PROSKAUER ROSE®

Senate Reform Bill Alert

A report for clients and friends of the firm

July 2002

President Signs Reform Bill, Which Will Have Substantial Impact On Public Companies And Their Professional Advisers

On July 30, 2002, the President signed the Sarbanes-Oxley Act of 2002 (the "Act"). The corporate governance provisions of the Act will have substantial impact on public companies and their professional advisers.

Title I (Public Company Accounting Oversight Board (the "Board")) and Title II (Auditor Independence) principally affect public companies' independent auditors.[1] However, companies subject to reporting periodically to the SEC will be required to have their annual financial statements audited by firms that are in compliance with the Board's rules.

Public companies[2] and their lawyers principally should be concerned about Title III (Corporate Responsibility); Title IV (Enhanced Corporate Disclosure); and Titles VIII, IX and XI (criminal and other penalties).

Corporate Responsibility

The SEC is required to adopt rules to prohibit national securities exchanges and associations, such as Nasdaq, from listing any company not in compliance with the Act's Corporate Governance provisions. These provisions, some of which also are the subject of SEC, stock exchange or Nasdaq rulemaking, are discussed below.

Audit Committees

- The audit committee would be directly responsible for appointment, compensation and oversight of the independent auditors, and the independent auditors must report directly to the audit committee; and
- Each member of the audit committee must be "independent;" that is, a member may not accept consulting, advisory or other compensatory fees from the company, other than in his or her capacity as a member of the committee, the board of directors or any other committee of the board, and may not be an affiliated person of the company or any of its subsidiaries.

In addition to the corporate governance provisions requirements discussed immediately above, audit committees would be required to:

- Approve, in advance, all audit services, including comfort letters in connection with securities underwritings;[3]
- Approve, in advance, audit and permissible non-audit services provided by a company's independent auditors;[4]
- Receive reports from the independent auditors concerning critical accounting policies and practices to be used by the company; *all* alternative treatments of financial information under GAAP that were discussed with management, and the ramifications of the use of those alternatives and the alternative preferred by the auditors, and other "material written communications" between the auditors and management, including management letters and schedules of unadjusted differences.

Certification of Periodic Reports. Section 302(a) of the Act requires that, within 30 days after July 30, 2002, the SEC

1 Title V deals with conflicts of securities analysts; Title VI deals with the resources of the Securities and Exchange Commission; Title VII requires certain studies and reports from the SEC; and Title X expresses the sense of the Senate that CEOs should sign corporate tax returns.

2 For purposes of the Act, a "public company" is a company, including a foreign company, with a class of equity securities registered under Section 12 of the Securities and Exchange Act of 1934 or which is required to file reports with the Securities and Exchange Commission pursuant to Section 15(d) of the Act.

3 Approval of these services would be required to be disclosed in the company's quarterly and annual reports filed with the SEC.

4 Approval of these services also would be required to be disclosed in the company's quarterly and annual reports filed with the SEC.

must adopt rules to require that quarterly and annual reports filed with it be accompanied by statements of the CEO and CFO certifying to, among other things,[5] the appropriateness of the financial statements and disclosures contained in the report and that those financial statements and disclosures "fairly present, in all material respects, the operations and financial condition of the [company]."[6]

In addition, Section 906 of the Act adds Section 1350 to the U.S. criminal code to require that each periodic report containing financial statements shall be accompanied by written statements by the chief executive officer and chief financial officer stating that the report "fully complies with the requirements of Section 13(a) or 15(d) of the [Exchange Act]" and that the information in the report "fairly presents, in all material respects, the financial condition and results of operations of the [company]." Whoever certifies such statements knowing that the statement does not "comport" with the foregoing requirements will be subject to a fine of not more than $1,000,000 and to imprisonment for not more than 10 years. Whoever willfully certifies such a statement knowing that it does not "comport" with those requirements is subject to fines of up to $5,000,000 and to imprisonment for up to 20 years.

These provisions would apply to both domestic and foreign companies and, under the Act, a U.S. company could not evade these provisions by reorganizing in a foreign jurisdiction.

Improper Interference on the Conduct of Audits. The SEC is required to adopt rules to prohibit any officer or director or persons acting at their direction from improper influence on the conduct of audits.

Forfeiture of Bonuses and Profits. Under the Act, CEOs would be required to forfeit any bonuses and incentive or equity-based compensation and any profits received from the sale of their companies' securities received during the 12-month period following the first filing which included financial statements of their companies that were required to be restated due to material non-compliance, as the result of misconduct, with any financial reporting requirement under the securities laws.

Officers' and Directors' Bars and Penalties. The standard for barring persons from serving as officers or directors of public companies would be changed from "substantial unfitness" to "unfitness." Also, in any civil action brought by the SEC, it may seek, and federal courts may grant, "any equitable relief that may be appropriate or necessary for the benefit of investors."

Insider Trading During Pension Fund "Black-Out" Periods. Officers and directors would be prohibited from purchasing, selling or otherwise transferring or acquiring equity securities of their companies during any period during which participants in the companies' retirement plans could not engage in those types of transactions. Any profits obtained by an officer or director in violation of these provisions could be recovered by the company or by a shareholder for the company.

Enhanced Financial Disclosures

Material Adjustments. Financial statements of SEC reporting companies prepared in accordance with GAAP would be required to reflect all material accounting adjustments identified by the independent auditors.

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5 The content of the required certification will be:

(1) the signing officer has reviewed the reports;

(2) based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading;

(3) based on such 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 as of, and for, the periods presented in the report;

(4) the signing officers -

(A) are responsible for establishing and maintaining internal controls;

(B) have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared;

(C) have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report; and

(D) have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date;

(5) the signing officers have disclosed to the issuer's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function) -

(A) all significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize, and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and

(B) any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and

(6) the signing officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

6 The SEC has proposed rules which would require similar certification, and ordered the CEOs and CFOs of 947 companies to provide similar certifications for specified previously filed reports. These actions were the subject of two previous Client Alerts. In addition, the New York Stock Exchange is considering requiring the CEOs of its listed companies to provide certifications of their companies' public disclosures.

Off-Balance-Sheet Transactions. The Act directs the SEC to adopt rules requiring disclosure of all material off-balance-sheet transactions, arrangements and obligations, contingent or otherwise, and other relationships of the company with unconsolidated entities or other persons that may have material current or future effects on the financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources or significant components of revenues or expenses.

Pro Forma Financial Information. The Act requires the SEC to adopt rules that would prohibit material false or misleading pro forma financial information in reports filed with the SEC or in any public disclosure and requires that such pro forma financial information be reconciled with the company's GAAP financial statements.

Conflicts of Interest. The Act, with certain exceptions relating to consumer and home improvement loans, would prohibit public companies from making or arranging for loans to their officers or directors.

Disclosures of Securities Holdings and Transactions. Unless the SEC otherwise determines, reports under Section 16(a) of the Securities Exchange Act of securities transactions by officers and directors and 10% beneficial owners would be required within two business days.

Managerial Assessment of Internal Controls. The Act requires the SEC to adopt rules to require that annual reports 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 an assessment, as of the end of the most recent fiscal year, of the internal control structure and procedures for financial reporting. The Act further would require that the company's independent auditors attest to, and report on, the assessment made by management.

Code of Ethics for Senior Financial Officers. The Act requires the SEC to adopt rules that would require public companies to disclose whether they have codes of ethics for their senior financial officers (principal financial officers, comptrollers or principal accounting officers, or persons performing similar functions), and, if not, the reasons why. (Changes in, or waivers of, these codes of ethics would be required to be promptly disclosed in a Form 8-K filed with the SEC.)

"Code of ethics" would mean standards that are reasonably necessary to promote:

- Honest and ethical conduct, including ethical handling of actual or apparent conflicts of interest "between personal and professional relationships";
- Full, fair, accurate, timely and understandable disclosure in the company's periodic reports; and
- Compliance with applicable governmental rules and regulations.

Disclosure of Audit Committee Financial Expert. The SEC will be required to adopt rules to provide for disclosure in periodic reports as to whether the company's audit committee is comprised of at least one member who is a "financial expert" (as defined by the SEC) and, if not, the reasons why.

SEC Authority to Prohibit Persons from Serving as Officers or Directors of Public Companies. The SEC would have the authority, in administrative cease-and-desist proceedings, to bar persons who violate the antifraud provisions of the federal securities laws from serving as officers and directors of public companies, if the persons' conduct demonstrates unfitness to serve in such capacities.

Review of Periodic Disclosure. The SEC would be required to review periodic reports on a regular (at least once every three years) and systematic basis using, among other factors, the following:

(1) issuers that have issued material restatements of financial results;

(2) issuers that experience significant volatility in their stock price as compared to other issuers;

(3) issuers with the largest market capitalizations;

(4) emerging companies with disparities in price to earning ratios;

(5) issuers whose operations significantly affect any material sector of the economy; and

(6) any other factors that the Commission may consider relevant.

Impact of Provisions That Principally Affect Independent Auditors of Public Companies and their Audit Committees

Although the Board would only have the authority to *request* testimony and production of documents from an independent auditor's client and its officers, directors and employees, the Board could request the SEC to issue a subpoena to compel testimony and production of documents from these persons.

To partially close "revolving doors," independent auditors could not perform audits of companies whose CEOs, CFOs, controllers or CAOs were employed by the auditors and participated in any way in an audit of the company within the one-year period preceding the date of the initiation of the audits.

Impact on Foreign Companies

A non-U.S. accounting firm that issues an audit report with respect to a foreign company subject to SEC filing requirements would be subject to the Act and the rules of the Board.

Moreover, there would be no exception for foreign companies under the Act from the requirement for CEOs and CFOs to certify to the contents of the reports filed with the SEC.

Impact on Lawyers

Section 307 of the Act requires the SEC to adopt 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:

(1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and

(2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the company 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.

Criminal Sanctions

The Act reflects the highly publicized concern of Congress that existing criminal statutes apparently do not provide a sufficient deterrent to the corporate conduct about which so much has been written recently. Many of the presumably new provisions merely prohibit conduct in language more specific than that under present statutes. In large part, the conduct proscribed could have been prosecuted under the more generally worded statutes already in the federal criminal code. Some provisions of the Act, though, create new crimes entirely, as well as enhance dramatically the maximum penalties for some already existing provisions.

As part of the Act Congress directs the United States Sentencing Commission to evaluate the factors used in calculating sentences in light of the increases in possible maximum penalties to ensure those factors adequately "deter and punish" the crimes specified in the bill. The Sentencing Commission is charged with the duty to complete this task within 180 days of the passage of the bill. How it will respond to this directive is not clear at this time. However, there is little doubt that the Commission will respond by modifying the factors affecting the new provisions so as to increase the likely actual sentence of one convicted.

New Provisions

Proposed 18 U.S.C. § 1519 prohibits the destruction, alteration or falsification of records in federal investigations and bankruptcy. Specifically, it states 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 impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or any case filed under Title 11, or in relation to or contemplation of any such matter or case, shall be fined under this title, imprisoned not more than 20 years, or both."

A corollary to this provision, new title 18 U.S.C. § 1520, applies explicitly to accountants who conduct audits of issuers of securities covered by Section 10A(a) of the Securities Exchange Act of 1934, 15 U.S.C. §78j-1(a). Under this new section of Title 18, accountants are required to 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." Moreover, a provision of new § 1520 directs the SEC to promulgate regulations within 180 days after adequate notice and an opportunity for comment on rules and regulations relating to the retention of relevant records as generally defined in section (2) of new § 1520. Failure to abide knowingly or willfully with the new retention requirement of the rules and regulations to be promulgated under section (2) can result in a prison sentence of up to 10 years plus a fine as defined in the U.S. Sentencing Guidelines.

Another new provision, entitled "Securities Fraud," contained in proposed 18 U.S.C. § 1348, criminalizes the attempt to execute, or the execution of, any scheme or artifice to defraud "any person in connection with any security of [a public company]." The prohibited conduct includes any attempt, successful or not, to obtain, by means of false or fraudulent pretenses, representation, or promises, any money or property in connection with the purchase or sale of any security of an issuer registered under Section 12 of the Securities Exchange Act of 1934 or an issuer that is required to file reports under Section 15(d) of the same act. Culpable persons will face a maximum prison sentence of not more than 25 years plus a fine calculated under the U.S. Sentencing Guidelines, while organizations convicted will face the latter only.

In one of the most far-reaching and controversial provisions, the Act criminalizes the failure of corporate officers to certify as accurate certain financial reports. The obligation is placed upon the Chief Executive Officer and Chief Financial Officer when filing periodic reports under Section 13(a) or 15(d) of the Securities Exchange Act of 1934. The statement required under the new law must certify the periodic report "fully complies" with the above sections of the Securities Exchange Act of 1934 and "fairly presents, in all material respects, the financial condition and results of operations of" the company. A knowing violation of this provision will subject a person to a maximum potential prison sentence of ten years; or, for a person or organization, a maximum possible fine of $1,000,000. By using the term "knowing," the new provision introduces specifically the application of the legal principle of "willful blind-

ness" and "reckless disregard for the truth." In the criminal law arena, application of these concepts has had the effect of placing a burden on the defendant to demonstrate everything reasonably possible to ensure accuracy was done prior to the certification. A willful violation of the certification provision will expose a person to a possible maximum term of imprisonment of 20 years; or in the case of a person or company, a potential maximum fine of $5,000,000.

Lastly, the federal obstruction of justice statute was amended by the bill to criminalize any action knowingly undertaken with intent to retaliate against any person who provides law enforcement personnel with truthful information relating to the commission or possible commission of any federal offense and will result in a possible maximum jail sentence of 10 years. Explicitly included as possible criminal acts in this new section of 18 U.S.C. § 1513 are any acts which constitute "interference with the lawful employment or livelihood" of any such person.

White Collar Crime Penalty Enhancements

Congress also modified the federal conspiracy statute by enhancing the penalties for some violations. Whereas the law previously set a maximum period of imprisonment for any violation of 18 U.S.C. § 371, the general federal conspiracy statute, as five years without regard to whether the object of the conspiracy was to violate another specific federal criminal provision or to defraud the United States, a new provision created by this bill, 18 U.S.C. § 1349, entitled "Attempt and conspiracy" establishes a new penalty based upon the object of the conspiracy. New § 1349 mandates that culpable conspirators, who have as an object of a conspiracy the violation of a specific federal law, face the maximum period of imprisonment, if convicted, prescribed for that specific federal law. This means that where the penalty for a violation of a specific federal criminal law is greater than five years, the penalty for a conspiracy to violate that statutory provision will result in a higher maximum potential sentence under 18 U.S.C. § 371 than before.

Similar penalty enhancements were codified for other provisions. For example, penalties under the federal "mail" and "wire" fraud provisions, 18 U.S.C. § 1341 and § 1343, respectively, go from a maximum of five to a potential 20 years. Maximum possible prison sentences for violations of 29 U.S.C. § 1131, the Employee Retirement Income Security Act, were increased from one year to 10 years. And, under new 15 U.S.C. § 78ff(a), willful violations of the Securities Exchange Act of 1934 or any rule or regulation thereunder, the violation of which is made unlawful or the observance of which is required, including probably the enhanced reporting requirements created in the bill, or any knowingly or willfully made false or misleading statement in any document required to be filed under the Exchange Act, will result in a possible sentence of not more than 20 years plus a fine of up to $5,000,000. Where the violator of this provision is other than a natural person, the maximum fine is $25,000,000.

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