LIFTING THE VEIL OF SARBANES-OXLEY
REVELATIONS THROUGH DECEMBER 1, 2002

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On July 30, 2002 President Bush signed the Sarbanes-Oxley Act of 2002 (H.R. 3763) (the "*SOB*") intended to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws. This is the "tough new corporate fraud SOB" being trumpeted by the politicians and in the media. Among other things, the SOB amends the Securities Exchange Act of 1934 (the "*1934 Act*") and the Securities Act of 1933 (the "*1933 Act*").

Although the SOB does have some specific provisions, and generally establishes some important public policy changes, it will be implemented in large part through rules to be adopted by the Securities and Exchange Commission (*"SEC"*) in various designated periods of time after July 30, 2002 – generally, 30 days (August 29, 2002), 180 days (January 26, 2003) and 270 days (April 26, 2003). As is always the case with broad grants of authority to a regulatory body, the rules may well contain some surprises. Further, the SEC will have opportunity through rulemaking under the SOB, as well as action on corporate governance proposals of the stock exchanges, to delve much farther into corporate governance than it has in the past.

SUMMARY

To What Companies Does SOB Apply. The SOB is generally applicable to all companies required to file reports with the SEC under the 1934 Act ("*reporting companies*") or that have a registration statement on file with the SEC under the 1933 Act, in each case regardless of size (collectively "*public companies*"). Some of the SOB provisions apply only to companies listed on a national securities exchange ("*listed companies*"), such as the New York Stock Exchange ("*NYSE*") or NASDAQ Stock Market ("*NASDAQ*"), but not to companies traded on the NASD Bulletin Board. Small business issuers that file reports on Form 10-QSB and Form 10-KSB are subject to SOB generally in the same ways as larger companies although some specifics vary (references herein to Forms 10-Q and 10-K include Forms 10-QSB and 10-KSB).

Accounting Firm Regulation. The SOB creates a five-member board to be appointed by the SEC and called the Public Company Accounting Oversight Board (the *"PCAOB"*) to oversee the

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accounting firms that serve public companies and to establish accounting standards and rules. The SOB does not address the accounting for stock options, but the PCAOB would have the power to do so. The PCAOB will be funded by assessing fees from public companies based on their market capitalization. It will have the authority to subpoena documents from public companies. The PCAOB is required to notify the SEC of any pending PCAOB investigations involving potential violations of the securities laws. Additionally, the SOB provides that the PCAOB should coordinate its efforts with the SEC's enforcement division as necessary to protect ongoing SEC investigations.

The SOB restricts the services accounting firms may offer to clients. Among the services that audit firms could not provide for their audit clients are (1) bookkeeping or other services related to the accounting records or financial statements of the audit client; (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 or dealer, investment adviser, or investment banking services; and (8) legal services and expert services unrelated to the audit.

CEO/CFO Certifications. The SOB contains *two* different provisions that require the chief executive officer ("*CEO*") and chief financial officer ("*CFO*") of each reporting company to sign and certify company SEC periodic reports, with possible criminal and civil penalties for false statements. The result is that CEOs and CFOs must each sign two separate certifications in their companies' periodic reports, one certificate being under rules adopted by the SEC under an amendment to the 1934 Act (the "*SOB §302 Certification*") and the other being under an amendment to the Federal criminal code (the "*SOB §906 Certification*"). Chairpersons of boards of directors who are not executive officers are not required to certify the reports.

Enhanced Attorney Responsibilities. The SOB sets forth rules of professional responsibility for attorneys representing public companies before the SEC, including: (1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty to the chief legal counsel or the chief executive officer of the company; and (2) if corporate executives do not respond appropriately, requiring the attorney to report to the audit committee of the board of directors.

Insider Loans. The SOB prohibits companies from making loans to directors or executive officers. There are exceptions for existing loans, for credit card companies to extend credit on credit cards issued to their employees and for securities firms to maintain margin account balances.

Disclosure Issues. Public companies will be required to publicly disclose in "plain English" additional information concerning material changes in their financial condition or operations on a "real time" basis. SEC rulemaking will define the specific requirements of the enhanced reporting.

The SOB also requires the SEC to regularly and systematically review corporate filings. Each issuer must be reviewed at least every three years. Material restatements, the level of market capitalization and price volatility are factors specified for the SEC to consider in scheduling reviews.

Criminal and Civil Sanctions. The SOB mandates maximum sentences of 20 years for such crimes as mail and wire fraud, and maximum sentences of up to 25 years for securities fraud. Civil penalties are also increased. The SOB restricts the discharge of such obligations in bankruptcy.

Trading Blackouts. Company executives and directors would also be restricted from trading stock during periods when employees cannot trade retirement fund-held company stock ("*blackout periods*"). These insiders would be prohibited from engaging in transactions in any equity security of the issuer during any blackout period when at least half of the issuer's individual account plan participants are not permitted to purchase, sell or otherwise transfer their interests in that security. The SOB also calls for adding a 30-day advance notice period of any blackouts to be added to existing ERISA legislation.

The SOB is organized in eleven titles which are summarized below with emphasis on those parts most relevant to public companies. Rules adopted by the SEC to date under the SOB are generally discussed below in relation to the SOB provisions being implemented thereby.

TITLE I: PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

The SOB establishes the Public Company Accounting Oversight Board (the "*PCAOB*") to: (1) oversee the audit of public companies that are subject to the securities laws; (2) establish audit report standards and rules; and (3) investigate, inspect, and enforce compliance relating to registered public accounting firms, associated persons, and the obligations and liabilities of accountants.

The PCAOB consists of 5 members appointed by the SEC, of whom no more than two may be certified public accountants. On October 24, 2002, the SEC appointed the following founding members of the PCAOB: Judge William H. Webster (chairman), Kayla J. Gillan, Daniel L. Goelzer, Willis D. Gradison Jr., and Charles D. Niemeier.[1] Judge Webster subsequently tendered his resignation. The members will serve on a full-time basis for five-year periods (though the first appointees each have staggered terms so that the positions expire in annual increments). Although members are prohibited from outside business or professional activities, the PCAOB is to establish compensation levels that are intended to be competitive with those in private industry. The PCAOB will be funded by assessing fees from public companies based on their market capitalization. SOB requires that the SEC certify that the PCAOB has the capacity to perform its functions by April 26, 2003.

Beginning 180 days after the SEC certifies that the PCAOB has the capacity to perform its functions, any public accounting firm that issues or participates in any audit report with respect to any public company must register with the PCAOB and renew such registration annually. The PCAOB is empowered to impose disciplinary or remedial sanctions upon registered public accounting firms and their associated persons. Subject to the SEC's oversight and enforcement authority over it, the PCAOB is to establish auditing, quality control and ethical standards that will require retention of records for seven years, concurring partner review of audit reports and inclusion within audit reports of information about the auditor's internal control testing of the issuer. It also is to regularly inspect each registered accounting firm to assess its compliance with SOB and the PCAOB's rules (firms that audit more than 100 public companies will be inspected annually, and other firms are to be inspected at least once every three years). In June 2002, the SEC issued a

[1] SEC Press Release 2002-153 (October 24, 2002), which sets forth biographical information about the founding members of the PCAOB.

proposal that contains an outline of how it would like the PCAOB to operate, and it is likely that many of the operating rules in that proposal will be adopted.[2]

TITLE II: AUDITOR INDEPENDENCE; NON-AUDIT SERVICES

The SOB amends the 1934 Act to prohibit a registered public accounting firm from performing specified non-audit services contemporaneously with an audit, and requires audit committee preapproval for other non-audit services. While the SEC must issue rules to carry out the provisions of Title II by January 26, 2003, the SOB provisions are effectively limits on registered public accounting firms and will only apply once the PCAOB is functioning and the particular accounting firm has registered with the PCAOB.

SOB §201 prohibits a registered public accounting firm from providing to a public company, contemporaneously with the audit, the following non-audit services:

(1) bookkeeping or other services related to the accounting records or financial statements of the audit client;

(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 or dealer, investment adviser, or investment banking services; and

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

The SOB (§202) requires audit committee preapproval of all auditing services (which may entail providing comfort letters in connection with securities underwritings or statutory audits required for insurance companies for purposes of State law) and non-audit services provided by the auditor. The audit committee may delegate the preapproval responsibility to a subcommittee of one or more independent directors. There is a de minimis exception with respect to the provision of non-audit services for an issuer, if (i) the aggregate amount constitutes not more than 5 percent of the total amount paid to the auditor during the fiscal year in which the non-audit services are provided; (ii) such services were not recognized by the issuer at the time of the engagement to be non-audit services; and (iii) such services are promptly brought to the attention of the audit committee and approved prior to the completion of the audit by the audit committee or by 1 or more members of the

[2] SEC Release No. 34-46120 (June 26, 2002), *Framework for Enhancing the Quality of Financial Information Through Improvement of Oversight of the Auditing Process*.

audit committee to whom authority to grant such approvals has been delegated by the audit committee.

The SOB (§203) mandates lead audit partner rotation every five years, but does not require rotation of registered public accounting firms, although the PCAOB may do so. Because many lead engagement partners have been working on their current audit clients for five years already, they will have to rotate immediately on their firms' registration with the PCAOB. Since provision applies only to registered firms, the effective date of the provision is the date a firm becomes registered, which would be sometime in mid- to late 2003. However, the SOB says an individual cannot serve on an audit as a lead or review partner if he or she "has performed audit services for that issuer in each of the five previous fiscal years of that issuer." As there is no indication in either the statute or the legislative history that the five-year period should start running after the enactment of SOB, the five year SOB look-back is effectively retroactive from the date the audit firm's registration becomes effective.

The SOB requires (§204) auditor reports to audit committees regarding (a) all critical accounting policies and practices to be used and (b) all alternative treatments of financial information within generally accepted accounting principles (*"GAAP"*) that have been discussed with management.

The SOB (§206) prohibits a registered public accounting firm from performing audit services for a public company if any of the issuer's senior management officials had been employed by such firm and participated in any capacity in the audit of that issuer during the one-year period preceding the audit initiation date.

Under the rulemaking directive of SOB §208, the SEC recently proposed rules[3] to effectuate the auditor independence provisions of SOB §§201-204 and §206. The proposed rules comport with their corresponding provisions in Title II, with only the following differences: (1) after partners on the audit engagement teams who had provided audit services for a client for five consecutive years are rotated off of the audit engagement, they may not perform any audit services for the client for a period of five years thereafter; (2) issuers will be required to disclose in Form 10-K information related to the audit and non-audit services provided by, and fees paid by the issuer to, the auditor of the issuer's financial statements for audits, tax preparation and all other services provided, for the year covered by the filing and for the previous year; and (3) an accountant would not be independent from an audit client if any partner, principal or shareholder of the accounting firm who is a member of the engagement team received compensation based directly on any service provided or sold to that client other than audit, review and attest services.

TITLE III: CORPORATE RESPONSIBILITY

Audit Committees. SOB §301 requires the SEC to issue rules that will effectively prohibit the listing of an issuer's stock unless the audit committee complies with certain enhanced requirements that seek to break what is perceived as the direct link between management and the

[3] SEC Press Release 2002-165 (November 19, 2002).

auditors. Audit committees for listed companies must take charge of the audit, including appointing, compensating, and overseeing the auditors, as well as resolve disputes on accounting matters between auditors and management. Although the audit committee is to control the audit of a listed company, the financial statements remain the responsibility of management, as evidenced by the required civil certification of all Forms 10-K and 10-Q in SOB §302 and criminal certification in SOB §906. Audit committees must also establish procedures to ensure that their members are independent, and must hear and act on employee complaints regarding accounting, internal controls, and auditing issues. These rules are the complement to the restrictions on registered firms' activities in SOB §201, and are considered an important step in ensuring auditor independence and preserving the integrity of the audit process.

By April 26, 2003, each national stock exchange and NASDAQ must adopt rules obligating each issuer to assure that the responsibilities of the audit committee comply with the new requirements of the SOB. Noncompliance would result in delisting, although the rules must provide procedures to permit issuers an opportunity to cure defects that would otherwise result in delisting. The specific requirements are:

- Oversight. The audit committee must have direct responsibility for the appointment, compensation, and oversight of any registered public accounting firm employed to perform audit services.

- Independence. Its members must be independent directors, which means that each member may not, other than as compensation for service on the board of directors or any of its committees: (i) accept any consulting, advisory or other compensation from the issuer or (ii) be an officer or other affiliate of the issuer.

- Procedures to Receive Complaints. The audit committee is responsible for establishing procedures for the receipt, retention, and treatment of complaints regarding accounting, internal accounting controls, or auditing matters, and the confidential, anonymous submission by employees of the issuer ("*whistleblowers*") of concerns regarding any accounting or auditing matters.

- Funding and Authority. The audit committee shall have the authority to hire independent counsel and other advisers to carry out its duties.

Also, each issuer must provide for funding, as the audit committee may determine, for payment of compensation of the issuer's auditor and of any advisors that the audit committee engages. Once each adopts its specific rules, each issuer should amend its charter to state the above responsibilities specifically.

Subject to the foregoing, to restrictions on loans discussed elsewhere herein and to director fiduciary duties, directors are not prohibited from transacting business with the issuer, either directly or through relationships with another person.

CEO/CFO Certifications. The SOB contains two separate certification requirements, which are applicable to all public companies regardless of size and are in addition to the certification

requirement which the SEC imposed on the CEOs and CFOs of the 947 largest public companies pursuant to a June 27, 2002 investigative order.

SOB §906 Certification. The SOB (§906) amended Federal criminal law to require the CEO and CFO to certify in writing in each SEC periodic report filed containing financial statements that the financial statements and the disclosures therein fairly present in all material aspects the operations and financial condition of the issuer.[4] It provides that the criminal penalties are (1) 20 years in prison for willful violation; and (2) 10 years for reckless and knowing violation. The §906 certification requirement was effective July 30, 2002 and was not predicated on any SEC rulemaking.

SOB §302 Certification. On August 27, 2002, the SEC adopted rules pursuant to SOB §302 requiring the CEO and CFO of each public company filing a Form 10-Q or 10-K after August 27, 2002, to certify that the financial statements filed with the SEC fairly present, in all material respects, the operations and financial condition of the issuer and as to the adequacy of "disclosure controls and procedures" and "internal controls," and as to certain other matters. The mandated CEO/CFO certification for a Form 10-Q is as follows:

> I, [identify the certifying individual], certify that:
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> 1. I have reviewed this quarterly report on Form 10-Q of [identify registrant];
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> 2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
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> 3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

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[4] A form of SOB §906 Certification follows:

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the _____ Report of _____ (the "Company") on Form 10-__ for the period ending _____ as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, _____, Chief [Executive] [Financial] Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/s/ _____

_____
Chief [Executive] [Financial] Officer
[Date]

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14[5]) for the registrant and we have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date[6];

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant'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 registrant's internal controls; and[7]

6. The registrant's other certifying officers and I have indicated in this quarterly 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 our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Clauses (1) and (2) of the SOB §302 mandated CEO/CFO certification are identical to the certification required by the SEC's Order Requiring the Filing of Sworn Statements, File No. 4-460

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5 For purposes of this certification, the term "disclosure controls and procedures" means controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the 1934 Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the 1934 Act is accumulated and communicated to the issuer's management, including its principal executive officer or officers and principal financial officer or officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

6 This certification mirrors the requirements in new 1934 Act Rules 13a-15 and 15d-15 which will require an issuer to establish and maintain an overall system of disclosure controls and procedures that is adequate to meet its 1934 Act reporting obligations. These rules are intended to complement existing requirements for reporting companies to establish and maintain systems of internal controls with respect to their financial reporting obligations.

7 This certification relates to the direction in SOB §404 that the SEC prescribe rules mandating inclusion of an internal control report and assessment in Form 10-K annual reports. The internal control report is required to (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) contain 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 SOB further requires the public accounting firm that issues the audit report to attest to, and report on, the assessment made by corporate management on internal controls. See discussion of SOB §404 *infra*.

(June 27, 2002), available at http://www.sec.gov/rules/other/4-460.htm; clauses (3)-(6) are new and additative.

Misleading Statements to Auditors. The SOB (§303) makes it unlawful, in contravention of rules to be adopted by the SEC, for any officer or director 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. On October 18, 2002 the SEC proposed a new Rule 13b2-2 under the 1934 Act which would prohibit officers or directors of an issuer, or persons acting under their direction, from subverting the auditor's responsibilities to investors to conduct a diligent audit of the issuer's financial statements and to provide a true report of the auditor's findings.[8]

Types of conduct that the SEC suggests might constitute improper influence include, but are not limited to, directly or indirectly:

- Offering or paying bribes or other financial incentives, including offering future employment or contracts for non-audit services,
- Providing an auditor with inaccurate or misleading legal analysis,
- Threatening to cancel or canceling existing non-audit or audit engagements if the auditor objects to the issuer's accounting,
- Seeking to have a partner removed from the audit engagement because the partner objects to the issuer's accounting,
- Blackmailing, and
- Making physical threats.

Proposed Rule 13b2-2 would apply throughout the professional engagement and after the professional engagement has ended when the auditor is considering whether to consent to the use of, reissue, or withdraw prior audit reports. Conducting reviews of interim financial statements and issuing consents to use past audit reports are within the scope of the proposed rule.

CEO/CFO Reimbursement. The SOB (§304) provides that, if an issuer is required to restate its financial statements owing to noncompliance with securities laws, the CEO and CFO must reimburse the issuer for (1) any bonus or incentive or equity based compensation received in the 12 months prior to the restatement and (2) any profits realized from the sale of issuer securities within the preceding 12 months.

The purpose of this provision is to "prevent CEOs and CFOs from making large profits by selling company stock, or receiving company bonuses, while management is misleading the public

[8] SEC Release No. 34-46685 (October 18, 2002).

and regulators about the poor heath of the company."[9] Because there is no relationship between the restatement and any misconduct of the CEO or CFO, the CEO and CFO could conceivably be responsible for misconduct of any employee of the issuer. SEC rules are expected to address such issues as what constitutes "misconduct", what kinds of restatements trigger this provision, how material the noncompliance with securities laws must be, how to measure profits, whether the disgorgement is limited to SEC action or a new private cause of action is created, etc.

D&O Bars. The SOB (§305) authorizes a court to prohibit a violator of certain SEC rules from serving as an officer or director of an issuer if the person's conduct demonstrates unfitness to serve (the pre-SOB standard was "substantial unfitness").

Insider Trading Freeze During Blackout. The SOB (§306) prohibits insider trades during pension fund blackout periods and states that profits realized from such trades shall inure to and be recoverable by the issuer irrespective of the intent of the parties to the transaction and directs the SEC in conjunction with the Labor Department to adopt implementing rules within 180 days of the effective date of SOB (January 26, 2003). On November 6, 2002, the SEC proposed rules[10] restricting trading by a reporting company's executive officers and directors[11] when employees are subject to a pension plan blackout that bars them from engaging in trades involving company securities held in their plan accounts.

The Enron scandal provided impetus for SOB §306(a) when insiders were able to liquidate their company stock before its price plunged, even as employees were stuck holding shares during a pension blackout period, resulting in often devastating losses in their accounts. The SOB §306(a) restrictions on transactions by insiders would apply to all reporting companies, including foreign private issuers, banks and savings associations, and small business issuers.

The statutory trading prohibition of SOB §306(a) is limited to equity securities that a director or executive officer acquired in connection with his or her service or employment as a director or executive officer. The proposed SOB §306 rule would specify instances where an acquisition of equity securities by a director or executive officer was "in connection" with his or her service or employment with an issuer. Acquisitions or dispositions of equity securities by family members, partnerships, corporations, limited liability companies, and trusts would be deemed acquisitions or dispositions by a director or executive officer if he or she had a "pecuniary interest" in the equity securities.

The trading prohibition of SOB §306(a) would be triggered only if a blackout period lasts more than three consecutive business days and temporarily suspends the ability of at least 50% of the

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9 Senate Report at 107-205.

10 SEC Release No. 34-46778 (November 6, 2002).

11 The term "director" in the proposed rules would have the same meaning as under the general 1934 Act rules, and the term "executive officer" would have the same meaning as the term "officer' under the insider reporting requirements of 1934 Act Section 16(a). This approach would enable security holders to monitor the trading activities of an issuer's directors and executive officers using the Section 16(a) reporting forms. Similarly, the proposed rules would cover "equity securities" of the issuer, including derivative securities relating to an equity security (as defined in the 1934 Act §16 rules) whether or not issued by the issuer.

participants or beneficiaries under all individual account plans maintained by the issuer to acquire or transfer an interest in issuer equity securities held in an account plan. The proposed SOB §306 rules would clarify that the 50% test is met only if at least 50% of U.S. plan participants are restricted in their trading. The restricted employees also would have to represent at least 15% of the issuer's shareholders.

Foreign issuers' outside directors would not be subject to the proposed rule. In addition, plan participants generally would get a 30-day notice of a blackout under rules recently adopted by the Labor Department, which calculated that there is a blackout once in every four or five years.

For violations of SOB §306(a), the SEC can bring an enforcement action against a director or executive officer. In addition, the statute provides that an issuer, or a security holder on behalf of an issuer, may bring an action to recover the profits realized by a director or executive officer from a prohibited transaction during a blackout period.

Enhanced Attorney Responsibilities. The SOB (§307) provides that, within 180 days after enactment of SOB (January 26, 2003), the SEC shall adopt rules of professional responsibility for attorneys representing public companies before the SEC, including: (1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty to the chief legal counsel ("*CLO*") or the CEO of the company; and (2) if corporate executives do not respond appropriately, requiring the attorney to report to the audit committee of the board of directors. The SEC has proposed rules implementing provisions of SOB §307 that prescribe "minimum standards of professional conduct for attorneys appearing and practicing before the SEC in any way in the representation of issuers."[12]

The proposed SOB §307 rules would apply to all attorneys, whether in-house counsel or outside counsel and those in foreign jurisdictions, and would define "appearing and practicing" before the SEC to include, without limitation: (1) transacting any business with the SEC, including communication with commissioners, the SEC or its staff; (2) representing any party to, or the subject of, or a witness in an SEC administrative proceeding; (3) representing any person in connection with any SEC investigation, inquiry, information request, or subpoena**,** (4) preparing, or participating in the process of preparing, any statement, opinion, or other writing that the attorney has reason to believe will be filed with or incorporated into any registration statement, notification, application, report, communication, or other document filed with or submitted to the commissioners, the SEC or its staff; or (5) advising any party that: (i) a statement, opinion or other writing need not or should not be filed with or incorporated into any registration statement, notification, application, report, communication, or other document filed with or submitted to the commissioners, the SEC or its staff; or (ii) the party is not obligated to submit or file any registration statement, notification, application, report, communication, or other document filed with or submitted to the commissioners, the SEC or its staff.

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[12] SEC Release No. 33-8150 (November 21, 2002). The proposed SOB §307 rules would constitute a new Part 205 to 17 CFR, Standards of Professional Conduct for Attorneys Appearing and Practicing before the Commission.

The proposed rules affirmatively state that an attorney representing an issuer represents the issuer as an entity, rather than the officers or others with whom the attorney interacts in the course of that representation, and that the attorney is obligated to act in the best interests of the issuer and its shareholders.

The reporting obligation under the proposed SOB §307 rules would be triggered when an attorney "reasonably believes" (not just "knows") that a material violation has occurred, is occurring or is about to occur. The proposed does not confine an attorney's duty to matters within the scope of the attorney's representation or as to matters as to which the attorney has formed a legal conclusion that there has been a material violation.

The attorney would be initially directed to make this report to the issuer's CLO, or to the issuer's CLO and CEO. The attorney also would be obligated to take reasonable steps under the circumstances to document the report and the response thereto, and to retain such documentation for a reasonable time.

When presented with a report of a possible material violation, the SOB §307 rules would obligate the issuer's CLO to determine whether to conduct an inquiry into the reported material violation to ascertain whether in fact a violation has occurred, is occurring or about to occur. A CLO who reasonably concludes that there has been no material violation would have to provide notice to the reporting attorney of this conclusion, and take reasonable steps to preserve relevant documentary evidence. A CLO who concludes that a material violation has occurred, is occurring or is about to occur would be required to take reasonable steps to ensure that the issuer adopts appropriate remedial measures or sanctions - including appropriate disclosures. Furthermore, the CLO would be required to report "up the ladder" within the issuer what remedial measures have been adopted, and to advise the reporting attorney of his or her conclusions.

The obligation of an attorney who has not received an appropriate response from the issuer differs for in-house attorneys and outside counsel. If outside counsel reasonably believes that the reported material violation is ongoing or is about to occur and is likely to result in substantial injury to the issuer or to investors, he must withdraw from the representation, notify the SEC of his withdrawal (a "*noisy withdrawal*"), and disaffirm any submission to the SEC he has participated in preparing that is tainted by the violation. In-house attorneys who reasonably believe that the reported violation is ongoing or is about to occur and is likely to result in substantial injury to the issuer or to investors need not resign, but must disaffirm any submission to the SEC he has participated in preparing that is tainted by the violation. If either in-house or outside counsel reasonably believes that a material violation has already occurred and has no ongoing effect, he is *permitted, but not required*, to take these steps, as long as he *also* reasonably believes that the reported material violation is likely to have caused substantial injury to the financial interest of the issuer or of investors. Finally, an attorney formerly employed or retained by an issuer who reasonably believes that he was discharged because he complied with the rule's reporting obligations *may,but is not required* to, notify the SEC of his belief he was so discharged and also disaffirm in writing any submission to the SEC that he participated in preparing that is tainted by the violation. Where an attorney files a notification with the SEC as part of a "noisy withdrawal," no violation or waiver of the attorney/client privilege would occur in the SEC's view.

As an alternative process for considering reports of material violations, an issuer may (but is not required to) establish a qualified legal compliance committee ("*QLCC*") comprised of at least one member of the issuer's audit committee, and two or more members of the issuer's board, all of whom must be independent, for the purpose of investigating reports made by attorneys of evidence of a material violation. The QLCC would be authorized to require the issuer to take remedial action. If the issuer were to fail to act as directed by the QLCC, each QLCC member would have the responsibility to notify the SEC. Attorneys who report evidence of a material violation to a QLCC would not be subject to the rule's "noisy withdrawal" requirement.

An attorney would be allowed to use the contemporaneous records he or she creates to defend against charges of attorney misconduct and to reveal confidential information to the SEC to the extent necessary to prevent the commission of an illegal act that he believes will either result in the perpetration of a fraud on the SEC or in substantial injury to the financial or property interests of the issuer or investors.

Finally, the proposed SOB §307 rule would provide that an issuer does not waive any applicable privileges by sharing confidential information regarding misconduct by the issuer's employees or officers with the SEC pursuant to a confidentiality agreement.

TITLE IV: ENHANCED FINANCIAL DISCLOSURES; PROHIBITION ON INSIDER LOANS

Off-Balance Sheet Transactions. The SOB (§401) instructs the SEC to require by rule within 180 days of SOB's enactment (January 26, 2003): (1) Form 10-K and 10-Q disclosure of all material off-balance sheet transactions and relationships with unconsolidated entities that may have a material effect upon the financial status of an issuer; and (2) presentation of pro forma financial information in a manner that is not misleading, and which is reconcilable with the financial condition of the issuer under generally accepted accounting principles. Also under SOB §401, each financial report must "reflect" all material adjustments proposed by the auditors, which we interpret to mean that all material suggested auditor adjustments must be disclosed in the 10-K or 10-Q, either through incorporation into the issuer's financial presentation or in a separate discussion explaining why the adjustment was not made. Pending PCAOB rules on this issue, we suggest considering disclosure of all material suggested auditor adjustments other than those that management agreed with and incorporated into the financials.

On November 5, 2002, the SEC issued a rule proposal "Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments"[13] to require disclosure of off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of an issuer with unconsolidated entities or other persons that have, or may have, a material effect on financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources. The new disclosure would be located in the "Management's Discussion and Analysis of Financial Condition and Results of Operations"

[13] SEC Release No. 33-8144 (November 4, 2002) available at http://www.sec.gov/rules/proposed/33-8144.htm.

("*MD&A*") section in a company's disclosure documents. The proposals would require a registrant to provide, in a separately captioned subsection of MD&A, a comprehensive explanation of its off-balance sheet arrangements. The proposed rule also would require a registrant (other than small business issuers) to provide an overview of its aggregate contractual obligations in a tabular format and contingent liabilities and commitments in either a textual or tabular format.

Prohibition on Loans to Directors or Officers. The SOB (§402) generally prohibits, effective July 30, 2002, a corporation from directly or indirectly making or arranging for personal loans to its directors and executive officers.[14] There are exceptions for the continuation without modification of existing loans and for extensions of credit made in the ordinary course of business by credit card companies on credit cards and brokerage firms on margin accounts, in each case on terms that are no more favorable than those offered to the general public. The SEC to date has not provided guidance as to the interpretation of SOB §402, although a number of interpretative issues have surfaced.

The prohibitions of SOB §402 apply only to an extension of credit "in the form of a personal loan" which suggests that all extensions of credit to a director or officer are not proscribed. While there is no legislative history or statutory definition to guide, it is reasonable to take the position that the following in the ordinary course of business are not proscribed: travel and similar advances, ancillary personal use of company credit card or company car where reimbursement is required; advances of relocation expenses ultimately to be borne by the issuer; stay and retention bonuses subject to reimbursement if the employee leaves prematurely; indemnification advances of expenses pursuant to typical charter, bylaw or contractual indemnification arrangements; and tax indemnification payments to overseas-based officers.[15]

Cashless stock option exercises raise issues in SOB §402 and have led a number of issuers to suspend cashless exercise programs. In a typical cashless exercise program, the optionee delivers the notice of exercise to both the issuer and the broker, and the broker executes the sale of some or all of the underlying stock on that day (T). Then, on or prior to the settlement date (T+3), the broker pays to the issuer the option exercise price and applicable withholding taxes, and the issuer delivers (*i.e.*, issues) the option stock to the broker. The broker transmits the remaining sale proceeds to the optionee. When and how these events occur may determine the level of risk under SOB §402.[16] The real question is whether a broker-administered same-day sale involves "an extension of credit in the

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[14] SOB §402(a) provides: "It shall be unlawful for any issuer (as defined in [SOB §2]), directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer. An extension of credit maintained by the issuer on the date of enactment of this subsection shall not be subject to the provisions of this subsection, provided that there is no material modification to any term of any such extension of credit or any renewal of any such extension of credit on or after that date of enactment."

[15] See outline dated October 15, 2002, authored jointly by a group of 25 law firms and posted at www.TheCorporateCounsel.net as "Sarbanes-Oxley Act: Interpretative Issues Under §402 – Prohibition of Certain Insider Loans."

[16] See *Cashless Exercise and Other SOXmania*, The Corporate Counsel (September-October 2002).

form of a personal loan" made or arranged by the issuer. The nature of the arrangement can affect the analysis.[17]

Accelerated Section 16(a) Reporting. SOB §403 amends Section 16(a) of the 1934 Act, effective August 29, 2002, to require officers, directors and 10% shareholders (collectively, "*insiders*") of companies with securities registered under Section 12 of the 1934 Act to file with the SEC Forms 4 reporting (i) a change in ownership of equity securities or (ii) the purchase or sale of a security based swap agreement involving an equity security "*before the end of the second business day following the business day on which the subject transaction has been executed…*"[18]

On August 27, 2002, the SEC issued a release (the "*16(a) Release*")[19] adopting final amendments to its rules and forms implementing the accelerated filing deadlines described above for transactions subject to Section 16(a). As anticipated, the rule amendments also subject all transactions between officers or directors and the issuer exempted from Section 16(b) short swing profit recovery by Rule 16b-3, which were previously reportable on an annual basis on Form 5 (including stock option grants, cancellations, regrants and repricings), to Section 16(a) and the new two business day reporting requirement on Form 4.

The SEC has enacted two narrow exceptions to the new two business day reporting requirement which apply only if the insider does not select the date of execution of the transaction.[20] These exceptions include (1) transactions pursuant to a contract, instruction or written plan for the purchase or sale of issuer securities that satisfies the affirmative defense conditions of Rule 10b5-1(c) (including, according to the 16(a) Release, transactions pursuant to employee benefit plans and

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17 If the issuer delivers the option stock to the broker before receiving payment, the issuer may be deemed to have loaned the exercise price to the optionee, perhaps making this form of program riskier than others. If the broker advances payment to the issuer prior to T+3, planning to reimburse itself from the sale of proceeds on T+3, that advance may be viewed as an extension of credit by the broker, and the question then becomes whether the issuer "arranged" the credit. The risk of this outcome may be reduced where the issuer does not select the selling broker or set up the cashless exercise program, but instead merely confirms to a broker selected by the optionee that the option is valid and exercisable and that the issuer will deliver the stock upon receipt of the option exercise price and applicable withholding taxes. Even where the insider selects the broker, the broker cannot, under Regulation T, advance the exercise price without first confirming that the issuer will deliver the stock promptly. In that instance, the issuer's involvement is limited to confirming facts, and therefore is less likely to be viewed as "arranging" the credit.

Where both payment and delivery of the option stock occur on the same day (T+3), there arguably is no extension of credit at all, in which case the exercise should not be deemed to violate SOB §402 whether effected through a designated broker or a broker selected by the insider.

If the insider has sufficient collateral in his or her account (apart from the stock underlying the option being exercised) to permit the broker to make a margin loan equal to the exercise price and applicable withholding taxes, arguably the extension of credit is between the broker and the insider, and does not violate SOB §402 assuming the issuer is not involved in arranging the credit.

18 Previously, Forms 4 were required to be filed by the 10th day of the month following the month in which the transaction was executed.

19 SEC Release No. 34-46421 (August 27, 2002).

20 For example, the SEC pointed out in the Release that transactions pursuant to a Rule 10b5-1(c) arrangement which specifies a date for purchases for sales (e.g., the first business day of each month) would not qualify for this exception.

dividend and interest reinvestment plans that are not already exempt from Section 16(a) reporting) and (2) "discretionary transactions" (as defined in Rule 16b-3(b)(1)) involving an employee benefit plan, whether or not exempted by Rule 16b-3. In these cases, the date of execution (triggering the two-day deadline) is deemed to be the earlier of the date the executing broker, dealer or plan administrator notifies the insider of the execution of the transaction or the third business day following the actual trade date of the transaction. Other transactions exempt from Section 16(b) previously reportable on Form 5 will remain reportable on Form 5. These transactions include small acquisitions not from the issuer and gifts.

In order to comply with these accelerated filing requirements, issuers need to create an early notification system which ensures that the issuer is promptly made aware of Section 16(a) transactions by both insiders and administrators of their broad-based employee benefit plans. The SEC expects insiders to make arrangements with executing entities to provide such notification to the insider as quickly as feasible and urges executing entities to provide such information either electronically or by telephone and not rely on mailed confirmations.

Additionally, the SEC's rules now reflect that Form 4 is not a monthly reporting form, but must be filed within two business days of the date of execution of the reported transaction. The SEC indicates that prior to publication of a new Form 4, insiders should use the old form, modifying Box 4 to state the month, date and year of the transaction, and, if applicable, including a footnote to include a deemed execution date in addition to the trade date.

The SEC has indicated that it expects to release rules requiring mandatory electronic filing of Section 16(a) change in ownership reports (but not initial statements of beneficial ownership reports on Form 3), and website posting of such reports by the SEC and issuers, in the next few months, well before the first anniversary of the enactment of the SOB (July 30, 2003). In the meantime, the SEC encourages insiders to file such reports electronically.[21]

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[21] Summarized below are some of the procedures applicable in filing insider trading reports on EDGAR.

A. EDGAR Access Codes

A prerequisite to filing the reports electronically on EDGAR is obtaining a set of EDGAR access codes. This is done by filing with the SEC a Form ID, which is available on the SEC website at http://www.sec.gov/about/forms/formid.pdf. It is very important that a separate Form ID be completed for each insider whose filings will be made via EDGAR. According to representatives in the SEC's Filer Support office, an individual who is an insider for more than one company need only file for one set of EDGAR access codes. It is also important to protect the integrity and security of the data sent by limiting the number of people who know the sender's CCC, password, and PMAC. Likewise, it may be prudent to apply for a certificate for added security purposes. [See the EDGAR Filer Manual for more information on certificates. The latest version of the EDGAR Filer Manual can be downloaded at http://www.sec.gov/info/edgar/filermanual.htm.] One should also take note that the SEC has discontinued the acceptance of requests for access codes for EDGAR on Form ID through the mail. Effective, November 6, 2001, all requests for these codes must come via fax. Fax Form ID to:

US Securities and Exchange Commission
ATTN: Filer Support
(202) 504-2474; or
(703) 916-7624

The SEC will also no longer return a hard copy of the access codes through the mail but will notify the applicant of the codes via telephone call. If a written confirmation of the codes is desired, include either an e-mail address or a fax number on the request.

Four EDGAR access codes will be created after filing the Form ID. One of the codes created is the Central Index Key ("CIK") code. The CIK code uniquely identifies each filer, filing agent, and training agent. The CIK is assigned after the filing of an initial application. This code cannot be changed. Another code that will be created is the CIK Confirmation Code ("CCC"). The CCC is used in the header of filings in conjunction with the CIK to ensure that the filing is authorized . The third code that is created is the password. The password allows a person to log onto the EDGAR system, submit filings, and change the CCC. Finally, holders of access codes will receive a Password Modification Authorization Code ("PMAC"). The PMAC allows a person to change their password.

B. Use of a Filing Service

Once the EDGAR access codes have been obtained and the necessary information for the applicable form has been compiled, an insider may electronically file the form with the assistance of a filing agent such as a printer or law firm. There are several companies that provide electronic filing services, websites for some of these companies include:

http://www.section16.net;

http://www.erestrictedstock.com;

http://www.realcorporatelawyer.com/RRDFilerNet.pdf; and

http://www.bowne.com/financialprint/bowne_file_16.asp

C. Filing By or On Behalf of Insider

If an insider wishes to file on his own behalf or the issuer desires to file on behalf of the insider, [In addition to this memorandum, one will need to refer to Regulation S-T (17.C.F.R. § 232) which sets forth the rules for filing electronically and the EDGAR Filer Manual which describes the procedures and technical formatting requirements of EDGAR.] her or she will need to go to the EDGAR Login page at https://www.edgarfiling.sec.gov and enter the CIK and password and click the Login to EDGAR button. Once EDGAR has been entered, if it has not already been done, Modernized EDGARLink Software should be installed. The filer will need to click on EDGARLink Software located on the EDGAR Welcome page. The EDGARLink Software Download page will appear whereon the filer will need to click on the Download EDGARLink button and follow the instructions.

Once Modernized EDGARLink Software has been downloaded, the filer will need to download the templates for the requested submission types he or she wishes to file. In the EDGAR menu, under the Downloads section, click on Submission Templates. By clicking on Submission Templates, the Submission Template Download Options page is opened. From this page the filer can scroll through the Submission Types list and select a submission by clicking on it. The submission types for Forms 3, 4 and 5 are 3, 4 and 5, respectively. Select the applicable submission type and then click Get it. The Submission Template Download Confirmation page will appear. Click on Download Template 2. The template should be saved before entering any data. One can access the template by double clicking the template from one's Window Explorer window, or the Template Viewer icon on one's desktop.

In order to make an insider report filing via EDGAR, the insider or person filing on behalf of the insider will need to prepare the insider report and save the document in an acceptable format such as ASCII or HTML. [Review the EDGAR Filer Manual for specific technical requirements of ASCII and HTML text.] Each document should be created in separate files. For example, if the filer wishes to create a cover letter for the filing and an insider report on Form 4, the filer should create the cover letter and Form 4 as separate files. The submission document, the document that will be used to transmit the insider report, may be created by clicking on the Template Viewer located on the desktop and then selecting the appropriate template file. The filer may then enter the information in the fields of the Main Page. In order to add the insider report to the submission document, the filer will need to click on the Documents button to go to the Documents page. The filer will then select Add Document, and then select Attach and find the file. Then the filer will select Open and Done. Do this for each document to be added to the submission and save the submission document once all documents

Internal Controls. The SOB (§404) directs the SEC to prescribe rules mandating inclusion of an internal control report and assessment in Form 10-K annual reports. The internal control report is required to (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) contain 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 SOB further requires the public

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have been attached. The submission documents may be reviewed by using the View Document button on the Document page. One may also check and correct errors using the Submission Validation button.

When the submission has been completed and validated, it can then be transmitted. The filer will need to enter the EDGAR website and click on Transmit, which will bring up the Transmit Submission page. Then click on Transmit as a LIVE Submission. The filer will then click on the Browse… button and then double click the submission. When the filer is ready to transmit a LIVE filing, click on the Transmit LIVE Filing button. Once the filer clicks this button, EDGAR will process the submission. The filer may find out the status of the submission through e-mail or by performing a Submission query on the Filing website.

EDGAR accepts direct transmissions of electronic submissions each business day, Monday through Friday, from 8:00 a.m. to 10:00 p.m. Eastern time, excluding Federal holidays. Transmissions started but not completed by 10:00 p.m. Eastern time will be canceled, and will have to be resubmitted on the next business day. If a filer begins direct transmission of a live submission after 5:30 p.m. Eastern time and the submission is accepted, it will have a filing date as of the next business day.

Please take note that an insider must submit a paper copy of his first electronic filing. Send the paper copy to the following address:

Operation Location
ATTN: Filer Support
US Securities and Exchange Commission
Mail Stop 0-7
6432 General Green Way
Alexandria, VA 22312

D. Additional Points to Consider

The following points should also be considered in preparing to file an insider report via EDGAR:

- A person cannot use the company's password for his or her insider trading report. If an insider uses the company's EDGAR password, even if the filing is initially accepted by EDGAR, it will not "count" as being filed by the individual. Further, each individual or company filing on behalf of an individual needs to make sure that it has only one EDGAR password for the individual in advance of any filing.
- Individuals should apply for EDGAR access codes well in advance. Historically it has taken 2 to 3 business days to receive EDGAR access codes, but due to the new two day requirement for Forms 4, it may take longer.
- If an insider wishes to file on his own behalf or the issuer desires to file on behalf of the insider without the aid of a filing service, it is recommended that the applicable persons prepare the submissions well in advance of the filing and utilize the Submission Validation features on EDGARLink.
- When a person prepares an ASCII document for submission, he or she must limit line width to 80 characters for text and 132 for tabular material (between tab tags).
- Keep a manually signed signature page (or equivalent document) on file for five years.
- Make a backup copy of the SEC-provided EDGAR Installation software downloaded from the Internet in case it needs to be re-loaded on the system.
- Filer Support Staff are available each business day from 8:00 a.m. to 7:00 p.m., Eastern time. They can be reached at (202) 942-8900.

accounting firm that issues the audit report to attest to, and report on, the assessment made by corporate management on internal controls. On October 22, 2002 the SEC proposed rules[22] regarding internal control reports to implement SOB §404[23] that would require reporting companies to include in Form 10-K an internal control report of management that includes:

- A statement of management's responsibilities for establishing and maintaining adequate internal controls and procedures for financial reporting;

- Conclusions about the effectiveness of the issuer's internal controls and procedures for financial reporting based on management's evaluation of those controls and procedures in accordance with 1934 Act Rules 13a-15 or 15d-15, as of the end of the issuer's most recent fiscal year; and

- A statement that the registered public accounting firm that prepared or issued the issuer's audit report relating to the financial statements included in the company's annual report has attested to, and reported on, management's evaluation of the company's internal controls and procedures for financial reporting.

Additionally, the proposed rules would require the referenced attestation by the issuer's registered independent public accounting firm to be filed as an exhibit to Form 10-K.

The SEC's proposed rules to implement the internal control report requirements included in SOB §404 also includes several conforming revisions to the SEC's recently adopted certification rules and related requirements.

The proposed rules would define "internal controls and procedures for financial reporting" as controls that pertain to the preparation of financial statements for external purposes that are fairly presented in conformity with generally accepted accounting principles as addressed by the Codification of Statements on Auditing Standards §319 or any superseding definition or other literature that is issued or adopted by the PCAOB.

The proposed reporting as to internal controls, if adopted, would not take effect until the PCAOB adopts standards for attestations by auditors and, therefore, is proposed to apply only to fiscal years that end on or after September 15, 2003.

Codes of Ethics. The SOB (§406) directs the SEC to issue rules requiring a code of ethics[24] for senior financial officers of an issuer applicable to the CFO, comptroller or principal accounting

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22 SEC Release No. 34-46701 (October 22, 2002).

23 SOB §404 requires the SEC to adopt rules requiring a company's management to present an internal control report in the company's annual report containing: (1) a statement of the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) an assessment, as of the end of the company's most recent fiscal year, of the effectiveness of the company's internal control structure and procedures for financial reporting. SOB §404 also requires the company's registered public accounting firm to attest to, and report on, management's assessment. The SOB §404 requirements are not applicable until the SEC's implementing rules are adopted.

24 A "code of ethics" is expected to contain such standards as are reasonably necessary to promote—

officer and to require the immediate disclosure on its Form 8-K of any change in or waiver of the code of ethics for senior financial officers.

Code of Ethics Disclosures. On October 22, 2002, the SEC proposed[25] rules to implement SOB §406[26] that would require reporting companies to disclose on Form 10-K:

- Whether the issuer has adopted a written code of ethics that applies to the issuer's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions; and

- If the issuer has not adopted such a code of ethics, the reasons it has not done so.[27]

In the proposed SOB §406 rules, "code of ethics" would mean a codification of standards that reasonably designed to deter wrongdoing and to promote:

- Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;

- Avoidance of conflicts of interest, including disclosure to an appropriate person or persons identified in the code of any material transaction or relationship that reasonably could be expected to give rise to such a conflict;

- Full, fair, accurate, timely, and understandable disclosure in reports and documents that a company files with, or submits to, the SEC and in other public communications made by the company;

- Compliance with applicable governmental laws, rules and regulations;

- The prompt internal reporting to an appropriate person or persons identified in the code of violations of the code;[28] and

- Accountability for adherence to the code.[29]

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(1) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;

(2) full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed by the issuer; and

(3) compliance with governmental regulations.

25 SEC Release No. 34-46701 (October 22, 2002).

26 The SOB §406 requirements are not applicable until the SEC's implementing rules are adopted.

27 Proposed Regulation S-K Item 406.

28 The company would retain discretion to choose the person to receive reports of code violations, but Release No. 34-46701 (October 22, 2002) suggests the person should have sufficient status within the company to engender respect for the code and authority to adequately deal with the persons subject to the code regardless of their stature within the company.

The proposed SEC rules indicate that in addition to providing the required disclosure, an issuer would be required to file a copy of its ethics code as an exhibit to its Form 10-K.

Proposed Form 8-K or Internet Disclosure Regarding Changes to, or Waivers From, the Code of Ethics. The proposed SOB code of ethics rules would add an item to the list of Form 8-K triggering events to require disclosure of:

- A change to an issuer's code of ethics that applies to the specified officers; or
- Waiver of application of the ethics code provision to a specified officer.

The issuer would be required to file the Form 8-K within two business days after it made the change or granted the waiver. As an alternative to filing a Form 8-K, the proposed rules would permit an issuer to use its website a means of disseminating this disclosure if the issuer has disclosed in its most recently filed Form 10-K:

- That it intends to disclose these events on its Internet website; and
- Its Internet website address.

Audit Committee Financial Experts. The SOB (§407) requires the SEC to promulgate rules no later than 180 days after enactment of SOB (January 26, 2003) mandating reporting company disclosure regarding whether (and, if not, why not) its audit committee comprises at least one member who is a "financial expert." On October 22, 2002, the SEC proposed[30] rules regarding audit committee financial experts to implement SOB §407[31] and would require reporting companies to disclose in Form 10-K:[32]

- The number and names of persons that the board of directors has determined to be "financial experts" serving on the issuer's audit committee;[33] and, if there is no financial expert serving on the audit committee, that fact and why it has no financial expert; and

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29 Instructions to Proposed Regulation SK Item 406.

30 SEC Release No. 34-46701 (October 22, 2002). Comments with respect to the proposed rules must be received by the SEC within 30 days of publication of the proposed rules in the Federal Register.

31 SOB §407 requires the SEC to adopt rules: (1) requiring a reporting company to disclose whether its audit committee includes at least one member who is a "financial expert"; and (2) defining the term "financial expert." The SOB §407 requirements are not applicable until the SEC's implementing rules are adopted.

32 The proposed rules discussed in this memorandum relating to annual reports of reporting companies on Form 10-K also contain similar provisions applicable to annual reports of small business reporting companies on Form 10-KSB. The Release also proposed rules with similar requirements for investment companies.

33 Section 3(a)(58) of the 1934 Act, as amended by SOB §205, defines the term "audit committee" as "a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and . . . if no such committee exists with respect to an issuer, the entire board of directors of the issuer."

- Whether the financial expert or experts are "independent,"[34] and if not, an explanation of why they are not.[35]

The SEC intends in the future to propose rules directing the national securities exchanges and NASDAQ to require that reporting companies have a completely independent audit committee as a condition to listing.

The proposed rules under SOB §407 define the term "financial expert" to mean a person who, through education and experience as a public accountant or auditor or a principal financial officer, controller, or principal accounting officer of a company that, at the time the person held such position, was a reporting company, or experience in one or more positions that involve the performance of similar functions (or that results, in the judgment of the issuer's board of directors, in the person's having similar expertise and experience), has the following attributes:

- An understanding of generally accepted accounting principles and financial statements;

- Experience applying such generally accepted accounting principles in connection with the accounting for estimates, accruals, and reserves that are generally comparable to the estimates, accruals and reserves, if any, used in the issuer's financial statements;

- Experience preparing or auditing financial statements that present accounting issues that are generally comparable to those raised by the issuer's financial statements;

- Experience with internal controls and procedures for financial reporting; and

- An understanding of audit committee functions.

To be a financial expert, an individual must possess all of the five specified attributes, and exposure to the rigors of preparing or auditing financial statements of a reporting company is important. The board of directors, however, can conclude that an individual possesses the required attributes without having the specified experience. If the board of directors makes such a determination on the basis of alternative experience, the company must disclose the basis for the

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[34] SOB §301 added a new § 10A(m)(3) to the 1934 Act providing as follows with respect to audit committee independence:

"(3) INDEPENDENCE.—

"(A) IN GENERAL.—Each member of the audit committee of the issuer shall be a member of the board of directors of the issuer, and shall otherwise be independent.

"(B) CRITERIA.—In order to be considered to be independent for purposes of this paragraph, a member of an audit committee of an issuer may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee—

"(i) accept any consulting advisory, or other compensatory fee from the issuer; or

"(ii) be an affiliated person of the issuer or any subsidiary thereof.

[35] Proposed Regulation S-K Item 309.

board's determination. While no such disclosure is required where the individual has the specified experience, disclosure would be appropriate in cases where there is any question. In any event, the board should maintain adequate minutes or other records showing the basis for its judgments.

In determining whether a potential financial expert has all of the requisite attributes, the board of directors of an issuer should evaluate the totality of an individual's education and experience. The board would be encouraged to consider a variety of factors in making its evaluation, including:

- The level of the person's accounting or financial education, including whether the person has earned an advanced degree in finance or accounting;
- Whether the person is a certified public accountant, or the equivalent, in good standing, and the length of time that the person has actively practiced as a certified public accountant, or the equivalent;
- Whether the person is certified or otherwise identified as having accounting or financial experience by a recognized private body that establishes and administers standards in respect of such expertise, whether the person is in good standing with the recognized private body, and the length of time that the person has been actively certified or identified as having such expertise;
- Whether the person has served as a principal financial officer, controller or principal accounting officer of a company that, at the time the person held such position, was required to file periodic reports pursuant to the 1934 Act and, if so, the length of any such service;
- The person's specific duties while serving as a public accountant, auditor, principal financial officer, controller, principal accounting officer or position involving the performance of similar functions;
- The person's level of familiarity and experience with all applicable laws and regulations regarding the preparation of financial statements required to be included in periodic reports filed under the 1934 Act;
- The level and amount of the person's direct experience reviewing, preparing, auditing or analyzing financial statements required to be included in periodic reports filed under the 1934 Act;
- The person's past or current membership on one or more audit committees of companies that, at the time the person held such membership, were required to file reports pursuant to the 1934 Act;
- The person's level of familiarity and experience with the use and analysis of financial statements of public companies; and

- Whether the person has any other relevant qualifications or experience that would assist him or her in understanding and evaluating the issuer's financial statements and other financial information and in making knowledgeable and thorough inquiries whether:

  -- The financial statements fairly present the financial condition, results of operations and cash flows of the company in accordance with generally accepted accounting principles; and

  -- The financial statements and other financial information, taken together, fairly present the financial condition, results of operations and cash flows of the company.

The fact that a person previously has served on the company's audit committee would not, by itself, justify the board of directors in "grandfathering" that person as a financial expert under the proposed rules.

The proposed attributes of a "financial expert" described above are more detailed and rigorous than those reflected in the current NYSE, NASDAQ, AMEX, PCX and other self-regulatory organization rules. Therefore, it is possible that a person who previously qualified as a financial expert under the current guidelines included in the rules of self-regulatory organizations may not have sufficient expertise to be considered a financial expert under these proposed rules. If the proposed rules are adopted, it will be important for reporting companies to re-evaluate whether an audit committee member who has the requisite level of financial expertise for purposes of the self-regulatory organizations also qualifies as a financial expert under the SEC rules.

As to the role of a financial expert on an audit committee and the effect on the liability of an individual designated as a financial expert and other members of the audit committee and the board of directors, the SEC has commented:

> The primary benefit of having a financial expert serving on a company's audit committee is that the person, with his or her enhanced level of financial sophistication or expertise, can serve as a resource for the audit committee as a whole in carrying out its functions. The mere designation of the financial expert should not impose a higher degree of individual responsibility or obligation on a member of the audit committee. Nor do we intend for the financial expert designation to decrease the duties and obligations of other audit committee members or the board of directors. Furthermore, in order to avoid any confusion in the context of Section 11 of the Securities Act, we do not intend for such a person to be considered an expert for purposes of Section 11 solely as a result of his or her designation as a financial expert on the audit committee. The role of the financial expert is to assist the audit committee in overseeing the audit process, not to audit the company. A conclusion that a financial expert is an "expert" for purposes of Section 11 might suggest a

higher level of due diligence than is consistent with the audit committee's oversight responsibilities.[36]

Systematic SEC Review of 1934 Act Filings. The SOB (§408) requires the SEC to review disclosures made by listed companies on a regular and systematic basis and in no event shall a public company be reviewed less frequently than once every three years. In scheduling the required reviews, the SEC is expected to focus upon:

(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 capitalization;

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

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

Accelerated Disclosure in Plain English. The 1934 Act is amended by SOB §409 to require reporting companies to "disclose to the public on a rapid and current basis such additional information concerning material changes in the financial condition or operations of the issuer, **in plain English**, which may include trend and qualitative information and graphic presentations," as the SEC may by rule prescribe.

Although no particular effective date was established for the SEC to issue these rules, this is a *major shift* from the prior law, which allowed issuers flexibility in disclosing material information to the public, as long as insiders were not trading in issuer securities and the issuer was not otherwise filing a report with the SEC that would be misleading without the additional information. It puts significant pressure on issuers to evaluate, almost on a daily basis, whether it should make a disclosure of a material event.

TITLE V: ANALYST CONFLICTS OF INTEREST

The SOB requires the SEC to adopt rules governing securities analysts' potential conflicts of interest, including: (1) restricting the prepublication clearance or approval of research reports by persons either engaged in investment banking activities, or not directly responsible for investment research; (2) limiting the supervision and compensatory evaluation of securities analysts to officials who are not engaged in investment banking activities; (3) prohibiting a broker or dealer involved with investment banking activities from retaliating against a securities analyst as a result of an unfavorable research report that may adversely affect the investment banking relationship of the broker or dealer with the subject of the research report; and (4) establishing safeguards to assure that securities analysts are separated within the investment firm from the review, pressure, or oversight of

[36] SEC Release No. 34-46701 (October 22, 2002).

those whose involvement in investment banking activities might potentially bias their judgment or supervision.

TITLE VI: SEC RESOURCES AND AUTHORITY

The SOB increases the SEC's budget (§601). It also grants the SEC censure authority in connection with appearance and practice before the SEC (§602) of any person the SEC finds to be unqualified, to be lacking in integrity or to have engaged in improper professional conduct or to have willfully violated, or willfully aided and abetted, any violation of securities laws.

TITLE VII: STUDIES AND REPORTS

The SOB mandates various studies and reports to Congress regarding the consolidation of public accounting firms and the role and function of credit rating agencies.

The SEC is required to do four studies and the Comptroller General to do three. The SEC is to report on (i) the role and function of credit rating agencies in the securities markets, including how well they are doing their job, (ii) all enforcement actions over the last 5 years involving violations of reporting requirements and financial statement restatements, to identify the areas most susceptible to fraud, (iii) the number of securities professionals practicing before the SEC who have been found to be primary violators and also secondary aiders and abettors who have not been sanctioned, and what their violations were (all of which are due by January 26, 2003), and lastly (iv) a study of issuer filings to determine the extent of off-balance sheet transactions and use of special purpose entities (*"SPE's"*) and whether GAAP results in financials statements of those issuers reflecting the off-balance sheet financing transactions in a transparent fashion. The report on SPE's and off-balance sheet financing is due by July 31, 2004.

The Comptroller General's three studies, all due by January 26, 2003, are on (i) the effect of requiring the mandatory rotation of registered public accounting firms, (ii) the consolidation of public accounting firms and its effect on the securities markets, and (iii) whether banks and financial advisors assisted public companies in earnings manipulation and financial statement misstatement and opaqueness.

TITLE VIII: CORPORATE AND CRIMINAL FRAUD ACCOUNTABILITY

Records Retention. Title VIII of the SOB is entitled the "Corporate and Criminal Fraud Accountability Act of 2002" and amends Federal criminal law to prohibit: (1) knowingly destroying, altering, concealing, or falsifying records with the intent to obstruct or influence an investigation in a matter in Federal jurisdiction or in bankruptcy (this offense is punishable by up to 20 years in prison); and (2) auditor failure to maintain for a five-year period all audit or review work papers pertaining to an issuer of securities. The SEC is directed to promulgate regulations regarding the retention of audit records containing conclusions, opinions, analyses, or financial data.

The SEC has proposed rules that would add Section 210.2-06 to Regulation S-X (under "Qualifications and Reports of Accountants"),[37] that would require accountants who review or audit an issuer's financial statements to retain, for five years after the end of the fiscal period in which an accountant audits or reviews an issuer's financial statements, workpapers and other documents that form the basis of the audit or review of an issuer's financial statements, and memoranda, correspondence, communications, other documents, and records (including electronic records) that (1) are created, sent or received in connection with the audit or review, and (2) contain conclusions, opinions, analyses, or financial data related to the audit or review. Non-substantive materials that are not part of the workpapers and other documents that do not contain relevant financial data or the auditor's conclusions, opinions or analyses would not meet the second of these criteria and would not have to be retained.

Note that the PCAOB is directed in SOB §103 to require auditors to retain for a period of seven years workpapers to support the auditor's conclusions. Many documents may be subject to both retention requirements, though this five-year retention requirement applies to a broader range of documents that does not necessarily just support conclusions. "Workpapers" means "documentation of auditing or review procedures applied, evidence obtained, and conclusions reached by the accountant in the audit or review engagement, as required by standards established or adopted by the SEC or the PCAOB." The materials retained under paragraph are not only those that support an auditor's conclusions about the financial statements but also those materials that may "cast doubt" on those conclusions. This requirement is intended to ensure the preservation of those records that reflect differing professional judgments and views (both within the accounting firm and between the firm and the issuer) and how those differences were resolved.

Non-dischargeable Fraud Judgments. The SOB (§803) amends Federal bankruptcy law to make non-dischargeable bankruptcy judgments and settlement agreements that result from a violation of Federal or State securities law or common law fraud pertaining to securities sales or purchases.

Extension of Statute of Limitation for Securities Fraud Claims. The SOB (§804) amends the Federal judicial code to permit a private right of action for a securities fraud claim to be brought not later than the earlier of: (1) five years after the date of the alleged violation or (2) two years after its discovery.

Sentencing Guidelines. The SOB (§805) directs the United States Sentencing Commission to review and amend Federal sentencing guidelines to ensure that the offense levels, existing enhancements or offense characteristics are sufficient to deter and punish violations involving: (1) obstruction of justice; (2) record destruction; (3) fraud when the number of victims adversely involved is significantly greater than 50 or when it endangers the solvency or financial security of a substantial number of victims; and (4) organizational criminal misconduct.

Whistleblower Protection. The SOB (§806) prohibits a publicly traded company from discharging or otherwise discriminating against an employee because of any lawful act by the

[37] SEC. Rel. No. 34-46869 (November 21, 2002).

employee to: (1) assist in an investigation of prohibited conduct by Federal regulators, Congress, or supervisors; or (2) file or participate in a proceeding relating to fraud against shareholders. Remedies for such aggrieved employee include reinstatement, back pay, and compensatory damages.

Enhanced Fraud Penalties. The SOB (§807) subjects to a fine and imprisonment up to 25 years any person who defrauds shareholders of publicly traded companies.

TITLE IX: WHITE-COLLAR CRIME PENALTY ENHANCEMENTS

Title IX of the SOB is called the "White-Collar Crime Penalty Enhancement Act of 2002." The SOB (§902) amends Federal criminal law to provide that conspiracy to commit an offense is subject to the same penalties as the offense and increase criminal penalties for mail and wire fraud from 5 years to 20 years.

The SOB (§905) directs the United States Sentencing Commission to review Federal Sentencing Guidelines to: (1) ensure that they reflect the serious nature of the offenses and the penalties set forth in the SOB, the growing incidence of serious fraud offenses, and the need to deter and punish such offenses; and (2) consider whether a specific offense characteristic should be added in order to provide stronger penalties for fraud committed by a corporate officer or director.

The SOB (§906) amends Federal criminal law to require the CEO and CFO to certify in writing that financial statements and the disclosures therein fairly present in all material aspects the operations and financial condition of the issuer.[38] It provides that the criminal penalties are (1) 20 years in prison for willful violation; and (2) 10 years for reckless and knowing violation.

TITLE X: CORPORATE TAX RETURNS

The SOB expresses the sense of the Senate that the Federal income tax return of a corporation should be signed by the chief executive officer of such corporation. This is not required by the Internal Revenue Code, and the effect of this provision by itself without any penalty provision is advisory only.

TITLE XI: CORPORATE FRAUD ACCOUNTABILITY

Title XI of the SOB is entitled the "Corporate Fraud Accountability Act of 2002" and provides in §1102 for up to 20 years in prison for altering, destroying or concealing anything with the intent to impair its use in any official proceeding or any attempt to do so. The SOB (§1103) also authorizes the SEC to seek a temporary injunction to freeze extraordinary payments earmarked for designated persons or corporate staff under investigation for possible violations of Federal securities laws.

[38] See CEO/CFO Certifications under Title III: Corporate Responsibility above regarding the certifications mandated by SOB §§302 and 906.