KIRKLAND & ELLIS **Alert**

Corporate Practice Group **August 2002**

PRESIDENT SIGNS INTO LAW SWEEPING ACCOUNTING REFORM AND CORPORATE GOVERNANCE LEGISLATION

BACKGROUND

On 7/30/02 President Bush signed into law the Sarbanes-Oxley Act of 2002, passed by both houses of Congress on 7/25/02 (by a House vote of 423 to 3 and Senate vote of 99 to 0), reflecting the intense political pressure to respond in a meaningful fashion to the many corporate and accounting scandals roiling public markets. The legislation's stated purpose is "to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws" and represents Congress's effort to restore investor confidence in public markets.

Portions of the Act take effect immediately, while other provisions await rule making by either the SEC or the new Public Company Accounting Oversight Board created by the Act, typically within legislatively established timetables ranging from 30 days to 1 year. The Act in many instances builds upon current rule making proposals already under consideration by the SEC, NYSE, Nasdaq, and Amex, and in other instances extends beyond previous proposals. In a significant departure from prior law, most provisions of the Act apply not only to U.S. public companies but also to non-U.S. companies registered with the SEC, with little room for SEC exemptive relief.

Many provisions are of considerable importance, and in some cases even surprising, to directors and officers of public companies. For example, the legislation (1) prohibits personal loans to directors and executive officers of public companies, (2) requires CEOs and CFOs of public companies to disgorge bonuses received from the company, or profits realized from sale of company securities, within 12 months after issuance of a financial statement that is subsequently restated "as a result of misconduct," (3) requires the CEO and CFO of ***all*** public companies to certify quarterly and annual reports filed with the SEC (effective on its face for all reports filed after the 7/30/02 enactment), (4) criminalizes a number of activities, and (5) substantially increases existing criminal penalties for financial fraud, authorizing prison terms up to 25 years.

The Act will require changes to the corporate governance policies and procedures of most public companies. Interestingly, many of the Act's provisions are applicable not only to companies currently subject to the SEC's public reporting requirements but also to companies that have filed (or in the future file) a 1933 Act registration statement with the SEC that has not become effective but has not been withdrawn; such a company may well wish promptly to withdraw such a registration.

DISCUSSION

DIRECTOR AND OFFICER PROVISIONS

CEO and CFO Certification of Periodic Reports. Strangely, the Act contains two separate provisions requiring top executives to certify SEC periodic reports. First, Act §302 requires the SEC to promulgate rules within 30 days after the 7/30/02 enactment requiring the principal executive officer and principal financial officer of every **public**

company[1] to certify in each annual or quarterly report filed with or submitted to the SEC that:

(1) he or she has reviewed the report,

(2) to his or her knowledge, the report does not contain a material misstatement or omission,

(3) to his or her knowledge, the financial statements and other financial information included in the report fairly present in all material respects the company's financial condition and results of operations, and

(4) the signing officers have (a) designed the company's internal controls to ensure that material information related to the company is made known to them, (b) within the last 90 days evaluated the company's internal controls and reported their conclusions, including any necessary corrective actions, and (c) disclosed to the company's auditors and audit committee all significant deficiencies as well as any fraud, whether or not material, involving management or other employees with a significant role in the company's internal controls.

This civil certification mandate is not effective until the SEC promulgates rules (presumably within 30 days).

Second, Act §906 contains a separate criminal certification mandate, requiring each periodic report containing financial statements filed with (but not merely "submitted to") the SEC "shall" be certified by the CEO and CFO (not qualified by the certifier's knowledge) as fully complying with the requirements of the Exchange Act and as fairly presenting in all material respects the company's financial condition and results of operations, with criminal penalties for a "knowing" or "willful" false certification. This criminal certification standard is similar but not identical to the civil certification standard discussed above and, unlike the civil certification, appears on its face to be **effective immediately**, i.e., for all reports filed after the 7/30/02 enactment. Hence, absent governmental clarification that the criminal certification requirement is not in effect until the SEC issues the civil certification rules, public companies should immediately comply with the criminal certification requirement for all post-7/30/02 filings.[2]

On 6/17/02, the SEC issued a rulemaking proposal requiring CEO and CFO certifications similar but not identical to those set forth in the Act and described above. The certifications set forth in the Act are also similar but not identical to (and do not in any way affect) the SEC order issued on 6/27/02, requiring a one-time certification of recent SEC reports by CEOs and CFOs of 947 specified U.S. companies (generally those with revenues exceeding $1.2 billion), due by 8/14/02 for calendar year companies. For an in depth discussion of the 6/17 SEC rulemaking proposal and the 6/27 SEC order, see Kirkland & Ellis Alert "SEC Orders Personal Certification of SEC Reports by CEOs and CFOs of Large Companies" (7/02).

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[1] Unless otherwise stated, "**public company**" means, for purposes of this Alert, each company (1) with equity or debt securities traded on a national securities exchange (a §12(b) company), or (2) with a class of equity securities held by 500 or more shareholders of record (a §12(g) company), or (3) which has previously sold equity or debt securities pursuant to a 1933 Act registration statement (a §15(d) company). A company described only in (3) with fewer than 300 holders of such security ceases to be a "public company" after the end of the fiscal year in which the 1933 Act registration statement became effective. A company that files periodic reports with the SEC on a voluntary basis (such as companies that file pursuant to bond indenture requirements) apparently constitutes a "public company" for this purpose.

"Public company" includes a non-U.S. company required to file periodic reports under the Exchange Act. Non-U.S. companies are required to include a certification in the Form 20-F Annual Report and, subject to clarification by the SEC, in Form 6-Ks "submitted to" or filed with the SEC to the extent that they contain earnings reports or interim financial statements. Certification does not apply to non-U.S. companies exempt from the Exchange Act periodic filing requirements pursuant to Rule 12g3-2(b) but furnish reports to the SEC pursuant to such exemption.

[2] Although Act §906 states that the specified officers "shall" certify periodic reports (apparently beginning immediately) and although §906 is entitled "Failure of corporate officers to certify…," the only penalty prescribed by §906 is for a false certification. Thus, it could be argued that a company (and its officers) can postpone certification of periodic reports until the SEC's publication of rules necessary to make the civil certification rules effective. However, absent governmental clarification, there may be peril to this course of action.

Ban on Loans to Directors and Executive Officers. The Act prohibits a public company[3] from extending or maintaining credit, arranging for an extension of credit, or renewing an extension of credit (directly or indirectly, including through a subsidiary), "in the form of a personal loan" to or for any director or executive officer. This prohibition is effective immediately, but grandfathers an extension of credit existing on the 7/30/02 date of enactment, so long as no material modification or renewal is made thereafter.

There are very limited exceptions, including for a home improvement loan but not, curiously, a relocation loan. There is no exception for personal loans to a director or executive officer to purchase company stock, a fairly common practice among public and private companies.[4]

This provision certainly does not appear to cover a compensatory transfer of property (other than cash) to an executive officer or director subject to vesting (e.g., company stock which must be returned to the company only if the person quits prior to a specified date), and likely does not cover a cash payment to such a person (e.g., a signing bonus) which must be returned to the company only if the person quits prior to a specified date, since such transfers are not "in the form of a personal loan."

Forfeiture of CEO and CFO Bonuses and Profits. If a public company[5] is "required to prepare an accounting restatement due to the [company's] material noncompliance . . . as a result of misconduct, with any financial reporting requirement under the securities laws," the company's CEO and CFO must disgorge to the company:

> (1) "any bonus or other incentive-based or equity-based compensation received by that person from the [company] during the 12-month period following public issuance" of the subsequently restated financial documents and
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> (2) "any profits realized from the sale of [the company's] securities . . . during that 12-month period."

The Act does not address (1) the meaning of "misconduct," (2) whose misconduct triggers disgorgement by the CEO and CFO, (3) the degree of requisite misconduct, (4) how material the financial reporting noncompliance must be, (5) how material the accounting restatement must be, (6) whether the restated financial document must itself be material to investors, and (7) whether the restatement must be adverse. For example, would the Act require the CEO and CFO to return all bonus compensation received, and profits realized from the sale of company securities, within 12 months after publication of the erroneous financial information where the company restated a single line item in that financial information as a result of a subordinate's misconduct at an insignificant foreign subsidiary, even though the CEO and CFO were first hired by the company after the misconduct?

Furthermore, the Act does not specify how "profits" are determined where the executive acquired securities at various prices, possibly many years earlier. Is it possible that profits would be calculated using the executive's lowest purchase price matched against the executive's sale price during the 12-month period? In such case, for example, where an executive purchased 100 shares of company stock 10 years ago at $1 per share and 100 shares 1 year ago at $90 per share, the stock rises in value to $100 per share just before publication of the erroneous financial information, and the executive then sells the most recently purchased stock (cost $90 per share) for $110 per share shortly after publication of the erroneous financial information, the Act might be read (wrongly we believe) as requiring the executive to disgorge to the company the difference between the executive's lowest cost shares (the shares purchased 10 years ago for $1 per share) and the

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[3] For this purpose, the definition of a public company is expanded to include a company that has filed a 1933 Act registration statement with the SEC (even though the registration statement never became effective) unless the company subsequently withdraws the registration statement.

[4] Naturally, the prohibition does not prevent the company from bonusing money to directors and executive officers that it otherwise would have loaned to them.

[5] For this purpose, the definition of a public company is expanded to include a company that has filed a 1933 Act registration statement with the SEC (even though the registration statement never became effective) unless the company subsequently withdraws the registration statement.

executive's $110 per share selling price (i.e., $109 per share times 100 shares sold)?

A far more rational reading of "profits" in this context would be the excess of the executive's sale price during the 12-month period over the stock's market price immediately after the restatement. In the above example, if the stock falls to $80 per share immediately after the restatement, the executive would disgorge to the company the excess of his or her selling price ($110 per share) over the stock's post-restatement market price ($80 per share), i.e., a "profit" of $30 per share times 100 shares sold.

Finally, the Act is silent on when this disgorgement provision goes into effect, i.e., on whether any (and if so, how many) of the statutorily required events must take place after the 7/30/02 enactment date. For example, does the disgorgement provision apply where the company published erroneous financial information on 1/15/02, the executive sold stock at a gain on 6/15/02, and the company restated the erroneous financial information on 7/29/02 (i.e., the day before enactment)? Does the disgorgement provision apply where the restatement did not occur until 8/1/02 (*i.e.*, the day after enactment)?

Interestingly, this provision is likely to put intense pressure on companies and their auditors to avoid financial restatements, which is obviously contrary to the spirit of the Act.

Survival of Securities Law Liabilities in Bankruptcy Proceedings. The Act amends the Bankruptcy Code so that any judgment, settlement, or court or administrative order for damages or fines for any federal or state securities law violation or fraud in connection with the purchase or sale of any security is no longer dischargeable in personal bankruptcy. Thus, directors and officers of a bankrupt company liable for securities law claims -- e.g., because their liability is not covered by D&O insurance or because the policy's coverage has been exhausted -- can no longer discharge these claims in personal bankruptcy. This rule applies only to an individual, not to a bankrupt company.

Trading Restrictions for Insiders During an Employee Benefit Plan Blackout Period. Effective 180 days after the 7/30/02 enactment, the Act prohibits any director or executive officer of a public company[6] from acquiring or disposing of any equity security received "in connection with [the director's or executive officer's] service or employment as a director or executive officer" during any employee benefit plan "blackout period."[7]

An employee benefit plan "blackout period" means a period exceeding 3 consecutive business days during which there is a "temporary suspension" of the ability of at least 50% of the participants in all the company's defined contribution plans to acquire or dispose of the security. However, neither a regularly scheduled suspension incorporated in the terms of the plan document and adequately disclosed to participants nor a suspension imposed solely in connection with a corporate transaction constitutes a "blackout period." The SEC may issue rules setting forth other exceptions to these trading restrictions, including purchases under an automatic dividend reinvestment program or purchases or sales pursuant to an advance election.

If a director or executive officer violates these trading restrictions, "any profits realized" by the director or executive officer must be paid to the company.

The company must timely notify all directors and executive officers and the SEC as to each blackout period. In addition, the plan administrator must notify all affected plan participants, generally at least 30 days in advance of a blackout period, and this notice requirement is not limited to public companies.[8]

Officer and Director Bars. The SEC's authority to prohibit a person who has violated the anti-fraud provisions of the Exchange Act from serving as an officer or director of a public company (permanently

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[6] For this purpose, the definition of a public company is expanded to include a company that has filed a 1933 Act registration statement with the SEC (even though the registration statement never became effective) unless the company subsequently withdraws the registration statement.

[7] Regulations will address the extent to which this provision applies to members of the company's controlled group. Employee benefit plans not regulated by ERISA, including non-U.S. plans, are not covered by this provision.

[8] For this purpose, "blackout period" is defined somewhat differently than for the trading restriction discussed above.

or for a specified period) is broadened so that it applies if the person's conduct demonstrates "unfitness" (rather than the prior standard of "substantial unfitness").

CRIMINAL AND ENFORCEMENT-RELATED PROVISIONS

The Act adds numerous criminal and civil penalties and vastly increases the jail and monetary penalties for many existing criminal provisions.

CEO and CFO Certification of Periodic Reports. The Act imposes a criminal penalty of up to $1 million and/or up to 10 years imprisonment for a "knowing" violation by the CEO or CFO of the §906 certification requirement discussed above and up to $5 million and/or up to 20 years for a violation which is both "willful" and "knowing". The distinction between the lesser penalty for a "knowing" violation and the greater penalty for a "willful" and "knowing" violation is not readily apparent, although neither of these terms presumably includes "reckless," which was stricken from the bill before passage.

Document Destruction. A person who "knowingly" alters, destroys, conceals or falsifies any document or record with intent to impede or obstruct a Federal investigation or proceeding is subject to fines and/or imprisonment up to 20 years.

An accountant who "knowingly and willfully" fails to maintain all audit or review work papers for at least 5 years "from the end of the fiscal period in which the audit or review was concluded" is subject to fines and/or imprisonment up to 10 years. The SEC is required within 180 days after the 7/30/02 enactment to promulgate rules relating to the retention of documents forming the basis of, or used in connection with, an audit or review, the violation of which would be subject to an equivalent penalty.

Securities Fraud. The Act creates a "securities fraud" crime with fines and/or imprisonment up to 25 years for a person knowingly engaging in a scheme to defraud anyone in connection with a public security (even if not in connection with the purchase or sale of a security).[9]

Willful Securities Law Violations. §32(a) of the Exchange Act has long imposed criminal penalties for "willful" violation of the Exchange Act or its regulations or for a "willful and knowing" false or misleading statement in an SEC filing. The Act increases the penalties: up to $5 million and up to 20 years imprisonment (previously up to $1 million and 10 years) or in the case of an entity, up to $25 million (previously $2.5 million).

Mail and Wire Fraud. Penalties for Federal mail or wire fraud (devising a scheme or artifice to defraud or using false or fraudulent pretenses involving mail or wire) are increased: up to 20 years imprisonment (previously 5 years).

Improper Influence on Audits. The Act makes it unlawful for any officer or director (or anyone under their direction) to fraudulently influence or mislead any auditor for the purpose of rendering the financial statements materially misleading. The SEC is required to propose rules no later than 90 days after enactment and to issue final rules no later than 270 days after enactment.

Federal Sentencing Guidelines. Within 180 days after the 7/30/02 enactment, the United States Sentencing Commission must review and amend, as appropriate, the Federal Sentencing Guidelines relating to the types of white collar crime dealt with in the Act to ensure that the penalties are sufficiently stiff.

Retaliation Against Informants. Any person who "knowingly, with intent to retaliate," takes action harmful to any person for providing truthful information to a law enforcement officer relating to the possible commission of a Federal offense is subject to fines and/or imprisonment up to 10 years.

Civil Whistleblower Protection. No public company (or any of its officers, employees or agents) may discharge, demote, threaten, or discriminate against an employee who lawfully provides information or assists in an investigation of securities law violations or who files, testifies, or participates in proceedings involving alleged securities law violations. In case of violation, an employee may sue for reinstatement, back pay, and compensation for damages, including attorneys' fees.

[9] Public security means one issued by a §12(b), §12(g), or §15(d) reporting company.

Temporary Freeze on Extraordinary Payments to Insiders. During any SEC investigation of possible Federal securities law violations by a company with publicly traded securities or any of its directors, officers, controlling persons, employees or agents, the SEC is authorized to petition a Federal court for a temporary order requiring the company to escrow any "extraordinary payments (whether compensation or otherwise)" the SEC believes are likely to be made to any such persons until the expiration of any legal proceedings instituted within 90 days thereafter.

AUDITOR AND AUDIT COMMITTEE PROVISIONS

Accounting Oversight Board. In a sweeping institutional change, the Act creates a Public Company Accounting Oversight Board (the "Oversight Board") to oversee public company audits.[10] The Oversight Board will be a non-governmental nonprofit corporation consisting of 5 full-time members, 2 of whom (and only 2) will be CPAs, serving staggered 5 year terms. The Oversight Board is charged with, among other things:

> (1) registering and inspecting all accounting firms that audit public companies,[11]
>
> (2) establishing rules regarding auditing, quality control, ethics, independence, and other standards related to the preparation of audit reports, and
>
> (3) investigating, disciplining, and sanctioning accountants and accounting firms (unlike the now dissolved Public Oversight Board, which lacked this authority).

The SEC is directed to appoint the initial members within 90 days after the 7/30/02 enactment and to oversee creation of a fully functioning Oversight Board within 270 days. Effective 180 days after creation of the Oversight Board, an unregistered accounting firm may not issue an audit report with respect to any such public company.

The Oversight Board can suspend or revoke an accounting firm's registration or can bar or suspend any person from association with a registered accounting firm. The Oversight Board can also impose civil penalties up to $100,000 for a natural person and $2 million for an entity per violation, or up to $750,000 for a natural person and $15 million for an entity per violation involving intentional conduct (including recklessness or repeated negligence).

The Oversight Board will establish rules regarding auditing standards, quality control standards, and ethics standards, including at a minimum that (1) a concurring or second partner must review and approve each audit report and (2) audit work papers must be retained for a period of at least 7 years. An Oversight Board rule becomes effective only when approved by the SEC.

The Oversight Board will be funded by an annual fee assessed against all public companies[12] based on their relative market capitalizations, except that the cost of registering public accounting firms and reviewing their annual reports will be funded by fees assessed against registered public accounting firms.

Prohibited Non-Audit Services. The Act prohibits a registered public accounting firm from providing a public company[13] for whom the accounting firm is performing an audit any of the following non-audit services:

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[10] The Oversight Board is quite similar to the Public Accountability Board proposed by the SEC on 6/26/02 (Release No. 33-8109), and replaces the Public Oversight Board, which dissolved earlier this year.

[11] For this purpose, the definition of a public company is expanded to include a company that has filed a 1933 Act registration statement with the SEC (even though the registration statement never became effective) unless the company subsequently withdraws the registration statement.

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[13] For this purpose, the definition of a public company is expanded to include a company that has filed a 1933 Act registration statement with the SEC (even though the registration statement never became effective) unless the company subsequently withdraws the registration statement.

(1) bookkeeping or other services related to the company's accounting records,

(2) financial information systems design and implementation,

(3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports,

(4) actuarial services,

(5) internal audit outsourcing services,

(6) management functions or human resources,

(7) broker, dealer, investment adviser, or investment banking services,

(8) legal services and expert services unrelated to the audit, and

(9) any other service the Oversight Board determines, by regulation, is not permitted.

The list does not specifically reference management consulting services but may include them within paragraph (6). This prohibition takes effect 180 days after the Oversight Board commences operations.

Audit Committee Pre-Approval of All Audit and Non-Audit Services. All audit services as well as non-audit services not prohibited by (1) through (9) above (including non-audit tax services) must be pre-approved by the company's audit committee (or, in the absence of an audit committee, the entire board), subject to a de minimus exception for certain non-audit services. Such non-audit services must be disclosed in the company's Exchange Act reports. The SEC's proxy rules continue to require the company to disclose the amount billed by its auditors for audit fees and other fees.

Audit Partner Rotation. It is unlawful for a registered public accounting firm to provide audit services to a company if the lead (or coordinating) audit partner (with primary audit responsibility), or the audit partner responsible for reviewing the audit, "has performed audit services" for the public company in each of the previous 5 years. The Act appears to count audit years prior to enactment, so that if the lead audit partner, or the lead review partner, has already performed audit services in each of the 5 years preceding enactment, immediate rotation would be required.

However, the provision on its face applies only to a "registered public accounting firm," defined in the Act as a public accounting firm registered with the Oversight Board. Since the Oversight Board has not yet been formed and thus no accounting firm has yet registered, it appears that this rotation provision is not effective until the Oversight Board is operational and registers the company's accounting firm, although some companies may want to implement this rule more quickly.[14]

Auditor Reports to Audit Committees. A registered public accounting firm is required by the Act to timely report to the company's audit committee (or, in the absence of an audit committee, the entire board):

(1) all of the company's critical accounting policies and practices,

(2) all alternative treatments of financial information within GAAP discussed with management, the ramifications of each such alternative treatment, and the accounting firm's preferred treatment, and

(3) other material written communications between the accounting firm and the company's management, such as any management letter or schedule of unadjusted differences.

Again this requirement appears to become effective when the Oversight Board is operational and has registered the company's accounting firm, although some companies may want to implement this provision more quickly.

Accountant Conflicts of Interest. A registered public accounting firm may not audit a public

[14] Strangely, Act §205(b) replaces references in Exchange Act §10A to "independent public accountant" with "registered public accounting firm," although it would be surprising if Congress thereby intended to suspend applicability of existing §10A until the Oversight Board is functioning and has registered accounting firms.

company[15] if the CEO, CFO, chief accounting officer, controller (or any equivalent) was employed by that accounting firm and participated in any capacity in the company's audit during the 1-year period preceding initiation of the audit.

The Act does not expressly provide any "grandfather" or transition rules for this provision, so that on its face the prohibition becomes effective when the Oversight Board is operational and registers the company's accounting firm.

Audit Committee Composition and Responsibilities. Within 270 days after the 7/30/02 enactment, the SEC is required to issue rules mandating that the national securities exchanges and national securities associations require, through listing standards, that each listed company's audit committee:

> (1) be directly responsible for appointment, compensation, and oversight of the company's accounting firm and resolution of any disagreement between the accounting firm and management,
>
> (2) be composed solely of independent directors (as described below),
>
> (3) establish procedures for receiving (including confidential, anonymous submissions) and responding to complaints and concerns regarding accounting, internal accounting controls, or auditing matters, and
>
> (4) have authority and appropriate funding to engage independent counsel and other outside advisors.[16]

"*Composed Solely" Requirement.* Currently, both stock exchanges and Nasdaq require that the audit committee be composed solely of independent directors, but permit a limited exception for one non-independent director where the board makes a determination, disclosed in the company's proxy statement, that the inclusion of the non-independent director is in the company's best interests. The Act does not contemplate any exception, but does provide the SEC with exemptive authority.

"Independent" Requirement. It is unclear whether the Act's standard for director independence departs from existing stock exchange and Nasdaq interpretations. Specifically, the Act states that in order to be independent, a board member may not "(i) accept any consulting, advisory, or other compensatory fee from the [company]" (other than in his or her capacity as a board or board committee member) or "(ii) be an affiliated person of the [company] or any subsidiary," without defining "affiliated person." Does the Act, for example, preclude a representative of a significant stockholder receiving compensation from the significant stockholder from serving on the committee? Under current NYSE interpretations such a person is generally not precluded from serving if the stockholder owns less than 50% of the outstanding common stock, and under current Nasdaq interpretations, less than 25%.

The NYSE, Nasdaq, and Amex have recently proposed rule changes to modify their audit committee independence requirements. These proposals are similar but not identical to those included in the Act.

NEW INSIDER AND COMPANY DISCLOSURE REQUIREMENTS

Accelerated Disclosure of Insider Transactions. Effective 30 days after the 7/30/02 enactment, the Act amends §16 of the Exchange Act to require every §16 insider (i.e., public company[17] directors and executive officers as well as a more than 10% stockholder of a class of equity securities registered under §12) to report (on Form 4) changes in beneficial ownership before the end of the 2nd

[15] For this purpose, the definition of a public company is expanded to include a company that has filed a 1933 Act registration statement with the SEC (even though the registration statement never became effective) unless the company subsequently withdraws the registration statement.

[16] It is unclear whether (and, if so, how) these rules could apply to the entire board where the company has no audit committee, although the Act's definition of "audit committee" contains a reference to the board where there is no audit committee.

[17] For this purpose, public company means a company with a class of equity securities traded on a national securities exchange (a §12(b) company) or a class of equity securities held by 500 or more shareholders of record (a §12(g) company).

business day following the day on which the transaction took place (or at such other time as the SEC may establish). In the past, §16 insiders have generally been required to report changes in beneficial ownership on the 10th calendar day of the month following the day on which the transaction took place.

The Act also requires, beginning no later than 1 year after enactment, that Form 4 reports be filed electronically with the SEC and posted to the company's website (if it has one) not later than the end of the business day following filing. Currently, these reports may be filed electronically or in paper format and are not required to be posted to the company's website (and seldom are).

These amendments are similar but not identical to rules proposed by the SEC on 4/12/02 (Release No. 33-8089 and Release No. 33-8090). One difference is that under the SEC proposals, the responsibility for publicly disclosing director and executive officer transactions in company stock within 2 business days would fall on the company, not the §16 insider (through an amendment to the filing requirements of Form 8-K).

Real Time Disclosure. The Act amends §13 of the Exchange Act to require that each company reporting under §13(a) or §15(d) of the Exchange Act disclose to the public "on a rapid and current basis" such additional information, "in plain English," concerning material changes in the company's financial condition and operations as the SEC determines by rule.

The Act does not indicate what might satisfy the "rapid and current basis" requirement or how such disclosure should be made (by press release, Form 8-K or otherwise), and sets forth no timeline for implementation. Once implemented, this provision could prove to be one of the more dramatic changes brought about by the legislation, because if implemented to require true "real time" disclosure, it would represent a fundamental departure from current law, under which (leaving aside the stock exchange and Nasdaq policies encouraging immediate dissemination of material information) public companies have no obligation to communicate to the market absent a duty to speak (which generally exists when, e.g., (1) the company or company insiders are trading in the company's securities, (2) the company is required to make an SEC filing, (3) the company is under a duty to correct or update past statements, or (4) rumors in the marketplace are attributable to the company).

Presentation of Pro Forma Financial Information. Not later than 180 days after the 7/30/02 enactment, the SEC must issue final rules requiring that pro forma financial information included in any report filed with the SEC or in any public disclosure or press release by a company filing reports with the SEC under §12, (1) not contain any material misstatement or omission and (2) contain a reconciliation with the company's GAAP financials. The new legislation is generally consistent with the SEC's informal guidance on the presentation of pro forma financial information issued on 12/12/01 and the more extensive rules proposed by the SEC on 5/10/02 (Release No. 33-8098).

Identification of Audit Committee Expert. Not later than 180 days after the 7/30/02 enactment, the SEC is required to issue final rules mandating that each company filing reports with the SEC pursuant to §12 or §15(d) disclose whether or not at least 1 audit committee member is a "financial expert" (and if not, the reasons why not). These rules are likely to be similar to existing exchange and Nasdaq audit committee rules, but will extend to non-listed companies and may include financial expertise criteria beyond current listing standards.

Management Assessment of Internal Controls. The SEC must prescribe rules requiring each annual report (including those of non-U.S. companies) filed with the SEC to contain an internal control report stating "the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting," containing the company's assessment as to the effectiveness of those procedures, and containing the company's accounting firm's report on management's assessment.

Code of Ethics for Senior Financial Officers. Not later than 180 days after the 7/30/02 enactment, the SEC must issue final rules mandating that each public company in periodic reports filed pursuant to §13(a) or §15(d) disclose whether or not (and if not, the reasons why not) the company has adopted a code of ethics for senior financial officers and requiring immediate disclosure of any change in or waiver of

the code of ethics for such officers. Obviously, the Act essentially requires creation of a code of ethics and the announcement of any change or waiver, since it is difficult to conceive of an appropriate reason for not doing so.

Accuracy of Financial Reports. The Act requires each financial report containing GAAP financial statements to reflect all material correcting adjustments identified by the company's accounting firm. It is unclear whether this is intended to pick up an adjustment proposed by the accounting firm prior to issuance of the audit report and accepted by the company in preparing its published financials or only an adjustment rejected by the company.

Off-Balance Sheet Arrangements. Not later than 180 days after the 7/30/02 enactment, the SEC is required to issue final rules requiring each annual and quarterly financial report filed with the SEC to disclose all material off-balance sheet arrangements and obligations (including contingent obligations) that may have a material effect on, among other things, financial condition, results of operations, liquidity, capital resources, or significant components of revenues or expenses. Within one year after the new SEC rules' effective date, the SEC is required to complete a study of filings by companies to determine the extent of off-balance sheet transactions and special purpose entities.

OTHER PROVISIONS

Analyst Conflict of Interest. Not later than one year after the 7/30/02 enactment, the SEC (or, at the SEC's direction, a registered securities association or national securities exchange) must adopt rules reasonably designed:

(1) to foster greater public confidence in securities research, and to protect the objectivity and independence of securities analysts, by restricting prepublication clearance or approval of research reports by investment bankers, preventing investment bankers from supervising or evaluating securities analysts, and requiring that an investment banker may not retaliate or threaten to retaliate against any securities analysts as a result of an unfavorable research report,

(2) to define periods during which participating broker/dealers participating in a public offering may not publish or distribute research reports,

(3) to establish structural safeguards to assure that securities analysts are walled off from investment bankers,

(4) to require analysts to disclose (in connection with a public appearance or research report) potential conflicts of interest, including whether the analyst owns any of the company's securities, whether the analyst or the analyst's firm has received any compensation from the company, whether the company is (or within one year has been) a client of the firm, and whether the analyst received compensation based upon investment banking revenues.

These measures are similar to many of the NYSE and Nasdaq rule changes approved by the SEC on 5/10/02 (Release No. 34-45908). On 7/25/02, the same day the House and Senate passed the Act, the SEC announced it was proposing a new Regulation AC (Analyst Certification) -- not yet released -- requiring research analysts to certify the truthfulness of their views in research reports and public appearances and to disclose whether they have received compensation related to their recommendations, with comments due 45 days after publication.

Extension of Statute of Limitations for Private Civil Suits. The Act extends the statute of limitations for private rights of action for securities law fraud to the earlier of 2 years after discovery of the facts constituting the violation (formerly 1 year) and 5 years after the violation (previously 3 years), applicable to proceedings commenced after the 7/30/02 enactment.

SEC Appropriations. The Act authorizes a $776 million SEC appropriation for fiscal year 2003, including $103 million to increase compensation of existing personnel and $98 million to add 200 professionals for oversight of auditors and audit services.

Enhanced Review of Periodic Reports. The SEC is required to review the periodic reports filed by every

company (including non-U.S. companies) at least once every 3 years.

Professional Responsibility Rules for Attorneys. Not later than 180 days after the 7/30/02 enactment, the SEC must issue rules establishing minimum standards of professional conduct for attorneys practicing before the SEC, including a rule "requiring an [inside or outside] attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agents . . . to the [company's] chief legal counsel . . . and . . . if the counsel or officer does not appropriately respond . . . ([by] adopting . . . appropriate remedial measures) . . . report the evidence to the audit committee."

Corporate Tax Returns. The Act expresses the (non-binding) sense of the Senate that Federal income tax returns of corporations (not just those of public companies) be signed by the CEO.

STUDIES MANDATED BY THE ACT

Auditor Rotation. The GAO must study limiting the number of years a particular accounting firm may serve as auditor for any particular company, and report to Congress on the results of its study within 1 year after enactment.

Principles-based Accounting. The GAO must study the possible effects of a shift in U.S. accounting from the current rules-based system to a principles-based system.

Public Accounting Consolidation. The GAO must study the consolidation in the accounting industry and its impact on the securities markets.

Credit Rating Agencies. The SEC must study the role and function of credit rating agencies in the operation of the securities markets.

Securities Law Violations, Enforcement Actions, and the Role of Investment Banks in Recent Failures. The SEC must study securities law violations over the last 4 years and enforcement actions over the last 5 years, and the GAO must study the role investment banks and financial advisors may have played in the Enron and Global Crossing failures and in creating and marketing transactions which may have been designed solely to enable companies to manipulate revenue streams, obtain loans, or move liabilities off balance sheet.

OTHER SIGNIFICANT LEGISLATION PENDING IN CONGRESS

Tax and Accounting Treatment of Stock Options. Unrelated to the Sarbanes-Oxley Act, a number of bills are pending in Congress to address the tax and accounting treatment of compensatory stock options issued by public, and in some cases private, companies. Currently, under APB 25 a company is not required to record any expense for GAAP purposes when granting a "fixed" option which is not in the money at grant. A company may, however, elect to utilize FASB 123 rather than APB 25 (which until recently few have done), in which case the company takes a GAAP accounting charge equal to the option's fair value at time of grant (generally as calculated under the Black-Scholes method approximately 35% of the option price for an option granted at the money) amortized as an expense over the option's vesting period.

Under the McCain bill, a corporation would be required to expense in the grant year any option on a publicly traded security granted to an employee, though it is not entirely clear whether this adopts an FASB 123 approach, perhaps with altered timing (i.e., expense recognized wholly in grant year rather than over vesting period).

Under the Levin and Dodd bills, the SEC and/or a new public accounting board would establish rules relating to accounting for stock options.

Under the Levin-McCain bill, the Internal Revenue Code would be amended to deny a Federal income tax deduction in excess of the company's accounting charge (apparently even where the company is privately held). Since the company's deduction for an NQO is normally the full spread at exercise, this bill would generally reduce the company's tax deduction even where the company adopts FASB 123-like rules by expensing the option's fair value at grant (since the option's fair value at grant is often less than the option's spread at exercise).

It is not clear at this time whether any of these stock option provisions will be enacted.

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