traded, but which nonetheless file periodic reports because they have recently completed a registered public offering of debt securities.

1 On June 14, 2002, the SEC issued a release that proposed rule changes ("Proposed Rules") to require certain certifications by an issuer's CEO and CFO. The Proposed Rules are discussed in our June 27, 2002 memorandum entitled "SEC Proposes New Rules Relating to 8-K Disclosure and Officer Certification." Because the Proposed Rules contemplate a less rigorous certification than will now be required under Section 302 of the Act, issuers should focus on the requirements contained in the Act rather than those in the Proposed Rules, which essentially have been superseded.

For those U.S. issuers that are subject to the June 27, 2002 order issued by the SEC (the "SEC Order")[2], which requires CEOs and CFOs of 947 U.S. publicly-traded companies to file with the SEC sworn statements regarding the accuracy and completeness of their companies' most recently filed Form 10-K, and other subsequently filed periodic reports and definitive proxy statements, the new certification requirement that is applicable immediately may require, as described below, some additional steps beyond those required by the SEC Order. For those issuers that are subject to the new certification requirements, but are not subject to the SEC Order, we recommend certain steps be taken, also described below, in order to provide the issuer's CEO and CFO with the necessary information in order to execute the required certification.

Section 906

Section 906 of the Act amends the U.S. Criminal Code and became effective July 30, 2002. Section 906 requires that each periodic report containing financial statements filed with the SEC by an issuer pursuant to Section 13(a) or 15(d) of the Exchange Act be accompanied by a written statement by the company's CEO and CFO (or persons performing similar functions) (the "906 Certification"). The 906 Certification must certify that:

- the report *fully complies* with the requirements of Section 13(a) or 15(d) of the Exchange Act, as applicable; and

- information contained in the report *fairly presents*, in all material respects, the financial condition and results of operations of the company.

The SEC has indicated that it will not be issuing interpretations of Section 906 at this time, which leaves unresolved questions such as whether reports on Form 8-K are "periodic reports" which must be accompanied by 906 Certifications to the extent they contain financial statements and whether reports on Form 6-K are subject to the 906 Certification requirements. The question of whether Section 906 applies to Form 6-K reports is discussed below under the caption "Application of the Act to Non-U.S. Issuers." As for Form 8-K reports, we observe that Form 8-K reports are not regular filings made on a periodic basis although listings of "periodic reports" in SEC

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2 The SEC Order is discussed in our July 15, 2002 memorandum entitled "New SEC Oath Requirements for CEOs and CFOs Regarding Recent Exchange Act Filings."

regulations have occasionally included Form 8-K reports. In addition, because the only financial statements presently required to be filed on Form 8-K are financial statements of certain businesses acquired by the filer, it would seem inappropriate that an issuer would be required by Section 906 to certify financial statements of another entity. In light of the foregoing, we believe that there is a basis for concluding that the 906 Certification requirements generally do not apply to Form 8-K reports, although the matter is not free from doubt. We anticipate that the SEC will provide some guidance on this issue in the context of the rulemaking required in connection with the Section 302 certification requirements discussed below.

Section 906 imposes criminal penalties for false certifications.[3] Any person who makes a 906 Certification knowing that the 906 Certification is false is subject to a fine of not more than $1,000,000 or imprisonment for not more than 10 years, or both.[4] A "willful" violator is subject to a fine of not more than $5,000,000, or imprisonment for not more than 20 years, or both.[5] By way of comparison, the maximum period of incarceration for committing perjury (willfully lying in court about a material fact) is only five years.

Comparing the Certification Required by the SEC Order with the 906 Certification

For all companies that have a fiscal quarter that ended on June 30, 2002, the first certifications under Section 906 and the required sworn statement pursuant to the SEC Order will be due by August 14, 2002. Although both certifications are due on

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3 Section 906 does not include a penalty for the failure to provide the required certification. Although conversations with Congressional staff have indicated that there was no intent to bring the 906 Certification within the penalty provisions of the Exchange Act, one of the introductory sections to the Act (Section 3(b)(1)) provides that a violation of any portion of the Act shall be treated as though it is a violation of the Exchange Act.

4 In the context of U.S. criminal law, a person acts "knowingly" if he or she acts intentionally and voluntarily and not because of ignorance, mistake, accident or carelessness. While ignorance may be a legal defense to a charge of knowingly filing a false 906 Certification, a certifying officer cannot be "intentionally ignorant." A person can be found to have acted "knowingly" if he or she deliberately closes their eyes to what otherwise would be obvious, or if he or she acts with a conscious purpose to avoid learning the truth.

5 In the context of U.S. criminal law, a person acts "willfully" if he or she acted with the intent to do what the law forbids (i.e., the person purposefully disobeyed or disregarded the law).

August 14, 2002, there are differences between the required certifications so that separate documents must be prepared in order to comply with both requirements.

There are five primary differences between the certification required under the SEC Order and the 906 Certification:

- the certification under the SEC Order must be made under oath, while the 906 Certification does not have to be made under oath;
- the certification under the SEC Order must certify that the materials then being filed and all prior filings back to the issuer's most recent annual report on Form 10-K, except as corrected or supplemented by a subsequent filing, were, as of the end of the period covered by such report, accurate and complete in all material respects; in contrast, the 906 Certification requires the officers to certify that (1) the particular periodic report being filed fully complies (without a materiality qualifier) with the requirements of Section 13(a) or 15(d) of the Exchange Act, as applicable, and (2) the information in the periodic report "fairly presents, in all material respects, the financial condition and results of operations of the issuer";
- the certification under the SEC Order must include a statement whether the certification was reviewed with the issuer's audit committee, but the 906 Certification has no such requirement;
- the certification under the SEC Order provides the certifying officers with the option of explaining why he or she cannot swear to the accuracy and completeness of the issuer's financial statements, while the 906 Certification does not provide this alternative; and
- the certification required under the SEC Order is a one-time certification, whereas the 906 Certification will be an on-going requirement.

Issues Raised by the 906 Certification

The 906 Certification raises two key issues. First, what does it mean to certify that a periodic report "fully complies" with the requirements of Section 13(a) or 15(d) of the Exchange Act? Second, what does it mean to certify that a company's financial condition and results of operations are "fairly presented"?

The statement that the report "fully complies" with the requirements of Section 13(a) or 15(d) of the Exchange Act involves a question of whether the report being filed complies with the requirements of SEC regulations for the particular form. The usage of the term "fully" imposes a stringent standard for compliance with the Exchange Act. However, for the most part, the concept of materiality is inherent in the periodic report forms. In addition, it is important to keep in mind that Section 906 of the Act criminalizes only "knowing" and "willfully" false certifications.

As to the second issue, we believe the 906 Certification requirement introduces a second new higher reporting standard. The certifying officer must certify that the information contained in the periodic report is a "fair" presentation of the issuer's financial condition and results of operations—which we believe is more than just that the information in the periodic report is not fraudulent (i.e., that it does not intentionally have material misstatements or omissions) and more than just that the financial statements are in technical compliance with generally accepted accounting principles.

906 Certification Procedures

We advise that certifying officers adopt the following procedures in connection with the 906 Certification (to the extent that such procedures have not already been implemented in connection with a certification pursuant to the SEC Order):

- Read carefully the applicable SEC disclosure documents and review the contents with the audit committee or, in the absence of an audit committee, the board of directors.
- Review company procedures for collecting, processing and describing information (including non-financial information) provided to investors.
- Assess the adequacy of these company procedures and ensure that they have been, and are being, properly executed.

In addition, depending on the facts and circumstances of a particular issuer, we recommend that CEOs and CFOs consider one or more of the following additional procedures in preparing their 906 Certifications and, if applicable, SEC Order certifications:

- Review the reports with the management personnel responsible for preparing them and the heads or chief financial officers of the business units described

in the reports. Areas on which the SEC has recently focused include revenue and expense recognition, off-balance sheet transactions, "related party" transactions by directors, officers and major shareholders with the issuer, reserves, pro forma reporting and disclosures regarding critical accounting practices.

- Review with the independent auditors their review of the interim financial statements pursuant to Statement on Auditing Standards No. 71.
- Review any negative comments about the issuer's accounting practices by analysts or the financial press and evaluate how the comments were addressed by management, the issuer's auditors and the audit committee.
- Review any issues and internal control concerns raised by auditors, including the independent auditor's most recent management review letter, and any responses by management.
- Review any communications by employees or shareholders raising concerns about accounting, management or other issues and the issuer's responses to such communications.
- To the extent that the reports include information regarding less than wholly-owned subsidiaries, review the procedures for incorporating the less than wholly-owned subsidiaries' information in the reports.

In addition to these areas of potential review, CEOs and CFOs may want to consider requesting written certifications from those individuals who participate in the preparation of the reports and the heads or chief financial officers of the business units whose businesses are described in the reports. Such certifications are, however, not required and companies will want to weigh the benefits of such certifications against the burdens of obtaining them.

We also recommend that CEOs and CFOs consult with the audit committee or its chairperson (or, if there is no audit committee, one or more independent board members) as to their views with respect to the adequacy of the procedures to be undertaken by the CEO and CFO in preparing their certifications prior to reviewing the contents of reports with the audit committee or independent board members. In that connection, CEOs and CFOs may wish to inform the audit committee (or independent board members) as to which of the recommendations set forth above they are

employing in preparing their certifications, including the procedures for collecting, processing and describing information required to be disclosed in the reports.

The 906 Certification raises additional concerns beyond the SEC Order because the 906 Certification requires CEOs and CFOs to certify that the periodic reports fully comply with SEC regulations and fairly present the financial condition and results of operations of the company. The certifying officers should discuss the applicable SEC regulations for the periodic report with the persons who prepared the report and satisfy themselves that the information in the report meets the requirements of those regulations. In addition, the certifying officers should consider the following types of issues and, when appropriate, discuss them with the issuer's audit committee:

- Are the company's periodic reports, including financial statements, MD&A and footnotes, written with a sufficient level of transparency that investors can understand them?
- Are there disclosures that technically inform the reader of facts but fail to provide sufficient detail to make a meaningful disclosure?
- Are accounting policies being utilized that, although technically in compliance with generally accepted accounting principles, obscure material trends or information about the financial condition of the issuer or the results of operations?

This list is merely illustrative of the sorts of inquiries officers may want to consider as they prepare to certify that the information in a periodic report "fairly presents" the company's financial condition and results of operations. The inquiries that are appropriate for any given issuer will clearly be issuer specific.

Although it is too soon to determine what standards will be used in deciding whether information in a periodic report is "fairly presented," it is clear that the more difficult it is to understand the information, the more difficult it will be for the issuer (and its CEO and CFO) to explain to the SEC or the Department of Justice how the financial statements "fairly presented" the issuer's financial condition and results of operations.

Section 302

Section 302 of the Act requires that the SEC adopt final rules no later than August 29, 2002 to require the CEO and the CFO of an issuer to provide—in addition to

the 906 Certification—a certification (the "302 Certification") in each annual or quarterly report submitted by the issuer pursuant to the Exchange Act. Because rulemaking will be required before this certification must be made, we will only briefly summarize the elements that ultimately will be part of a 302 Certification. In brief, the 302 Certification must recite that:

- the signing officer has reviewed the report;
- based on the officer's knowledge, the report is materially accurate and complete;
- based on the 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;
- the company has adequate internal controls, the effectiveness of the controls has been evaluated within the last 90 days and the results of the evaluation have been included within the periodic report;
- the signing officers have disclosed to the issuer's auditors and the audit committee all significant deficiencies in the design or operation of the system of internal controls and any fraud involving management or employees with a significant role in the issuer's internal controls; and
- any significant changes in internal controls.

After the SEC adopts rules under Section 302, all companies filing reports under Section 13(a) or Section 15(d) of the Exchange Act, regardless of market capitalization, annual revenues or jurisdiction of incorporation, will be required to file a Rule 302 Certification. It is possible that the SEC will include the 906 Certification in the 302 Certification thereby requiring a single public certification in connection with annual and quarterly report filings.

The Act does not specify penalties for failure to make the 302 Certification. However, the general penalties provision in Section 32 of the Exchange Act will make it unlawful to willfully fail to provide the required officer certifications under Section 302 or to make false certifications. Section 32, as amended by the Act, is discussed below under the caption "Criminal Sanctions and Other Penalties—Section 32: Violation of the Exchange Act."

Prohibition on Loans to Insiders

The Act contains a broad prohibition on new loans by issuers to directors or executive officers. Section 402 of the Act, which became effective July 30, 2002, amends the Exchange Act to make it unlawful for any issuer, directly or indirectly, including through any subsidiary, to extend or maintain credit, or arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any of its directors or executive officers (or equivalent persons). Loans outstanding on July 30, 2002 are not subject to the prohibition, so long as the loans are not renewed or materially modified.

The Act provides limited exceptions for companies generally engaged in a lending or credit business. The ban on loans does not apply to "home improvement and manufactured home loans" (as defined in the Home Owners' Loan Act), "consumer credit" (as defined in the Truth in Lending Act), or any extension of credit under an "open end credit plan" or "charge card" (each as defined in the Truth in Lending Act) or any extension of credit by a broker or dealer to an *employee* to buy, trade, or carry securities that is permitted under the rules of the Board of Governors of the Federal Reserve System (other than an extension of credit that would be used to purchase the stock of the issuer) that:

- is made or provided in the ordinary course of the consumer credit business of the issuer;
- is of a type that is generally made available by the issuer to the public; and
- is made by the issuer on market terms, or terms that are no more favorable than those offered by the issuer to the general public.

In addition, the prohibition does not apply to loans made or maintained by an "insured depositary institution" under the Federal Deposit Insurance Act, if the loan is subject to the insider lending restrictions of the Federal Reserve Act.

The limited exceptions are applicable only to certain U.S. issuers and not their non-U.S. counterparts in the lending or credit businesses. We expect that the SEC will, in time, create comparable exemptions for foreign private issuers.

Disgorgement of Profits and Bonuses Following a Restatement

Section 304 of the Act, which became effective July 30, 2002, provides that if an issuer is required to prepare an accounting restatement because of the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the CEO and CFO of the issuer shall reimburse the issuer for:

- any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the SEC (whichever first occurs) of the financial document embodying the financial reporting requirement; and

- any profits realized from the sale of securities of the issuer during that 12-month period.

Under the Act, the amount of the accounting restatement bears no relation to the amount of the potential reimbursement. For example, a $10,000,000 earnings restatement resulting from misconduct and material noncompliance with a financial reporting requirement could require reimbursement of $20,000,000 in stock option proceeds. The reimbursement requirement also appears to apply even if the CEO and CFO were not aware of the misconduct. Further, the Act does not clarify what type of actions or inactions would constitute misconduct and whether the term constitutes a standard lower than, or equivalent to, fraud.

The SEC has the power to exempt any person from this provision as it deems necessary and appropriate.

Prohibition on Improper Influence over the Audit Process

Section 303 of the Act provides that it shall be unlawful, in contravention of rules to be adopted by the SEC, for any director or officer of an issuer, or any other person acting under the direction thereof, to take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading.

The SEC has exclusive authority to enforce this prohibition; it does not create a private right of action for security holders of the issuer. Violation of this provision may give rise to criminal liability under Section 32 of the Exchange Act. The SEC is required

to issue final rules required by this provision no later than April 26, 2003. It should be noted that existing SEC Rule 13b2-2 under the Exchange Act already prohibits officers and directors of issuers from making false or misleading statements to an accountant in connection with any audit or examination of the financial statements of the issuer.

Independent Audit Committees

The Act contains provisions regarding the composition and responsibilities of audit committees for issuers whose securities are listed on a national securities exchange (such as the NYSE) or traded on an automated quotation facility of a national securities association (such as the Nasdaq Stock Market). Section 301 of the Act amends the Exchange Act to provide that, by April 26, 2003, the SEC shall, by rule, direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the following requirements:

- the issuer's registered public accounting firm must report directly to the audit committee;
- the audit committee must be directly responsible for the appointment, compensation and oversight of any registered public accounting firm employed by the issuer to prepare or issue audit reports and related work, including for the resolution of any disagreements between management and the auditor regarding financial reporting;
- each member of the audit committee must be an independent board member;
- the audit committee must establish procedures for:
  - the receipt, retention and treatment of complaints received by the issuer regarding accounting, internal accounting controls or auditing matters; and
  - the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters;
- the audit committee must have the authority to engage its own independent legal counsel and other advisors as it deems necessary to carry out its duties; and

- the issuer must provide for appropriate funding, as determined by the audit committee, for payment of compensation:
  - to the registered public accounting firm employed by the issuer for the purpose of rendering or issuing an audit report; and
  - to any other advisers employed by the audit committee.

The Act requires that the SEC's rules implementing these requirements provide issuers that have not complied with the foregoing requirements with an opportunity to cure such non-compliance before their securities are delisted from U.S. securities exchanges.

The Act defines an "independent" director, for purposes of serving on an audit committee, as one that, except in his or her capacity as a member of the audit committee, another board committee or the board:

- does not accept any consulting, advisory or other compensation from the issuer; and
- is not an "affiliated person" of the issuer or its subsidiaries, as defined in the Act.

The SEC may exempt a particular relationship with respect to audit committee members from these requirements. It is unclear whether the SEC may grant blanket exemptions or exemptions only on a case-by-case basis.

The provisions of Section 301 of the Act address some audit committee-related issues recently proposed by the NYSE and the Nasdaq Stock Market, including the requirement that all members of an issuer's audit committee be independent. We expect that these concepts will be harmonized through the SEC rulemaking process and finalization of the new listing standards proposed by the NYSE and the Nasdaq Stock Market, although it is likely that some sets of rules will require compliance with more stringent standards than others.

"Financial Expert" Disclosure

Section 407 of the Act directs the SEC to issue rules requiring each issuer, together with its periodic reports filed under the Exchange Act, to disclose whether or not the audit committee of the issuer has at least one member who is a "financial

expert" and, if not, the reason for the failure to have an expert on its audit committee. The Act requires the SEC to define "financial expert."

In defining the term "financial expert," the Act requires the SEC to consider whether a person, through education and experience as a public accountant or auditor or a principal financial officer, comptroller, or principal accounting officer of an issuer, or from a position involving the performance of similar functions, has:

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

The Act requires that the SEC adopt these rules not later January 26, 2003.

While Section 407 of the Act and the NYSE's recent proposals address similar objectives, there are certain differences. For example, the NYSE's proposals require that the chairman of a NYSE-listed company's audit committee have accounting or related financial management expertise, while Section 407 simply requires that one member of the committee be a "financial expert."

Trading Restrictions During Retirement Plan Blackout Periods

The Act imposes trading restrictions on directors and executive officers during certain retirement plan blackout periods and requires notice of blackout periods to plan participants and beneficiaries, issuers of employer securities subject to the blackout, the SEC and affected directors and executive officers.

Trading Restrictions

Pursuant to Section 306 of the Act, it is unlawful for any director or executive officer of an issuer of any equity security (other than an exempt security), directly or indirectly, to purchase, sell or otherwise acquire or transfer any equity security of the issuer (other than an exempt security) during any "blackout period" with respect to the

equity security if the director or officer acquired the equity security in connection with service or employment as a director or executive officer.

Blackout Periods

For purposes of the trading restrictions, a "blackout period" means, with some exceptions, any period of more than three consecutive business days during which the ability of not fewer than 50% of the participants or beneficiaries under all "individual account" retirement plans (for example, 401(k) plans and profit sharing plans) maintained by the issuer to purchase, sell or otherwise acquire or transfer an interest in any equity of the issuer held in the individual account retirement plan is temporarily suspended by the issuer or by a fiduciary of the plan. A "blackout" period for these purposes does not include, under regulations which are to be prescribed by the SEC, suspensions imposed solely in connection with persons becoming or ceasing to be participants by reason of certain corporate transactions involving the plan or plan sponsor, or a regularly scheduled period under the plan in which participants may not purchase, sell, or otherwise acquire or transfer an interest in any equity of the issuer, if the period is timely disclosed to affected employees and participants.

Notice Requirements

In any case in which a director or executive officer is subject to these trading restrictions during a blackout period, the issuer of the equity securities is required to timely notify affected directors and executive officers, as well as the SEC, of the blackout period. Section 306 of the Act does not specify when notice is considered to be "timely." The Act also amends the Employee Retirement Income Security Act of 1974 ("ERISA") to require plan administrators to provide participants and beneficiaries, as well as the issuer of any employer securities subject to the blackout period, with advance notice of blackout periods under individual account retirement plans. For these ERISA purposes, a "blackout" period has a much broader meaning, and notice generally must be provided to affected participants and beneficiaries at least 30 days in advance of the blackout period, subject to specified exceptions.

Remedy for Violations

Any profit realized by a director or executive officer of the issuer from any transaction in violation of the trading restrictions will be recoverable by the issuer, irrespective of the director or executive officer's intention in entering into the transaction. An action to recover profits may be instituted by the issuer, or by the owner of any security of the issuer in the name and on behalf of the issuer if the issuer does not bring the action within 60 days after the date of request, or fails diligently to

prosecute the action thereafter, except that no such suit may be brought more than two years after the date on which the profit was realized.

Civil penalties may be imposed on plan administrators by the Secretary of Labor (up to $100 per day for each affected person) for failure to provide required notices to plan participants and beneficiaries of blackout periods.

Future Regulations

The Act requires the SEC, in consultation with the Secretary of Labor, to adopt rules to clarify the application of, and to prevent evasion of, the trading restrictions. The rules may provide for appropriate exceptions, including exceptions for trades made pursuant to automatic dividend reinvestment plans or advance elections.

The trading restrictions and notice requirements become effective January 26, 2003.

Conduct of Attorneys

Section 307 of the Act contains provisions requiring counsel to report evidence of securities law violations or breaches of fiduciary duty or similar violations to an issuer's chief legal counsel or CEO and, in some circumstances, the issuer's audit committee or board of directors. Section 307 of the Act also requires the SEC to issue rules setting forth minimum standards of professional conduct for attorneys appearing and practicing before the SEC in any way in the representation of issuers, including a rule requiring:

- an attorney to report evidence of a material violation of the securities laws or a breach of fiduciary duty or similar violation by the company or any agent thereof to the chief legal counsel or the CEO of the company (or the equivalent persons); and

- if the chief legal counsel or CEO does not appropriately respond to the evidence and adopt, as necessary, appropriate remedial measures or sanctions with respect to the violation, the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.

The Act requires that the SEC adopt these rules by January 26, 2003.

Although it is premature to predict the likely contours of the SEC's proposed rules implementing Section 307, the Act's mandate to the SEC is noteworthy for several reasons:

- Section 307 applies to attorneys "appearing and practicing before the [SEC] in any way in the representation of issuers." Accordingly, the language of this section appears broad enough to include both in-house and outside counsel involved in a securities offering for an issuer and not simply those who sign documents filed with the SEC.[6]

- Although the SEC already has power under Rule 102(e) of its Rules of Practice to bar attorneys and other professionals from practicing before it, that Rule historically has been used principally against accountants. Its use against attorneys has been confined largely to those who willfully participated in fraudulent securities offerings.

- The SEC's setting of "minimum standards of professional conduct for attorneys appearing and practicing before" it will involve the SEC in an area traditionally the province of the individual states and bar associations through their adoption and enforcement of professional responsibility rules. One consequence is that attorneys appearing and practicing before the SEC will likely be held to different standards of professional conduct than currently in effect at the state level.

- For example, in contrast to American Bar Association's Model Rule 1.13 (addressing the attorney's ethical obligations where the client is an "organization"), which has been adopted by a majority of the states and vests considerable discretion in attorneys to choose the best course of action once he or she "knows" of unlawful conduct by a company's officers or employees, Section 307 of the Act provides that:

  - The attorney's initial reporting obligation would be triggered as soon as there is "*evidence* of a material violation of the securities laws or a breach

6 Under existing SEC regulations, the phrase "practice before the [SEC]" includes "transacting any business with the [SEC]" and the "preparation of any statement, opinion or other paper by any attorney … filed with the [SEC] in any registration statement, notification, application, report or other document with the consent of such attorney." SEC Rules of Practice 1.02(f).

of fiduciary duty or similar violation by the company or any agent," implying a lower threshold than the attorney's knowledge of an actual violation.

- If this threshold is met, in contrast to Model Rule 1.13, the attorney would have virtually no discretion in determining the how to proceed. The attorney would have to report the evidence to the chief legal counsel or CEO; if the chief legal counsel or CEO did not "appropriately respond" to such evidence and "adopt, as necessary, appropriate remedial measures or sanctions with respect to the violation," a second reporting obligation would be triggered whereby the attorney would have to report "to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors."

- Left unclear is whether an attorney's judgment as to the appropriateness of any remedial measures or sanctions adopted by the chief legal counsel or CEO—and thus whether a second reporting obligation is triggered—would be judged by a subjective or objective standard.

Employee Whistleblower Protections

Section 806 of the Act adds a new Section 1514A to the U.S. Criminal Code to provide a private right of action for "whistleblowers." Section 1514A provides that a public company and its officers, employees, contractors, subcontractors or agents may not discharge, demote, suspend, threaten, harass or in any way discriminate against any employee in the terms and conditions of employment because of any lawful act done by the employee to:

- provide information, cause information to be provided, or otherwise assist in an investigation regarding conduct which the employee reasonably believes constitutes mail fraud, wire fraud, bank fraud or securities fraud or a violation of any SEC regulation or any Federal law relating to fraud against shareholders in an investigation by:

  - a Federal regulatory or law enforcement agency;

  - any member of Congress or Congressional committee; or

  - the person's supervisor or any other person working for the employer who has the authority to investigate, discover or terminate misconduct; or

- file, cause to be filed, testify, participate in or otherwise assist in a proceeding filed or about be filed (with any knowledge of the employer) relating to an alleged violation of the statutes related to mail fraud, wire fraud, bank fraud or securities fraud or a violation of any SEC regulation, or any provision of Federal law relating to fraud against shareholders.

The statute requires that any action brought pursuant to it must be commenced within 90 days of the date of the violation.

An employee prevailing in any action under this provision will be entitled to relief, including reinstatement with the same seniority, back pay (with interest) and compensation for special damages resulting from the discrimination, including litigation costs, expert witness fees and reasonable attorney fees.

Retaliation Against Informants

Section 1107 of the Act adds a new Section 1513(e) to the U.S. Criminal Code. Section 1513(e) provides that whoever knowingly, with the intent to retaliate, takes any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense, shall be fined not more than $250,000, or imprisoned not more than 10 years, or both.

Prohibiting Persons from Serving as Directors or Officers

Section 305 of the Act provides for a change to the standard by which a court may restrict a person from acting as a director or officer of a public company if that person violates Section 10(b) of the Exchange Act or Section 17(a)(1) under the Securities Act of 1933, as amended. Prior to the Act, the securities laws required a showing that the person's conduct demonstrated "substantial unfitness" to serve as a director or officer. The new standard represents the more encompassing standard of "unfitness."

In addition, Section 1105 of the Act extends to the SEC the power, in any cease-and-desist proceeding under relevant sections of the Federal securities laws, to prohibit any person who has violated Section 10(b) of the Exchange Act, Section 17(a)(1) of the Securities Act or regulations thereunder from acting as a director or officer of any

public company, permanently or for a period of time, if the conduct of that person demonstrates unfitness to serve as a director or officer of that company.

Criminal Statutes for Fraud, Record-Keeping and Obstruction; Increased Penalties

In addition to the corporate responsibility provisions described in this section, the Act amends the U.S. Criminal Code to increase the penalties for violations of existing statutes regarding fraud, record-keeping and obstruction and to establish other new criminal provisions. Summaries of the provisions are set forth below in the section captioned "Criminal Sanctions and Other Penalties."

ENHANCED DISCLOSURE

Regular and Systematic Review of Periodic Reports by SEC

Section 408 of the Act requires the SEC to review on a regular basis annual reports on Form 10-K and other disclosures (including financial statements) by issuers reporting under the Exchange Act that have a class of securities listed on a national securities exchange, such as the NYSE, or traded on an automated quotation facility of a national securities association such as the Nasdaq Stock Market. The Act requires the SEC to review each issuer that files reports under Section 13(a) or 15(d) of the Exchange Act at least once every three years. In scheduling the order and timing of reviews, the Act directs the SEC to consider specific criteria, including issuers with material financial statement restatements, significant stock price volatility and the largest market capitalizations and emerging companies with disparities in price to earnings ratios.

Real Time Disclosure

Section 409 of the Act requires issuers reporting under Section 13(a) or 15(d) of the Exchange Act to disclose to the public, on a rapid and current basis and in plain English, any additional information concerning material changes in their financial condition or operations as the SEC determines, by rule, is necessary or useful for the protection of investors and in the public interest.

Real time disclosure had already been one of the most important initiatives of the SEC under Chairman Pitt. Chairman Pitt has spoken repeatedly regarding the importance of real time disclosure in ensuring that the markets are alerted to material developments in a timely manner rather than waiting until the filing of periodic reports.

Consistent with this emphasis on real time disclosure, on June 17, 2002 the SEC proposed new rules that would, among other things, require U.S. issuers to file current reports on Form 8-K with respect to a significantly expanded list of events that the SEC believes are presumptively of such importance that prompt disclosure must be made. The proposed rules would require that Form 8-K filings triggered by the occurrence of any of such events be filed within two business days of the occurrence of the event. The June 17, 2002 SEC release was the subject of our separate memorandum entitled "*SEC Proposes New Rules Relating to 8-K Disclosure and Officer Certification*." The proposed rules are subject to a comment period that expires on August 26, 2002. We expect that the proposed rules, revised to also require Form 8-K disclosure of any waivers of the code of ethics for senior financial officers, will be adopted on an expedited basis. Additional rulemaking may well follow, particularly as Chairman Pitt has advocated the affirmative obligation to disclose promptly all material information.

Reporting of Equity Trades by Officers, Directors and Principal Shareholders

Section 403 of the Act amends Section 16(a) of the Exchange Act to shorten to two business days the length of time that directors, officers and principal shareholders of a company with equity securities registered pursuant to Section 12 of the Exchange Act have to report changes in ownership of the issuer's equity securities on Form 4.

Under existing law, officers and directors of a company with equity securities registered pursuant to Section 12 of the Exchange Act and "beneficial owners" of 10% or more of any class of such equity securities (other than exempt securities) had to report changes in that person's ownership of the equity securities or the purchase or sale of a security-based swap agreement involving the equity securities before the 10th day after the close of the calendar month during which the change occurs. Section 403 amends the Exchange Act to provide that officers and directors of such a company and 10% beneficial owners described above must file with the SEC (and any applicable exchange) a statement before the end of the second business day following the day on which the reportable transaction is executed. The statement must indicate the ownership by the filing person at the date of filing and any changes in ownership or purchases or sales of security-based swap agreements since the prior filing by that person.

The Act provides that this amendment to Section 16(a) of the Exchange Act will become effective August 29, 2002.

The Act also provides that the SEC may promulgate rules permitting later filings in cases where the two business day requirement is not feasible. The SEC may likely also continue to use its general exemption authority to provide for annual reporting (or in some cases, no reporting) of most types of transactions that the SEC has determined are exempt from the "short-swing" liability provisions of Section 16(b) of the Exchange Act and, to the extent that the Act has voided the existing exemption, to exempt officers, directors and 10% beneficial owners of foreign private issuers from Section 16 of the Exchange Act. If, however, the SEC does not issue new rules, or reconfirm its existing rules, prior to August 29, 2002, officers, directors and 10% beneficial owners will be required to report *all* transactions in equity securities before the end of the second business day following the transactions.

In addition to the provisions set forth above, by July 30, 2003:

- the statements filed to report a change in ownership or the entering into a security-based swap must be filed electronically;
- the SEC must provide each statement on a publicly accessible Internet site not later than the end of the business day following a filing; and
- the issuer (if it maintains a corporate website) must provide each statement on the website not later than the end of the business day following a filing.

Additional Disclosure Matters for Issuers

The Act contains a number of provisions specifying, or requiring the SEC to specify, information to be included in financial statements of public companies in relation to material correcting adjustments identified by the independent auditors of a public company, off-balance sheet transactions and pro forma financial statements. Some of these requirements already are encompassed in the SEC's rules applicable to financial statement disclosures.

The Act also contains provisions requiring specific disclosures regarding a public company's internal controls and financial reporting procedures, whether it has adopted a code of ethics for senior financial officers and whether there have been any waivers of the code of ethics.

Material Correcting Adjustments

Section 401 of the Act amends the Exchange Act to require that each financial report that contains financial statements and that is required to be prepared in accordance with (or reconciled to) generally accepted accounting principles and filed with the SEC reflect all material correcting adjustments that have been identified by a registered public accounting firm in accordance with generally accepted accounting principles and SEC rules. This provision became effective July 30, 2002, but only applies to material correcting adjustments identified by a registered public accounting firm. There currently are no such registered firms and will not be any such firms until after the Oversight Board begins to register firms.

Investment companies registered under the Investment Company Act of 1940, as amended, are exempt from this requirement.

Off-Balance Sheet Transactions

Section 401 of the Act amends the Exchange Act to direct the SEC, by January 26, 2003, to issue final rules requiring that annual and quarterly financial reports filed with the SEC disclose all material off-balance sheet transactions, arrangements, obligations (including contingent obligations) and other relationships of the filing company with unconsolidated entities or other persons that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources or significant components of revenues or expenses.

Investment companies registered under the Investment Company Act are exempt from this requirement.

Pro Forma Financial Information

Section 401 of the Act amends the Exchange Act to require that the SEC, by January 26, 2003, issue final rules providing that pro forma financial information included in any periodic or other report, press release or other public disclosure of a public company will be presented in a manner that:

- does not contain an 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 it with the financial condition and results of operations of the company under generally accepted accounting principles.

Investment companies registered under the Investment Company Act are exempt from this requirement.

Internal Controls in Annual Reports

Section 404 of the Act requires the SEC to adopt rules requiring each annual report filed under the Exchange Act to contain an internal control report that:

- states the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and

- contains an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

The Act requires the issuer's public accounting firm to attest to, and report on, the assessment of internal controls made by management. The attestation must be made in accordance with standards for attestation engagements promulgated by the Oversight Board discussed below under the caption "Regulation of the Accounting Profession—Audit Quality Control and Independence Rules."

Investment companies registered under the Investment Company Act are exempt from this requirement.

The Act does not specify a deadline for adoption of SEC rules pursuant to Section 404.

Code of Ethics Disclosure

Section 406 of the Act requires the SEC to issue rules to require each issuer to disclose, together with its periodic reports filed under the Exchange Act, whether or not the issuer has adopted a code of ethics for senior financial officers and, if not, the reason therefor. The code of ethics will be applicable to the issuer's principal financial officer and comptroller or principal accounting officer or persons performing similar functions.

The Act defines "code of ethics" to mean any standards that 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 issuer's periodic reports; and
- compliance with governmental rules and regulations.

The Act requires the SEC to amend its rules concerning matters requiring prompt disclosure on Form 8-K to require the immediate disclosure, by means of the filing of Form 8-K, dissemination by the Internet or by other electronic means, by any issuer of any change in or waiver of its code of ethics for senior financial officers. In addition, the Act requires that the SEC adopt the required rules by January 26, 2003.

The NYSE's proposed listing standards also would require listed companies to adopt a code of business conduct and ethics, containing certain minimum requirements that may differ from those required pursuant to the Act, and to promptly disclose any waivers from such code for directors or executive officers.

REGULATION OF THE ACCOUNTING PROFESSION

The Act provides for a Public Company Accounting Oversight Board (the "Oversight Board") that will function as a self-regulatory body subject to SEC supervision similar to the NASD. As a result of the Act, public accounting firms and their accounting professionals will be regulated in many ways similar to broker-dealers and their associated persons. As a result of these provisions, particularly the ability of the board to inspect, investigate and discipline registered public accounting firms and share information with the SEC, we anticipate that issuers and their financial statements and other financial information will be subject to additional scrutiny by the SEC.

The Public Company Accounting Oversight Board

Section 101 of the Act establishes the Oversight Board to oversee the audits of public companies that are subject to the Federal securities laws. The Oversight Board will have five members, each selected by the SEC, only two of whom may be or have been certified public accountants. The SEC will name the initial members by October 28, 2002, after consultation with the Chairman of the Board of Governors of the Federal

Reserve System and the Secretary of the Treasury. After the initial terms, subsequent Oversight Board members will serve staggered five-year terms. No member may serve more than two terms. Members may not be employed in any other professional or business activity, nor receive a share of any profits from any public accounting firm (other than customary and fixed retirement payments).

The Oversight Board's responsibilities include:

- registering all public accounting firms that prepare audit reports for issuers;
- adopting auditing, quality control, ethics, independence and other standards relating to the preparation of audit reports;
- conducting regular inspections of registered public accounting firms; and
- investigating and disciplining registered public accounting firms and their "associated persons," as defined in the Act.

The Oversight Board has no authority to act with respect to audits of companies that do not have publicly held securities, other than companies that have filed registration statements under the Securities Act that have not become effective and have not been withdrawn. The Oversight Board is required to be operational and have the capacity to carry out the requirements of the Act on or prior to April 26, 2003.

Application to be a Registered Public Accounting Firm

Beginning 180 days after the SEC determines that the Oversight Board has the capacity to carry out the requirements of the Act, it shall be unlawful for any person not registered as a public accounting firm with the Oversight Board to prepare or issue or participate in the preparation of any audit report for an issuer. To register with the Oversight Board pursuant to Section 102 of the Act, an accounting firm must submit an application with information concerning the following matters: its audit clients and all fees derived therefrom; its quality control policies used in conducting audits; a list of all accountants associated with the firm who participate in preparation of audit reports; financial information regarding the firm; information regarding any pending proceedings related to its audit services; and publicly disclosed information regarding any accounting disagreements with audit clients during the previous calendar year.

The Act requires firms to provide the Oversight Board with periodic reports updating the information in the application annually, or more frequently as necessary. The registration applications and periodic reports generally will be publicly available.

Audit, Quality Control and Independence Rules

The Oversight Board will issue, pursuant to Section 103 of the Act, including through standards adopted by one or more professional groups of accountants or advisory groups, as described below, rules establishing audit standards, quality control standards, ethics standards, and independence standards for registered public accounting firms to follow in preparing and issuing audit reports. The Act sets forth certain minimum requirements for the Oversight Board's rules.

Audit Standards

The Oversight Board's audit standards must ensure that each registered public accounting firm, in connection with performing an audit:

- maintains audit work papers and other information related to any audit report for at least seven years and in sufficient detail to support the report's conclusions;
- provides a concurring or second partner review and approval of any audit report, and concurring approval in its issuance, by a "qualified person" or an "independent reviewer," each to be defined in the rules to be adopted by the Oversight Board; and
- describes in each audit report the scope of the auditor's testing of the internal controls structure and procedures of the client for financial reporting required by Section 404(b) of the Act and further sets forth:
  - the findings of the auditor from the testing;
  - an evaluation of whether the internal controls, structure and procedures (1) include maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer and (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and

expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and

- a description, at a minimum, of material weaknesses in the internal controls, and of any material noncompliance found on the basis of the testing.

Quality Control Standards

The Oversight Board's quality control rules must include standards for each registered public accounting firm related to monitoring professional ethics and maintaining independence from audit clients; consulting internally on accounting and audit questions; supervising audit work; accepting and continuing engagements; hiring and providing for professional development and advancement of personnel; and conducting internal inspections.

Independence Standards

The Oversight Board may establish any rules that are necessary to implement any of the provisions of the Act described in the part of this memorandum captioned "Auditor Independence and Standards."

Rulemaking Process

In establishing rules for auditing and quality control, the Oversight Board may adopt its own standards or use any portion of auditing standards or professionalism standards proposed by professional groups of accountants designated for such purpose by rule (such as the American Institute of Certified Public Accountants) or other advisory groups. These rules will be subject to approval by the SEC (with a notice-and-comment process based on the rulemaking process for self-regulatory organizations such as the NASD), except for initial or transition rules that will be subject only to SEC approval.

The Act requires the Oversight Board to cooperate with professional groups of accountants and other advisory groups regarding the ongoing need for changes in its auditing, quality control and independence standards. Further, the Oversight Board must respond in a timely manner to requests from professional and advisory groups for any changes in its standards.

Inspections, Investigations and Disciplinary Actions

Sections 104 and 105 of the Act provide that the Oversight Board may conduct inspections, investigations and disciplinary proceedings with respect to evaluating compliance by registered public accounting firms and their associated persons with the Act, the rules of the Oversight Board and the SEC, accounting principles established by the standard setting body described below, the performance of audits, issuances of audit reports and related matters involving issuers.

Inspections and Reports

The Oversight Board will inspect on an annual basis firms that audit more than 100 issuers and other firms at least once every three years. In conducting an investigation, the Oversight Board will inspect and review selected audits and review the firm's engagements to evaluate the sufficiency of the quality control systems of the firm. The Oversight Board will provide a written report of its findings with respect to each inspection and make an initial draft available to the firm for an opportunity to review and respond. The Oversight Board may revise its report based on the firm's response.

The final report will be made public (with certain confidential information removed). Prior to being made public, any criticisms of, or potential defects in, the quality control systems of the subject firm will be deleted from the public report if the criticisms and defects are addressed by the firm, to the satisfaction of the Oversight Board, within one year of the preparation of the report.

A firm may seek SEC review of the Oversight Board's final report if (i) it disagrees with the Oversight Board's assessments contained in the report or (ii) if the firm disagrees with the Oversight Board's finding that criticisms or defects identified in the report have not been satisfactorily addressed within the one year period prior to public release.

Investigations

The Oversight Board will have authority, in connection with its investigations, to:

- compel testimony of any registered public accounting firm and its associated persons;

- require production of documents and information in the possession of any registered public accounting firm and its associated persons (wherever domiciled);
- request testimony or document production of any persons; and
- seek issuance by the SEC of a subpoena to require testimony or document production by any person.

The Oversight Board may impose sanctions on registered public accounting firms and their associated persons for the failure to cooperate with the Oversight Board.

The Oversight Board is required to notify the SEC of any pending Board investigation involving a potential violation of the securities laws and coordinate its work with the SEC's Division of Enforcement. The Oversight Board may refer an investigation to the SEC, to any other Federal functional regulator (such as the Comptroller of the Currency or the Federal Reserve Board) or, at the direction of the SEC, to the U.S. Attorney General, the attorney general of one or more states or state regulatory authorities that regulate accountants.

Disciplinary Proceedings

The Oversight Board may impose sanctions as it determines appropriate in connection with any disciplinary proceeding, including suspension or permanent termination of registration and civil penalties of up to $100,000 for an individual or $2,000,000 for a firm (or $750,000 and $15,000,000, respectively, for certain intentional, knowing conduct or repeated instances of negligent conduct).

The Oversight Board can also impose sanctions on a registered public accounting firm or its supervisory personnel for the failure to reasonably supervise an associated person if the associated person commits a violation for which disciplinary sanctions are available. However, the Oversight Board cannot sanction a firm for failure to reasonably supervise if:

- there have been established in and for that firm procedures, and a system for applying the procedures, that comply with applicable rules of the Oversight Board and that would reasonably be expected to prevent and detect violations by associated persons; and

- the firm has reasonably discharged the duties and obligations incumbent upon it by reason of the procedures and system, and had no reasonable cause to believe that the procedures and system were not being complied with.

This safe harbor is similar to those that exist for broker-dealers.

Any person disciplined by the Oversight Board may seek SEC review of any findings or sanctions.

Foreign Public Accounting Firms

Section 106 of the Act subjects to the Act any foreign public accounting firm that prepares or furnishes audit reports with respect to any issuer. In addition, registered public audit firms that rely on the opinion of a foreign public accounting firm in issuing any audit report are deemed to have secured the agreement of the foreign public accounting firm to produce audit work papers.

This provision appears to be in response to difficulties encountered by the SEC's Division of Enforcement in obtaining work papers from foreign accounting firms that are affiliates of U.S. accounting firms.

Officials for the European Union and some of its member countries have already made public statements protesting the extension of U.S. regulatory oversight to European companies and European accounting firms.

Standard Setting Body—FASB

Section 108 of the Act provides that the SEC may recognize as "generally accepted" any accounting standards established by a "standard setting body" that meets the requirements of the Act. The standard setting body would be responsible for proposing accounting principles that improve the accuracy and effectiveness of financial reporting and the protection of investors under the securities laws.

Although the Act does not refer to any particular body, the Senate Committee Report describing the Act envisions the Financial Accounting Standards Board serving as the standard setting body under the Act. The Senate Committee Report states that the Act seeks to "strengthen the independence of the FASB by assuring its funding and eliminating any need for it to seek contributions from accounting firms or companies

whose financial statements must conform to FASB's rules."[7] However, to meet the specified independence requirements of the Act, the FASB would need to change its organizational structure.

Funding

Section 109 of the Act provides that the budget of the Oversight Board and the standard setting body referred to above shall be payable from annual accounting support fees levied on public companies based in part on their equity market capitalization, less, in the case of the Oversight Board, registration and annual fees of registered public accounting firms collected by the Oversight Board under the Act. The budget of the Oversight Board is subject to SEC approval.

AUDITOR INDEPENDENCE AND STANDARDS

The Act contains provisions intended to further the independence of public accounting firms. These provisions, for the most part, cover areas not directly addressed by the Report of the New York Stock Exchange Corporate Accountability and Listing Standards Committee dated June 6, 2002. As a result, we expect the NYSE to adopt most of the recommendations relating to audit committees in the report. For purposes of the discussion below, an "audit committee" of a company means a committee of the board of directors of the company established by the board of directors for the purpose of overseeing the accounting and financial reporting processes of the company and audits of the financial statements of the company and, if no such committee exists, the entire board of directors of the issuer.

7 S. Rep. No. 107-205 (July 3, 2002).

Specified Non-Audit Services Prohibited

Section 201 of the Act amends the Exchange Act to provide that it shall be unlawful for a registered public accounting firm that performs audits for an issuer (and, to the extent determined by the SEC, any associated persons of that firm) to provide that issuer, contemporaneously with the audit, the following non-audit services:

- 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, providing fairness opinions or preparing 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 Oversight Board prohibits through regulation.

In addition, it shall also be unlawful for a registered public accounting firm (and, to the extent determined by the SEC, any associated persons of that firm) that performs audits for an issuer to provide that issuer, contemporaneously with an audit, any other non-audit services, including tax services, unless the activity is approved in advance by the audit committee of the issuer as described below.

The Oversight Board may, on a case by case basis, exempt any person or transaction from the prohibition on non-audit services, subject to review by the SEC. The accounting industry had asked that the Oversight Board be permitted to grant blanket exemptions for types of non-audit services.

Audit Committee Approval Process

Section 202 of the Act further amends the Exchange Act to provide that all audit services (including the provision of comfort letters for securities offerings or statutory audits required for insurance companies under state law) and permissible non-audit services (including tax services) provided to an issuer by its auditor must be preapproved by the issuer's audit committee. Preapproval, however, is not necessary for minor non-audit services if:

- the services do not constitute prohibited non-audit services set forth above under the section captioned "—Specified Non-Audit Services Prohibited";
- the aggregate amount of all such non-audit services does not exceed 5% of the total revenues paid by the issuer to the auditor during the fiscal year in which the non-audit services are provided;
- the services were not recognized to be non-audit services by the issuer at the time of the engagement; and
- the services are promptly brought to the attention of the audit committee and approved prior to the completion of the audit.

An issuer must disclose any approval of non-audit services by its audit committee in the issuer's periodic reports filed under the Exchange Act. The audit committee may delegate to one or more of its independent members the authority to grant the approvals, so long as the issuer subsequently presents each approval to the entire audit committee at its next meeting.

Audit Partner Rotation

Section 203 of the Act further amends the Exchange Act to provide that it shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the five previous fiscal years of that issuer.

Reports by Accounting Firms to Audit Committees

Section 204 of the Act amends the Exchange Act to provide that registered public accounting firms must provide the audit committees of client issuers with timely reports regarding:

- all critical accounting policies and practices to be used;
- all alternative treatments of financial information within generally accepted accounting principles that have been discussed with the issuer's management, the ramifications of the use of the alternative disclosures and treatments, and the treatment preferred by the accounting firm; and
- any other material written communications between the accounting firm and the issuer's management.

Conflicts of Interest

Section 206 of the Act further amends the Exchange Act to provide that it shall be unlawful for a registered public accounting firm to perform any audit service required by Section 10A of the Exchange Act if a CEO, controller, CFO, chief accounting officer or any person serving in an equivalent position for the issuer was employed by that accounting firm and participated in the audit of that issuer during the one-year period preceding the initiation of the audit.

Loss of Audit Rights for Violation

Section 208 of the Act amends of the Exchange Act to provide that it shall be unlawful for any registered public accounting firm (or associated person thereof) to prepare or issue any audit report for any issuer if the firm or the associated person has engaged in any of the prohibited actions described above with respect to that issuer.

As a result of this provision, if a registered public accounting firm engages in any of the prohibited actions with respect to an issuer, that issuer would, in effect, be required to engage a new registered public accounting firm.

APPLICATION OF ACT TO NON-U.S. ISSUERS

The Act generally does not distinguish between U.S. and non-U.S. companies. The Act contains an anti-avoidance provision prohibiting U.S.-incorporated entities from seeking to avoid the application of the Act by reincorporating overseas. The anti-avoidance provision allows an inference to be drawn that some provisions of the Act may not apply to non-U.S. companies. However, essentially all of the operative provisions of the Act, by their terms, apply to companies (domestic and foreign alike) which are subject to periodic reporting under the Exchange Act.

Although the SEC's recently issued sworn certification requirement for CEOs and CFOs does not apply to non-U.S. issuers, the 302 Certification and 906 Certification do not so exempt non-U.S. issuers. The 302 Certification and 906 Certification apply to periodic reports filed under the Exchange Act that contain financial statements, including annual reports on Form 20-F. There is some question as to whether the 906 Certification requirement applies to Form 6-K reports that include financial statements. Under current SEC practice, Form 6-K reports are not deemed to be "filed" for purposes of certain liability provisions of the Exchange Act, but are rather "furnished" or "submitted" to the SEC under that Act.[8] In addition, Form 6-K reports may not be deemed "periodic" reports to the extent that the obligation to file a Form 6-K report arises not from the lapse of a period of time but rather from home country and foreign securities exchange reporting requirements and the distribution, or required distribution, of information to security holders. Accordingly, we believe that there is a basis to conclude that the 906 Certification requirement does not apply to Form 6-K reports, although the matter is not free from doubt. We anticipate that the SEC will provide some guidance on this issue in the context of the rulemaking required in connection with the Section 302 Certification requirements.

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8 By contrast, Section 302 of the Act also covers reports that are "submitted" under the Exchange Act and, as such, encompasses Form 6-K reports containing financial statements. The use of "submitted" in the context of the Section 302 Certification lends some support for the conclusion that the Section 906 Certification does not apply to Form 6-K reports on the basis that if Section 906 was intended to include Form 6-K reports, the Act would have specifically referenced "submitted" reports as was done in Section 302.

The prohibition on insider loans contained in Section 402 applies to all companies that are required to file reports under the Exchange Act. For companies incorporated under the laws of jurisdictions outside the United States and whose home country governance and regulatory structures permit loans to be made to executives or directors, the Act raises significant issues regarding the extraterritorial application of U.S. law.

In our experience, many non-U.S. issuers have not adopted codes of ethics or audit committee charters of the type contemplated by the Act. We recommend that each non-U.S. issuer promptly commence a review of the advisability of adopting such a code and charter. Upon request, we can provide samples of these documents. Where a non-U.S. issuer has already adopted comparable guidelines under home country law or practice, they should be reviewed to determine the extent to which the Act may require modifications to these documents.

The Act grants to the SEC rulemaking authority in implementing the provisions of the Act. Accordingly, it is possible that the SEC will make some distinctions between U.S. and non-U.S. companies in implementing the Act. In the legislative history of the Act, Senator Enzi of Wyoming, the ranking member of the subcommittee with jurisdiction over the SEC, indicated that the Act was not intended to apply in all respects to non-U.S. companies and that it was "the intent of the [Senate] conferees to permit the [SEC] wide latitude in using their rulemaking authority to deal with technical matters such as the scope of the definitions and their applicability to foreign issuers."[9] Notwithstanding this expression of intent with respect to non-U.S. companies, the provisions of the Act should be read in accordance with their terms, absent relaxation, amendment or technical correction by subsequent legislation or, to the extent not contrary to the Act, subsequent SEC rules.

RESEARCH ANALYST INDEPENDENCE AND CONFLICTS OF INTEREST

Section 501 of the Act creates a new Section 15D of the Exchange Act that require rules designed to mitigate securities analyst conflicts of interest and requiring disclosures of relationships that may affect analyst independence. Specifically the new

9 48 Cong. Rec. S7350 (July 25, 2002).

Section 15D requires the SEC to adopt, or cause self-regulatory organizations ("SROs"), such as the NASD and the NYSE, to adopt, within one year, rules that:

- restrict prepublication clearance or approval of research reports by persons engaged in investment banking activities or other personnel not directly responsible for investment research, except legal and compliance personnel;
- limit the supervision and compensation evaluation of securities analysts to personnel not engaged in investment banking activities;
- prohibit broker or dealer retaliation against any securities analyst employed by that broker or dealer or its affiliates as a result of an unfavorable research report that could adversely affect investment banking relationships with the subject company;
- call for blackout periods during which brokers or dealers who have participated or are to participate in a public offering of securities as underwriters cannot publish or distribute research reports related to those securities or their issuer; and
- require structural and institutional safeguards within brokers or dealers to separate securities analysts by informational partitions from review, pressure or oversight by those whose involvement in investment banking activities might bias their judgment or supervision.

New Section 15D of the Exchange Act will also require the adoption of rules requiring securities analysts to disclose in public appearances, and brokers or dealers to disclose in research reports, conflicts of interest that are known or should have been known by the analyst, broker or dealer to exist at the time of the appearance or report. The disclosures would include:

- investments by the securities analyst in the issuer that is the subject of the appearance or research report;
- compensation received by the broker or dealer or its affiliates from the subject issuer (with the SEC to craft an exemption to ensure that material non-public information regarding specific future transactions is not disclosed);

- whether the subject issuer currently is, or during the prior one-year period has been, a client of the broker or dealer (and, if so, the types of services provided);

- whether the analyst received compensation with respect to a research report that is based, in whole or in part, on investment banking revenues (either generally or specifically earned from the issuer being analyzed) of the broker or dealer; and

- any other disclosures of conflicts of interest that are material to investors, research analysts or the broker or dealer, as the SEC determines.

The term "securities analyst" means any associated person of a broker or dealer that is principally responsible for, and any associated person who reports directly or indirectly to a securities analyst in connection with, the preparation of the substance of a research report, whether or not the person has the title of "securities analyst." The term "research report" means a written or electronic communication that includes an analysis of *equity securities* of individual issuers or industries, and that provides information reasonably sufficient upon which to base an investment decision.

The Act requires that the SEC, or upon direction of the SEC, SROs, adopt the required rules by July 30, 2003. The SEC may seek civil penalties for violations of these disclosure rules pursuant to Section 21B of the Exchange Act.

Interestingly, much of what is required by new Section 15D of the Exchange Act is covered in SRO rule changes approved by the SEC on May 10, 2002. For example, NYSE Rule 472 and NASD Rule 2210, as amended, limit relationships and communication between a firm's investment banking department and its research department, require disclosures of conflicts of interests, in both reports and in public appearances, and impose research blackout periods. When the SEC approved the SRO rule changes it did so on the then existing statutory authority, which was much less specific than new Section 15D of the Exchange Act. In practice, the import of Section 15D of the Exchange Act may be to establish a specific statutory "floor" under the new rules, but not require much in the way of new rulemaking.

It is possible the Act will create some pressure to make the new SRO rules more stringent. For instance, the Act calls for a rule that defines periods during which broker and dealers that participate in public offerings of securities as underwriters or dealers should not publish research. The new SRO rules only restrict managers and

co-managers of IPOs and secondary offerings and allow firms to publish in accordance with internal rules during the blackout period to cover significant new developments. In addition, the SRO rules currently exempt secondary offerings from research blackouts if the offering is Regulation M exempt. Among other things, this would exempt offerings for issuers with greater than $1,000,000 average daily trading volume and $150,000,000 of public float. It is not clear whether the statute will result in the SROs revising their rules to cover all underwriters and whether they would eliminate the Regulation M and "significant developments" carveouts. If these changes are made, one implication could be a possible increase in the use of Rule 144A for debt and convertible debt offerings (which would not trigger a blackout under the rules contemplated by the Act because they are not "public offerings") and a decrease in public offerings off of shelf registration statements.

Given the public focus on the area, it is reasonable to assume the rules will continue to evolve and impose additional disclosures and other requirements. In fact, the new SRO rules do just that, requiring disclosure of the plain meaning of a firm's research rating categories and requiring disclosures of the percentage of issuers receiving each rating. In addition, the SEC is proposing for comment rules requiring analyst certification of their reports. The certification would require the analyst to state that the research reflects their own views and include a statement as to whether their research recommendation is in any way related to their compensation. Similar certifications would need to be made quarterly with respect to views expressed in public appearances in the prior quarter.

CRIMINAL SANCTIONS AND OTHER PENALTIES

Section 32: Violations of Exchange Act

Section 32 of the Exchange Act, as amended by the Act, provides that:

- any person who willfully violates any provision of the Exchange Act (other than Section 31 related to fees), or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of the Exchange Act; or
- any person who willfully and knowingly makes, or causes to be made, any statement in any application, report, or document required to be filed under

the Exchange Act or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in Section 15(d) of the Exchange Act, or by any self-regulatory organization in connection with an application for membership or participation therein or to become associated with a member thereof, which statement was false or misleading with respect to any material fact,

shall upon conviction be fined not more than $5,000,000, or imprisoned not more than 20 years, or both, except that when such person is a person other than a natural person, a fine not exceeding $25,000,000 may be imposed; but no person shall be subject to imprisonment under Section 32 for the violation of any rule or regulation if he or she proves that he or she had no knowledge of such rule or regulation. Section 32 contains different penalties for violations of Section 15(d) (relating to failure to file specified information, documents, or reports) and Section 30A (relating to the Foreign Corrupt Practices Act).

Section 1106 of the Act increased the maximum penalties that can be imposed pursuant to Section 32(a) of the Exchange Act. Under the Act, the maximum penalties for individuals increased from a $1,000,000 fine, imprisonment of not more than 10 years, or both to a $5,000,000 fine, imprisonment of not more than 20 years, or both. The maximum penalty for corporate and other legal entities increased from $2,500,000 to $25,000,000.

Other New or Amended Criminal Statutes

Titles VIII, IX and XI of the Act contain the Corporate and Criminal Fraud Accountability Act of 2002, the White-Collar Crime Penalty Enhancement Act of 2002 and the Corporate Fraud Accountability Act of 2002, which provide for the following new or amended criminal statutes:

18 U.S.C. §1348: Securities Fraud

Section 1348 provides that whoever knowingly executes or attempts to execute, a scheme or artifice (i) to defraud any person in connection with any security of an issuer with a class of securities registered under Section 12 of the Exchange Act or required to file periodic reports under Section 15(d) of the Exchange Act 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 security of such an issuer shall be fined not more than $250,000, or imprisoned not more than 25 years, or both.

18 U.S.C. §1512: Tampering with a Record or Impeding an Official Proceeding

Section 1512 has been amended to provide that whoever corruptly (1) alters, destroys, mutilates, or conceals a record, document, or other object, or attempts to do so, with the intent to impair the object's integrity or availability for use in an official proceeding or (2) otherwise obstructs, influences, or impedes any official proceeding, or attempts to do so, shall be fined not more than $250,000, or imprisoned not more than 20 years, or both.

The statute, which appears to be in reaction to reports of document shredding in the Enron matter, will make prosecutions for such conduct easier. This statute, unlike the provision under which Arthur Andersen was charged, does not require the government to prove that the obstruction occurred in a "pending proceeding," but only that it occurred, essentially, with the intent to interfere with an official proceeding, even if no proceeding was yet underway.

18 U.S.C. §1519: Destruction, Alteration or Falsification of Records in Federal Investigations and Bankruptcy Cases

Section 1519 provides that whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies or makes a false entry in any record, document, or tangible object with the intent to obstruct or influence any U.S. governmental investigation or administrative procedure before any U.S. department or agency or any contemplated or filed bankruptcy proceeding shall be fined not more than $250,000, or imprisoned not more than 20 years, or both.

18 U.S.C. §1520: Destruction of Corporate Audit Records

Section 1520 provides that any accountant who conducts an audit of an issuer subject to Section 10A of the Exchange Act shall maintain all audit or review workpapers for a period of five years from the end of the fiscal period in which the audit or review was concluded. Section 1520 further requires the SEC to adopt, no later than January 26, 2003, rules as are reasonably necessary relating to the retention of relevant records such as workpapers, documents that form the basis of an audit or review, memoranda, correspondence, communications, other documents, and records (including electronic records) which are created, sent, or received in connection with an audit or review and contain conclusions, opinions, analyses, or financial data relating to such an audit or review, which is conducted by any accountant who conducts an audit of an issuer of securities to which Section 10A(a) of the Exchange Act applies.

Whoever knowingly and willfully violates this statutory requirement or the rules to be adopted by the SEC is subject to a fine of not more than $250,000, or imprisonment not more than 10 years, or both.

18 U.S.C. §1349: Attempts and Conspiracies to Commit Criminal Fraud Offenses

Section 1349 provides that any person who attempts or conspires to commit mail, wire, bank or securities fraud or who conspires to submit a false certification of financial reports shall be subject to the same penalties as those prescribed for the offense, the commission of which was the object of the attempt or conspiracy.

18 U.S.C. §1350: Failure of Corporate Officers to Certify Financial Reports

This provision is discussed in this memorandum under the caption "CEO/CFO Certifications and Corporate Responsibility—Certification of Annual and Quarterly Reports."

18 U.S.C. §1513: Retaliation Against Informants

This provision is discussed in this memorandum under the caption "CEO/CFO Certification and Corporate Responsibility—Retaliation Against Informants."

Increased Penalties

The Act also increases penalties under the following statutes:

Mail Fraud and Wire Fraud

Section 903 of the Act increases the maximum period of incarceration for violations of 18 U.S.C. §1341 (mail fraud) and 18 U.S.C. §1343 (wire fraud) to 20 years. The previous maximum prison term was five years.

ERISA Violations

Section 904 of the Act increases the criminal penalties for willful violations of the reporting and disclosure provisions under ERISA (and regulations thereunder). For individuals, the maximum penalties under the Act are a $100,000 fine and a 10-year prison term (increasing the maximum penalties from a $5,000 fine and a one-year prison term). For corporate and other legal entities, the maximum fine under the Act is $500,000 (increasing from $100,000).

Debts Not Dischargeable in Bankruptcy if Incurred in Violation of Securities Fraud Laws

Section 803 of the Act amends the U.S. Bankruptcy Code to provide that certain debts resulting from penalties under the securities laws are not dischargeable in a bankruptcy proceeding. A debt does not qualify for discharge if it (A) is for the violation of any federal or state securities laws, or any regulation or order issued thereunder or common law fraud, deceit, or manipulation in connection with the purchase or sale of any security and (B) results from judgments, orders, penalties or settlements.

Sentencing Guidelines

The Act directs the U.S. Sentencing Commission to review and amend, as necessary, the Federal Sentencing Guidelines and related policy statements to ensure that the Guidelines adequately assign guideline levels and enhancements for white collar crime so as to be reasonably consistent with other sentencing guidelines and to sufficiently deter and punish white collar crime.

EXTENSION OF STATUTE OF LIMITATIONS FOR PRIVATE ACTIONS

Section 804 of the Act extends the statute of limitations for a private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in violation of a regulatory requirement concerning the securities laws. Under the Act, a claim may be brought not later than the earlier of (1) two years after the discovery of the facts constituting the violation and (2) five years after such violation.

The new limitations period applies to all proceedings commenced on or after July 30, 2002, including proceedings based on conduct that occurred prior to its passage. It is therefore possible that actions that were previously time-barred are now timely pursuant to the longer limitations period set forth in the Act. For the most commonly-asserted securities fraud claims (those filed pursuant to Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder), the previous limitations period was the earlier of (1) one year after the discovery of the facts constituting the violation and (2) three years after such violation.

The limitations period set forth in Section 804 applies to violations of the "securities laws" which are defined by reference to include the Securities Act, the Exchange Act, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act, the Investment Advisers Act of 1940 and the Securities Investor Protection Act of 1970, each as amended. Some provisions contained in these statutes explicitly set forth a limitations period that differs significantly from the period that governs claims brought under Section 10(b) of the Exchange Act. It is unclear whether Congress intended to modify all of these disparate limitations periods through passage of the Act.

EXPANSION OF SEC ENFORCEMENT AUTHORITY

Authority to Freeze Extraordinary Payments to Directors or Officers

Section 1103 of the Act provides that whenever, during an investigation involving possible violations of the Federal securities laws by an issuer or any of its directors, officers, partners, controlling persons, agents or employees, it shall appear to the SEC that it is likely that the issuer will make extraordinary payments (whether compensation or otherwise) to any of the foregoing persons, the SEC may seek a temporary order requiring the issuer to escrow the payments in an interest-bearing account for 45 days, with the possibility of extension for another 45 days.

If the issuer or another person subject to the order is charged with any violation of the Federal securities laws before the expiration of the temporary order, the order would remain in effect, subject to court approval, until the conclusion of any legal proceedings, and the affected issuer or person will have the right to petition the court for a review. If the affected issuer or person is not charged before the expiration of the temporary order, the escrow will terminate, and the disputed payments (with accrued interest) will be returned.

Barring Firms and Persons from SEC Practice

Section 602 of the Act adopts as law a controversial rule of practice at the SEC (Rule 102(e)). Under the new statutory provision, the SEC can censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the SEC in any way, if the SEC finds, after notice and opportunity for a hearing in the matter, that the person:

- does not possess the requisite qualifications to represent others;
- is lacking in character or integrity or has engaged in unethical or "improper professional conduct"; or
- has willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or regulations issued thereunder.

The term "improper professional conduct" is defined, with respect to any public accounting firm or associated person, to mean (1) intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards and (2) negligent conduct in the form of either:

- a single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which the firm or associated person knows, or should know, that heightened security is warranted; or
- repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the SEC.

Additional Ability to Obtain Equitable Relief

Section 305 of the Act provides that in any action or proceeding under any of the Federal securities laws, the SEC may seek, and federal courts may grant any equitable relief that may be appropriate or necessary for the benefit of investors.

Restrictions on Brokers and Dealers

Section 604 of the Act authorizes the SEC to bar from the securities industry persons who have been suspended or barred by a state securities, banking or insurance

regulator, or are otherwise subject to any SEC order suspending or barring the right of the person to be associated with a broker or dealer because of fraudulent, manipulative or deceptive conduct.

The Act provides similar authority with respect to investment advisors under the Investment Advisers Act.

STUDIES AND REPORTS

The Act calls for the following studies and reports to be delivered to Congress:

Adopting Principles-Based Accounting

Section 108 of the Act requires the SEC to examine the extent to which principles-based accounting and financial reporting exist in the United States, the length of time required to change from a rules-based to a principles-based financial reporting system, the feasibility of, and proposed methods by which, a principles-based system may be implemented in the United States, and to prepare an economic analysis of that implementation. The report is due by July 30, 2003.

Mandatory Rotation of Accounting Firms

Section 207 of the Act requires the Comptroller General of the United States to study and review the potential effects of requiring mandatory rotation of public accounting firms. The report is due by July 30, 2003.

Fair Funds for Investors

Section 308 of the Act requires the SEC to review and analyze (i) SEC enforcement actions that have included proceedings to obtain civil penalties or disgorgements so as to identify areas where such proceedings may be utilized to obtain restitution for injured investors and (ii) other means to provide restitution to injured investors, including methods to improve the collection rates for civil penalties. The report is due by January 26, 2003.

Special Purpose Entities

Section 401 of the Act requires the SEC to study the use of off-balance sheet transactions and whether generally accepted accounting rules result in financial statements properly reflecting the economics of such transactions in a transparent

fashion. The report is due within one year after the effective date of the off-balance sheet disclosure rules discussed above under the caption "Enhanced Disclosure—Additional Disclosure Matters for Issuers."

Consolidation of Public Accounting Firms

Section 701 of the Act requires the Comptroller General of the United States to study the factors that have led to consolidation in the accounting industry since 1989 and the reduction of the number of firms providing audit services (and the impact of, and problems caused by, consolidation). This report is due by July 30, 2003.

Credit Rating Agencies

Section 702 of the Act requires the SEC to study the role and function of credit rating agencies in the securities market, including any impediments to the accurate appraisal by credit rating agencies of the financial resources and risks of issuers. The report is due by January 26, 2003.

Violators and Violations

Section 703 of the Act requires the SEC to conduct a study regarding the number of securities professionals who were found to have "aided and abetted" a violation of the Federal securities laws, but were not sanctioned as primary violators in such action and who also were found to have other primary violations of the Federal securities laws. The report is due by January 30, 2003.

Enforcement Actions

Section 704 of the Act requires the SEC to study SEC enforcement actions involving violations of reporting requirements and restatements of financial statements so as to identify areas of reporting that are most susceptible to fraud, inappropriate manipulation, or inappropriate earnings management, such as revenue recognition and the accounting treatment of off-balance sheet special purpose entities. The report is due by January 26, 2003.

Investment Banks

Section 705 of the Act requires the Comptroller General of the United States to study whether investment banks and financial advisers assisted issuers in manipulating earnings and otherwise obfuscating their financial condition, and the role banks and advisers play in creating and marketing transactions that may have been designed to manipulate revenue streams, obtain loans, or move liabilities off balance sheets without

altering the economic and business risks faced by issuers. The report is due by January 26, 2003.

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Please contact your relationship partner or any of the individuals listed below if we can be of assistance regarding these important developments.

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ANNEX A: TIMETABLE FOR EFFECTIVENESS

Date	Sarbanes-Oxley Act Provision	Memorandum Caption
July 30, 2002	▪ Certification of periodic reports. (§906) ▪ Prohibition on loans to insiders. (§402) ▪ Disgorgement of profits and bonuses following restatement. (§304) ▪ Employee whistleblower protections. (§806) ▪ Retaliation against informants. (§1107) ▪ Authority of Federal courts or the SEC to prohibit persons from serving as officers or directors. (§§305, 1105)	CEO/CFO Certifications and Corporate Responsibility
	▪ Regular and systematic review by the SEC. (§408) ▪ Real time disclosure.[1] (§409) ▪ Material correcting adjustments disclosure.[2] (§401) ▪ Internal controls in annual reports.[3] (§404) - *SEC directed to adopt rules requiring disclosure*	Enhanced Disclosure
	▪ Extension of statute of limitations for private actions. (§804)	Extension of Statute of Limitations for Private Actions
	▪ 18 U.S.C. §1348: Securities fraud. (§807) ▪ 18 U.S.C. §1512: Tampering with a record or impeding an official proceeding. (§1102)	Criminal Sanctions and Other Penalties

1 Section 409 became effective immediately upon enactment, but its operative provisions require the SEC to adopt rules for appropriate disclosure. The Act does not set a deadline for the adoption of the SEC rules.

2 Section 401(a) became effective immediately upon enactment, but its operative provisions only apply when a "registered public accounting firm" identifies a material correcting adjustment. Under the Act, there will not be any "registered public accounting firms" until the Oversight Board becomes effective and begins registering accounting firms (potentially as late as October 23, 2003).

3 Section 404 became effective immediately upon enactment, but its operative provisions direct the SEC to prescribe rules to require the disclosure. The Act does not set a deadline for the adoption of the SEC rules.

Date	Sarbanes-Oxley Act Provision	Memorandum Caption
	▪ 18 U.S.C. §1519: Destruction, alteration or falsification of records in federal investigations and bankruptcy cases. (§802) ▪ 18 U.S.C. §1520: Destruction of corporate audit records. (§802)	

Date	Sarbanes-Oxley Act Provision	Memorandum Caption
July 30, 2002	▪ 18 U.S.C. §1349: Attempts and conspiracies to commit criminal fraud offenses. (§902) ▪ 18 U.S.C. §§1341-42: Mail and wire fraud. (§903) ▪ 18 U.S.C. §1514A: Civil action to protect against retaliation in fraud cases. (§806) ▪ 18 U.S.C. §1350: Failure of corporate officers to certify financial reports. (§906) ▪ 18 U.S.C. §1513: Retaliation against informants. ▪ Increased criminal penalties for Exchange Act violations. (§1106) ▪ Criminal penalties for ERISA violations. (§904) ▪ Debts not dischargeable in bankruptcy if incurred in violation of securities fraud. (§803)	Criminal Sanctions and Other Penalties
	▪ Authority to freeze extraordinary payments to directors or officers. (§1103) ▪ Barring firms and persons from SEC practice. (§602) ▪ Additional ability to obtain equitable relief. (§305) ▪ Restrictions on brokers and dealers. (§604)	Expansion of SEC Enforcement Authority
	▪ Audit committee approval process.[4] (§202)	Auditor Independence and Standards

4 Section 202 became effective immediately upon enactment. Section 208 directs the SEC to issue final regulations not later than January 26, 2003 to carry out the provisions of Section 202.

On or before August 29, 2002	▪ Certification of annual and quarterly reports. (§302) - *SEC shall have adopted final rules.*	CEO/CFO Certifications and Corporate Responsibility
August 29, 2002	▪ Reporting of trades by officers, directors and 10% holders. (§403) - *Accelerated Form 4 disclosure requirements.*	Enhanced Disclosure

Date	**Sarbanes-Oxley Act Provision**	**Memorandum Caption**
On or before October 28, 2002	▪ Public Company Accounting Oversight Board. (§101) - *SEC shall have appointed initial members.*	Regulation of the Accounting Profession
On or before January 26, 2003	▪ Conduct of attorneys. (§307) - *SEC shall have adopted rules for attorneys practicing before it.* ▪ "Financial Expert" disclosure. (§407) - *SEC shall have adopted rules to implement requirement.*	CEO/CFO Certifications and Corporate Responsibility
	▪ Off-balance sheet transactions. (§401) - *SEC shall have issued rules regarding disclosure requirements.* ▪ Pro forma financial information. (§401) - *SEC shall have issued rules regarding disclosure requirements.* ▪ Code of ethics disclosure. (§406) - *SEC shall have adopted rules regarding disclosure requirements, including for changes to and waivers of the code of ethics.*	Enhanced Disclosure
	▪ Specified non-audit services prohibited. (§§201, 208) - *SEC shall have issued final regulations but operative provisions do not apply until registration with Oversight Board is effective.* ▪ Audit committee approval process. (§§201, 208) - *SEC shall have issued final regulations.* ▪ Audit partner rotation. (§§203, 208) - *SEC shall have issued final regulations but operative provisions do not apply until registration with Oversight Board is effective.* ▪ Reports by accounting firms to audit committees. (§§204, 208) - *SEC shall have issued final regulations but operative provisions do not apply until registration with Oversight Board is effective.*	Auditor Independence and Standards

Date	Sarbanes-Oxley Act Provision	Memorandum Caption
	▪ Conflicts of interest. (§§206, 208) - *SEC shall have issued final regulations.*	

Date	Sarbanes-Oxley Act Provision	Memorandum Caption
January 26, 2003	▪ Trading restrictions during blackout periods.[5] (§306) - *Restrictions become effective.*	CEO/CFO Certifications and Corporate Responsibility
On or before April 26, 2003	▪ Prohibition on improper influence on the audit process. (§303) - *SEC shall have issued final rules.* ▪ Independent audit committees. (§301) - *SEC shall have directed by rule delisting of any security of any issuer not in compliance with audit committee requirements.*	CEO/CFO Certifications and Corporate Responsibility
	▪ SEC "determination" of Oversight Board. (§101) - *Oversight Board shall have taken sufficient actions to enable the SEC to certify Board's operational capability.* ▪ Oversight Board's rulemaking subject to notice-and-comment process for self-regulatory organizations. (§107)	Regulation of the Accounting Profession
On or before July 30, 2003	▪ Reporting of trades by officers, directors and 10% holders. (§403) - *Mandatory electronic filings of Form 4;* - *SEC required to make filings available on Internet;* - *Filers must make filings available on corporate website.*	Enhanced Disclosure

5 Section 306(a) directs the SEC, in consultation with the Secretary of Labor, to adopt rules to clarify and to prevent evasion of the restrictions on trading during blackout periods, but does not specify a deadline for the adoption of those rules.

Date	Sarbanes-Oxley Act Provision	Memorandum Caption
	▪ Securities analysts and research reports. (§501) - *The SEC or self-regulating organizations shall have adopted rules.*	Research Analyst Independence and Conflicts of Interest
180 days after date of SEC §101(d) determination	▪ Deadline for registration of public accounting firms with the Oversight Board. (§102)	Regulation of the Accounting Profession
Upon becoming a registered public accounting firm [6]	▪ Internal controls in annual reports.[7] (§404) - *Attestations by registered public accounting firms.*	Enhanced Disclosure
	▪ Public accounting firms subject to Oversight Board's power to inspect, investigate and discipline. (§§104, 105)	Regulation of the Accounting Profession
	▪ Prohibition on specified non-audit services.[8] (§201) ▪ Audit partner rotation. (§203) ▪ Reports by accounting firms to audit committees. (§204) ▪ Conflicts of interest. (§206) ▪ Loss of audit rights for violations. (§208)	Auditor Independence and Standards

6 Sections 404, 104, 105, 201, 203, 204, 206 and 208 all became effective immediately upon enactment, but their operative provisions only apply to a "registered public accounting firm". Under the Act, there will not be any "registered public accounting firms" until the Oversight Board becomes effective and begins registering accounting firms (potentially as late as October 23, 2003).

7 Section 404 became effective immediately upon enactment, but the auditor attestation requirement in Section 404(b) applies to "registered public accounting firms" and under the Act, there will not be any "registered public accounting firms" until the Oversight Board becomes effective and begins registering accounting firms (potentially as late as October 23, 2003). Furthermore, Section 404(b) requires auditor attestations to be made in accordance with standards issued or adopted by the Oversight Board, but does not set a deadline for the issuance or adoption of those standards.

8 For purposes of Section 201, "registered public accounting firms" do not become subject to the Oversight Board's rules until on or after 180 days following the commencement of the operations of the Oversight Board.