EFFECT OF SARBANES-OXLEY ON M&A TRANSACTIONS

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TABLE OF CONTENTS

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On July 30, 2002, President Bush signed the Sarbanes-Oxley Act of 2002 (H.R. 3763) (*"SOX"*) 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 bill" trumpeted by the politicians and in the media.[1] Among other things, SOX amends the Securities Exchange Act of 1934 (the *"1934 Act"*) and the Securities Act of 1933 (the *"1933 Act"*).

Although SOX does have some specific provisions, and generally establishes some important public policy changes, it is being implemented in large part through rules adopted and to be adopted by the Securities and Exchange Commission (*"SEC"*). As is always the case with broad grants of authority to a regulatory body, the rules contain some surprises, some of which may not be appreciated initially. Furthermore, the SEC is taking the opportunity through further rulemaking under SOX, as well as taking action on corporate governance proposals of the stock exchanges, to delve much farther into corporate governance than it has in the past.[2] Adaptation to SOX is proving costly both domestically and internationally.[3]

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1 Patricia Wilson, *Bush Signs Tough New Corporate Fraud Bill*, MONTERY HERALD, July 30, 2002, *available at* http://www.mercurynews.com/mld/montereyherald/business/financial_markets/3762106.htm?1C.

2 On November 24, 2003, the SEC adopted new proxy statement rules requiring expanded disclosure of companies' director nomination processes and specific disclosure of procedures by which shareholders may communicate with directors. Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors, Securities Act Release No. 8340, Exchange Act Release No. 48,825, 68 Fed. Reg. 66,992 (Nov. 28, 2003), *available at* http://www.sec.gov/rules/final/33-8340.htm. These rules followed the July 15, 2003, release of an SEC Staff report recommending a number of proxy rules changes, including recommendations about these proposed proxy statement rules and rules to be proposed that would provide, under certain circumstances, direct shareholder access to the company's proxy materials in connection with the nomination of directors. SEC Staff Report: Review of the Proxy Process Regarding the Nomination and Election of Directors, SEC Division of Corporation Finance, July 15, 2003, *available at* http://www.sec.gov/news/studies/proxyreport.pdf. A rule proposal was also made at the time. Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors, Exchange Act Release No. 48,301, 68 Fed. Reg. 48,724 (proposed Aug. 14, 2003), *available at*

I.
SUMMARY

To What Companies Does SOX Apply. SOX 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*" or "*issuers*"). Some of the SOX provisions apply only to companies listed on a national securities exchange[4] ("*listed companies*"), such as the New York Stock Exchange ("*NYSE*") or the NASDAQ Stock Market ("*NASDAQ*")[5] (the national securities exchanges and NASDAQ are referred to collectively as "*SROs*"), but not to companies traded on the NASD Over The Counter Bulletin Board or quoted in the Pink Sheets or the Yellow Sheets.[6] Small business issuers that file reports on Form 10-QSB and Form 10-KSB are subject to SOX 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).[7]

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http://www.sec.gov/rules/proposed/34-48301.htm. *See* Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporation Law Impacts of the Enron Debacle*, 57 Bus. Lawyer 1371 (Aug. 2002).

3 Disclosure and compliance budgets for publicly traded companies are increasing by 90% or more across the board, with the biggest cost increase being for accounting (105% before internal controls work). See James Morrow, *Costly Compliance*, CHIEF LEGAL EXECUTIVE, Spring 2003, at 58.

4 17 CFR § 240.6a (2004). A "national securities exchange" is an exchange registered as such under 1934 Act §6. There are currently nine national securities exchanges registered under 1934 Act §6(a): the American Stock Exchange (AMEX), the Boston Stock Exchange, the Chicago Board Options Exchange (CBOE), the Chicago Stock Exchange, the Cincinnati Stock Exchange, the International Stock Exchange, the New York Stock Exchange (NYSE), the Philadelphia Stock Exchange, and the Pacific Stock Exchange.

5 17 CFR § 240.15A (2004). A "national securities association" is an association of brokers and dealers registered as such under 1934 Act §15A. The National Association of Securities Dealers ("*NASD*") is the only national securities association registered with the SEC under 1934 Act §15A(a). The NASD partially owns and operates the NASDAQ Stock Market ("*NASDAQ*"), which has filed an application with the SEC to register as a national securities exchange.

6 The OTC Bulletin Board, the Pink Sheets, and the Yellow Sheets are quotation systems that do not provide issuers with the ability to list their securities. Each is a quotation medium that collects and distributes market maker quotes to subscribers. These interdealer quotations systems do not maintain or impose listing standards, nor do they have a listing agreement or arrangement with the issuers whose securities are quoted through them. Although market makers may be required to review and maintain specified information about the issuer and to furnish that information to the interdealer quotation system, the issuers whose securities are quoted on the systems do not have any filing or reporting requirements to the system. *See* Standards Relating to Listed Company Audit Committees, Securities Act Release No. 8220, Exchange Act Release No. 47,654, 68 Fed. Reg. 18,788 (April 16, 2003), *available at* www.sec.gov/rules/final/33-8220.htm [hereinafter the "*SOX § 301 Release*"].

7 17 CFR § 240.0-10(a) (2004). "*Small business issuer*" is defined in 1934 Act Rule 0-10(a) as an issuer (other than an investment company) that had total assets of $5 million or less on the last day of its most recent fiscal year, except that for the purposes of determining eligibility to use Forms 10-KSB and 10-QSB that term is defined in the 1934 Act Rule as a United States ("*U.S.*") or Canadian issuer with neither annual revenues nor "public float" (aggregate market value of its outstanding voting and non-voting common equity held by non-affiliates) of $25,000,000 or more. Some of the rules adopted under SOX apply more quickly to larger companies that are defined as "accelerated filers" under 1934 Act Rule 12b-2 (generally issuers with a public

SOX and the SEC's rules thereunder are applicable in many, but not all, respects to (i) investment companies registered under the Investment Company Act of 1940 (the "*1940 Act*") and (ii) public companies domiciled outside of the U.S. ("*foreign companies*").[8]

Companies that file periodic reports with the SEC solely to comply with covenants under debt instruments, to facilitate sales of securities under Rule 144, or for other corporate purposes ("*voluntary filers*"), rather than pursuant to statutory or regulatory requirements to make such filings, are not issuers and generally are not required to comply with most of the corporate governance provisions of SOX.[9] The SEC's rules and forms implementing SOX that require disclosure in periodic reports filed with the SEC apply to voluntary filers by virtue of the fact that voluntary filers are contractually required to file periodic reports in the form prescribed by the rules and regulations of the SEC.[10] The SEC appears to be making a distinction in its rules between governance requirements under the Act (which tend to apply only to statutory "issuers") and disclosure requirements (which tend to apply to all companies filing reports under the 1934 Act).

While SOX is generally applicable only to public companies, there are three important exceptions: (i) SOX Sections 802 and 1102 make it a crime for any person to alter, destroy, mutilate or conceal a record or document so as to (x) impede, obstruct or influence an investigation or (y) impair the object's integrity or availability for use in an official proceeding; (ii) SOX Section 1107 makes it a crime to knowingly, with the intent to retaliate, take any action harmful to a person for providing to a law enforcement officer truthful information relating to the commission of any federal offense; and (iii) SOX Section 904 raises the criminal monetary penalties for violation of the reporting and disclosure requirements of the Employee Retirement Income Security Act of 1974 ("*ERISA*"). These three provisions are applicable to private and nonprofit entities as well as public companies.

Further, the principles of SOX are being applied by the marketplace to privately held companies and nonprofit entities. Private companies that contemplate going public, seeking financing from investors whose exit strategy is a public offering or being acquired by a public

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common equity float of $75 million or more as of the last business day of the issuer's most recently completed second fiscal quarter that have been reporting companies for at least 12 months).

8 17 CFR § 240.3b-4 (2004). Many of the SEC rules promulgated under SOX's directives provide limited relief from some SOX provisions for the "*foreign private issuer*," which is defined in 1934 Act Rule 3b-4(c) as a private corporation or other organization incorporated outside of the U.S., as long as:

- More than 50% of the issuer's outstanding voting securities are not directly or indirectly held of record by U.S. residents;
- The majority of the executive officers or directors are not U.S. citizens or residents;
- More than 50% of the issuer's assets are not located in the U.S.; and;
- The issuer's business is not administered principally in the U.S.

See infra Section XIII.

9 *See* Question 1, Division of Corporation Finance: Sarbanes-Oxley Act of 2002 – Frequently Asked Questions (revised November 14, 2002), *at* http://www.sec.gov/divisions/corpfin/faqs/soxact2002.htm.

10 *Id.*

company, may find it advantageous or necessary to conduct their affairs as if they were subject to SOX.[11]

Accounting Firm Regulation. SOX creates a five-member board appointed by the SEC called the Public Company Accounting Oversight Board (the *"PCAOB"*) to oversee the accounting firms that serve public companies and to establish accounting standards and rules.[12] SOX does not address the accounting for stock options, but the PCAOB would have the power to do so. The PCAOB is a private, non-profit corporation to be funded by assessing public companies based on their market capitalization.[13] It has the authority to subpoena documents from public companies.[14] The PCAOB is required to notify the SEC of any pending PCAOB investigations involving potential violations of the securities laws.[15] Additionally, SOX provides that the PCAOB should coordinate its efforts with the SEC's enforcement division as necessary to protect ongoing SEC investigations.[16]

Restrictions on Providing Non-Audit Services to Audit Clients. SOX and the SEC rules thereunder restrict the services accounting firms may offer to clients.[17] Among the services that audit firms may 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; (8) legal services; and (9) expert services unrelated to the audit.[18] Accounting firms may generally provide tax services to their audit clients, but may not represent them in tax litigation.[19]

Enhanced Audit Committee Requirements/Responsibilities. SOX provides, and the SEC has adopted rules such that, audit committees[20] of listed companies (i) must have direct

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11 *See infra* Section XIV.

12 *See infra* Section II.

13 *Id.*

14 *Id.*

15 *Id.*

16 SOX § 105, 15 U.S.C.A. § 7215 (West Supp. 2004) [hereinafter "*SOX § 105*"].

17 *See infra* "Prohibited Non-Audit Services" in Section III.

18 *Id.*

19 *See* Fay Hansen, *Separating Audit and Tax*, Business Finance, May 2003, at 35, *available at* http://www.businessfinancemag.com/magazine/archives/article.html?articleID=13963.

20 SOX § 2(a)(3), 15 U.S.C.A. § 7201 (West Supp. 2004). SOX § 205 amended the 1934 Act § 3(a)(58) and included this definition of an audit committee within that act. *See* 15 U.S.C.A. § 78c(a)(58) (West Supp. 2004). The provision reads:

> (58) *Audit Committee*. The term "audit committee" means—
>
> (A) 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
>
> (B) If no such committee exists with respect to an issuer, the entire board of directors of the issuer.

responsibility for the appointment, compensation, and oversight (including the resolution of disagreements between management and the auditors regarding financial reporting) of the auditors; (ii) must be composed solely of 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, accept any consulting, advisory, or other compensation from the issuer, directly or indirectly, or be an officer or other affiliate of the issuer; and (iii) must be 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 questionable accounting or auditing matters.[21] Whistleblowers are protected against discharge or discrimination by an issuer.[22]

Issuers are required to disclose (i) the members of the audit committee and (ii) whether the audit committee has an "*audit committee financial expert*" and, if so, his or her name.[23]

SOX requires that auditors report 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 for financial reporting in the U.S. ("*GAAP*") that have been discussed with management.[24]

SOX requires audit committee pre-approval of all auditing services and non-audit services provided by an issuer's auditor.[25] The audit committee may delegate the pre-approval responsibility to a subcommittee of one or more independent directors.

CEO/CFO Certifications. SOX 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.[26] The result is that CEOs and CFOs must each sign two separate certifications in their companies' periodic reports, one certificate being required by rules adopted by the SEC under an amendment to the 1934 Act (the "*SOX §302 Certification*") and the other being required by an amendment to the Federal criminal code (the "*SOX §906 Certification*").[27] Chairpersons of boards of directors who are not executive officers are not required to certify the reports.

Improperly Influencing Auditors. Pursuant to SOX, the SEC has adopted a rule that specifically prohibits officers and directors and "persons acting under [their] direction" (which would include attorneys), from coercing, manipulating, misleading, or fraudulently influencing an auditor "engaged in the performance of an audit" of the issuer's financial statements when the

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21 *See infra* "Audit Committees" in Section IV.

22 *See infra* "Whistleblower Protection" in Section IX.

23 *See infra* "Audit Committee Financial Experts" in Section V.

24 *See infra* "Auditor Reports to Audit Committees" in Section III.

25 *See infra* "Audit Committee Pre-Approval of All Audit and Non-Audit Services" in Section III.

26 *See infra* "CEO/CFO Certifications" in Section IV.

27 *Id.*

officer, director, or other person "knew or should have known" that the action, if successful, could result in rendering the issuer's financial statements filed with the SEC materially misleading.[28]

Enhanced Attorney Responsibilities. The SEC has adopted under SOX 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 any U.S. law or fiduciary duty to the chief legal officer (*"CLO"*) or the CEO of the company and (2) if corporate executives do not respond appropriately, requiring the attorney to report to an appropriate committee of independent directors or to the board of directors.[29]

CEO/CFO Reimbursement to Issuer. SOX 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.[30]

Insider Trading Freeze During Plan Blackout. Company executives and directors are restricted from trading stock during periods when employees cannot trade retirement fund-held company stock (*"blackout periods"*).[31] These insiders are 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.[32]

Insider Loans. SOX prohibits issuers from making loans to their directors or executive officers.[33] There are exceptions for existing loans, for credit card companies to extend credit on credit cards issued by them, for securities firms to maintain margin account balances, and for certain regulated loans by banks.[34]

Disclosure Enhancements. 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.[35] SEC rulemaking is defining the specific requirements of the enhanced reporting.

SOX instructs the SEC to require by rule: (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

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28 *See infra* "Misleading Statements to Auditors" in Section IV.

29 *See infra* "Enhanced Attorney Responsibilities" in Section IV.

30 *See infra* "CEO/CFO Reimbursement to Issuer" in Section IV.

31 *See infra* "Insider Trading Freeze During Plan Blackout" in Section IV.

32 *Id.*

33 *See infra* "Prohibition on Loans to Directors or Officers" in Section V.

34 *Id.*

35 *See infra* "Accelerated Disclosure in Plain English" in Section V.

a manner that is not misleading and which is reconcilable with the financial condition of the issuer under generally accepted accounting principles ("*GAAP*").[36] The SEC has adopted rule changes under SOX designed to address reporting companies' use of "non-GAAP financial measures" in various situations, including (i) Regulation G which applies whenever a reporting company publicly discloses or releases material information that includes a non-GAAP financial measure and (ii) amendments to Item 10 of Regulation S-K to include a statement concerning the use of non-GAAP financial measures in filings with the SEC.[37]

Effective August 23, 2004, the SEC has adopted amendments to Form 8-K, which require disclosure of additional items for all public companies.[38] In addition to the new disclosure items, many of the old disclosure items were reworked. New Item 2.02 incorporates the substantive disclosures previously required by Item 12, "Results of Operations and Financial Condition." Item 2.02 requires issuers to furnish to the SEC all releases or announcements disclosing material non-public financial information about completed annual or quarterly periods.[39]

SOX amends Section 16(a) of the 1934 Act to require officers, directors, and 10% shareholders to file Form 4 with the SEC 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. . .*"[40] and the SEC has amended Regulation S-T to require insiders to file Forms 3, 4, and 5 (§16(a) reports) with the SEC on EDGAR.[41] The rules also require an issuer that maintains a corporate website to post on its website all Forms 3, 4, and 5 filed with respect to its equity securities by the end of the business day after filing.[42]

SOX also requires the SEC to regularly and systematically review corporate filings.[43] Each issuer must be reviewed at least every three years.[44] Material restatements, the level of market capitalization and price volatility are factors specified for the SEC to consider in scheduling reviews.[45]

Internal Controls. As directed by SOX, the SEC has prescribed rules mandating inclusion of an internal control report and assessment in Form 10-K annual reports.[46] The internal control report is required to (1) state the responsibility of management for establishing and maintaining an

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36 *See infra* "Off-Balance Sheet Transactions; Use of Non-GAAP Financial Measures" in Section V.

37 *Id.*

38 *See* Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Release No. 33-8400, (May 16, 2004), *available at* http://www.sec.gov/rules/final/33-8400.htm.

39 *See infra* "Form 8-K Filing of Earnings Release" in Section V.

40 *See infra* "Accelerated §16(a) Reporting in Section V.

41 *Id.*

42 *Id.*

43 *See infra* "Systematic SEC Review of 1934 Act Filing" in Section V.*Id.*

44 *Id.*

45 *Id.*

46 *See infra* "Internal Controls" in Section V.

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.[47] SOX 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.[48]

Codes of Ethics. The SEC has adopted rules that require reporting companies to disclose on Form 10-K:

- Whether the issuer has adopted a 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.[49]

Record Retention. SOX and SEC rules thereunder prohibit (1) destroying, altering, concealing, or falsifying records with the intent to obstruct or influence an investigation in a matter in Federal jurisdiction or in bankruptcy and (2) auditor failure to maintain for a five-year period all audit or review work papers pertaining to an issuer.[50]

Criminal and Civil Sanctions. SOX 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.[51] Civil penalties are also increased.[52] SOX restricts the discharge of such obligations in bankruptcy.[53]

SOX Organization. SOX 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 SOX are generally discussed below in relation to SOX provisions being implemented thereby.

II.
PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD (SOX TITLE I)

SOX establishes the PCAOB to: (1) register accounting firms that prepare audit reports on U.S. public companies; (2) write and administer rules governing auditor (i) auditing standards; (ii) quality control; (iii) ethics; and (iv) independence; (3) conduct inspections of registered accounting firms in relation to audits of U.S. public companies; and (4) conduct investigations, bringing disciplinary proceedings and imposing sanctions for violations related to the preparation of audit

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47 *Id.*

48 *Id.*

49 *See infra* "Codes of Ethics" in Section V.

50 *See infra* "Records Retention" in Section IX.

51 *See infra* Sections IX, X and XII.

52 *Id.*

53 SOX § 803, *amending* 11 U.S.C.A. § 523 (West Supp. 2004) [hereinafter *"SOX § 803"*].

reports on the financial statements of U.S. public companies.[54] The PCAOB is not charged with licensing individual accountants.

The PCAOB consists of five members appointed by the SEC, of whom no more than two may be certified public accountants.[55] On October 24, 2002, the SEC appointed the following founding members of the PCAOB: Judge William H. Webster (Chair), Kayla J. Gillan, Daniel L. Goelzer, Willis D. Gradison Jr., and Charles D. Niemeier.[56] Judge Webster subsequently tendered his resignation, and William J. McDonough was unanimously elected his successor on May 21, 2003.[57] The members 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).[58] Although members are prohibited from outside business or professional activities, the PCAOB is authorized to establish compensation levels that are intended to be competitive with those in private industry.[59] The PCAOB will be funded by assessing fees from public companies and mutual funds based on their market capitalization.[60]

On April 25, 2003, the SEC certified that the PCAOB has the capacity to perform its functions.[61] As a result, as of October 22, 2003 (180 days after that certification), any public

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54 SOX § 101, 15 U.S.C.A. § 7211 (West Supp. 2004) [hereinafter *"SOX § 101"*].

55 SOX § 101(e)(3), *supra* note 54.

56 Press Release, SEC, Commission Announces Founding Members of Public Company Accounting Oversight Board (October 25, 2002), *available at* http://www.sec.gov/news/press/2002-153.htm. This press release sets forth biographical information about the founding members of the PCAOB.

57 Press Release, SEC, SEC Unanimously Approves William J. McDonough as Chairman of Public Company Accounting Oversight Board (May 21, 2003), *available at* http://www.sec.gov/news/press/2003-63.

58 *Id.*

59 *Id.*

60 PCAOB Rulemaking: Public Accounting Oversight Board; Notice of Filing of Proposed Rule on Funding, Exchange Act Release No. 48,075, 68 Fed. Reg. 38,406 (June 27, 2003), *available at* http://www.sec.gov/rules/pcaob/34-48075.htm. The PCAOB has proposed that its annual "accounting support fees" to be paid by public companies and mutual funds would equal its annual budget, less registration and annual fees to be collected from public accounting firms, and would be assessed on two classes of issuers: (1) publicly-traded companies with average monthly U.S. equity market capitalizations during the preceding year, based on all classes of common stock, of greater than $25 million and (2) investment companies with average monthly U.S. equity market capitalizations (or net asset values) of greater than $250 million. All other issuers, including (i) those that are not required to file audited financial statements with the SEC; (ii) employee stock purchase, savings, and similar plans; and (iii) bankrupt issuers that file modified reports, would not be required to pay any accounting support fees to the PCAOB. The firms that must pay the fees would be allocated a share of the total fee based on the ratio of their market capitalization to the aggregate market capitalization of all assessed issuers, except that a mutual fund's capitalization for this purpose would be 10% of its actual capitalization in recognition that accounting issues presented by mutual funds are less complicated than those of other issuers.

61 Order Regarding Section 101(d) of the Sarbanes-Oxley Act of 2002, Securities Act Release No. 8223 (April 25, 2003), *available at* http://www.sec.gov/rules/other/33-8223.htm. *See also* PCAOB Rulemaking: Order Approving Proposal Rules Relating to Registration System, Exchange Act Release No. 48,180, 68 Fed. Reg. 43,242 (July 21, 2003), *available at* http://www.sev.gov/rules/pcaob/34-48180.htm; PCAOB Rulemaking: Order Approving Proposal Rules Relating to Registration System, Exchange Act Release No. 48,212, 68 Fed. Reg. 44,553 (July 29, 2003), *available at* http://www.sec.gov/rules/pcaob/34-48212.htm.

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.[62] The PCAOB is empowered to impose disciplinary or remedial sanctions upon registered public accounting firms and their associated persons.[63] Subject to the SEC's oversight and enforcement authority over it, the PCAOB is authorized 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.[64] It also is required to regularly inspect each registered accounting firm to assess its compliance with SOX 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).[65] In June 2002, the SEC issued a proposal that contains an outline of how it would like the PCAOB to operate.[66] Since that time, a variety of the rule proposals have been adopted.[67]

III.
AUDITOR INDEPENDENCE; NON-AUDIT SERVICES (SOX TITLE II)

SOX 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 pre-approval for other non-audit services. On January 28, 2003, the SEC issued Release No. 33-8183, adopting rules to implement SOX Title II (the *"Title II Release"* and the *"Title II Rules"*).[68] These rules are applicable to all public companies regardless of size, effective May 6, 2003, except that effectiveness of the rules requiring audit partner rotation was delayed until the commencement of the issuer's first fiscal year beginning after May 6, 2003.[69]

Prohibited Non-Audit Services. SOX Section 201 and the related Title II Rules prohibit a registered public accounting firm from providing to a public company, contemporaneously with the audit, the following non-audit services:[70]

(1) bookkeeping[71] or other services related to the accounting records or financial statements[72] of the audit client;

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62 Exchange Act Release No. 48,180, *supra* note 61.

63 SOX § 105, *supra* note 16.

64 SOX § 103, 15 U.S.C.A. § 7213 (West Supp. 2004) [hereinafter *"SOX § 103"*].

65 SOX § 104, 15 U.S.C.A. § 7214 (West Supp. 2004) [hereinafter *"SOX § 104"*].

66 Framework for Enhancing the Quality of Financial Information Through Improvement of Oversight of the Auditing Process, Securities Act Release No. 8109, Exchange Act Release No. 46,120, 67 Fed. Reg. 44,964 (proposed June 26 2002), *available at* http://www.sec.gov/rules/proposed/33-8109.htm.

67 *See generally*, Rules of the Board, available at http://www.pcaobus.org/Rules_of_the_Board/rules_of_the_board.asp.

68 Strengthening the Commission's Requirements Regarding Auditor Independence, Securities Act Release No. 8183, Exchange Act Release No. 47,265, 68 Fed. Reg. 6006 (Feb. 5, 2003), *available at* http://www.sec.gov/rules/final/33-8183.htm [hereinafter the *"Title II Release"*].

69 *Id.*

70 SOX § 201, *amending* 15 U.S.C.A. § 78j-1(g)-(h) (West Supp. 2004) [hereinafter *"SOX § 201"*].

(2) financial information systems design and implementation;[73]

(3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports;[74]

(4) actuarial services;[75]

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[71] 17 C.F.R. § 210.2-01(c)(4)(i) (2004). The Title II Rules utilize a definition of bookkeeping or other services which focuses on the provision of services involving: (1) maintaining or preparing the audit client's accounting records; (2) preparing financial statements that are filed with the SEC or the information that forms the basis of financial statements filed with the SEC; or (3) preparing or originating source data underlying the audit client's financial statements.

[72] An accountant's independence would be impaired where the accountant prepared an issuer's statutory financial statements if those statements form the basis of the financial statements that are filed with the SEC. Under these circumstances, an accountant or accounting firm who has prepared the statutory financial statements of an audit client is put in the position of auditing its own work when auditing the resultant U.S. GAAP financial statements.

[73] 17 C.F.R. § 210.2-01(c)(4)(ii) (2004). The SEC's Title II Rules prohibit an accounting firm from providing any service related to the audit client's information system unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements. These rules do not preclude an accounting firm from working on hardware or software systems that are unrelated to the audit client's financial statements or accounting records as long as those services are pre-approved by the audit committee.

In the SEC's view, designing, implementing, or operating systems affecting the financial statements may place the accountant in a management role, or result in the accountant auditing his or her own work or attesting to the effectiveness of internal control systems designed or implemented by that accountant. For example, if an auditor designs or installs a computer system that generates the financial records, and that system generates incorrect data, the accountant is placed in a position of having to report on his or her firm's own work. Investors may perceive that the accountant would be unwilling to challenge the integrity and efficacy of the client's financial or accounting information collection systems that the accountant designed or installed.

However, this prohibition does not preclude the accountant from evaluating the internal controls of a system as it is being designed, implemented, or operated either as part of an audit or attest service or making recommendations to management. Likewise, the accountant would not be precluded from making recommendations on internal control matters to management or other service providers in conjunction with the design and installation of a system by another service provider.

[74] 17 C.F.R. § 210.2-01(c)(4)(iii) (2004). Under Title II Rules, appraisal and valuation services include any process of valuing assets, both tangible and intangible, or liabilities. These services include valuing, among other things, in-process research and development, financial instruments, assets and liabilities acquired in a merger, and real estate. Fairness opinions and contribution-in-kind reports are opinions and reports in which the firm provides its opinion on the adequacy of consideration in a transaction.

The Title II Rules do not prohibit an accounting firm from providing such services for non-financial reporting purposes (*e.g.*, transfer pricing studies, cost segregation studies, and other tax-only valuations). Also, the rules do not prohibit an accounting firm from utilizing its own valuation specialist to review the work performed by the audit client itself or an independent, third-party specialist employed by the audit client, provided the audit client or the client's specialist (and not the specialist used by the accounting firm) provides the technical expertise that the client uses in determining the required amounts recorded in the client's financial statements. In those instances, the accountant will not be auditing his or her own work because a third party or the audit client is the source of the financial information subject to the audit.

[75] 17 C.F.R. § 210.2-01(c)(4)(iv) (2004). The SEC believes that when the accountant provides actuarial services for the client, he or she is placed in a position of auditing his or her own work. Accordingly, the Title II Rules prohibit an accountant from providing to an audit client any actuarially-oriented advisory service involving the

(5) internal audit outsourcing services;[76]

(6) management functions[77] or human resources;[78]

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determination of amounts recorded in the financial statements and related accounts other than assisting a client in understanding the methods, models, assumptions, and inputs used in computing an amount, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements. It is permissible, however, to advise the client on the appropriate actuarial methods and assumptions that will be used in the actuarial valuations, while it is not appropriate for the accountant to provide the actuarial valuations for the audit client. Further, the accountant may utilize his or her own actuaries to assist in conducting the audit provided the audit client uses its own actuaries or third-party actuaries to provide management with its actuarial capabilities.

[76] 17 C.F.R. § 210.2-01(c)(4)(v) (2004). The Title II Rules prohibit the accountant from providing to the audit client internal audit outsourcing services. This prohibition includes any internal audit service that has been outsourced by the audit client that relates to the audit client's internal accounting controls, financial systems, or financial statements, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements.

While conducting the audit in accordance with generally accepted auditing standards ("*GAAS*"), or when providing attest services related to internal controls, the auditor evaluates the company's internal controls and, as a result, may make recommendations for improvements to the controls. Doing so is a part of the accountant's responsibilities under GAAS or applicable attestation standards and, therefore, does not constitute an internal audit outsourcing engagement.

Along those lines, the prohibition on "outsourcing" does not preclude engaging the accountant to perform nonrecurring evaluations of discrete items or other programs that are not, in substance, the outsourcing of the internal audit function. For example, the company may engage the accountant, subject to the audit committee pre-approval requirements, to conduct "agreed-upon procedures" engagements related to the company's internal controls, since management takes responsibility for the scope and assertions in those engagements. The prohibition also does not preclude the accountant from performing operational internal audits unrelated to the internal accounting controls, financial systems, or financial statements.

[77] 17 C.F.R. § 210.2-01(c)(4)(vi) (2004). The Title II Rules prohibit the accountant from acting, temporarily or permanently, as a director, officer, or employee of an audit client, or performing any decision-making, supervisory, or ongoing monitoring function for the audit client. The SEC believes, however, that services in connection with the assessment of internal accounting and risk management controls, as well as providing recommendations for improvements, do not impair an accountant's independence. Accountants must gain an understanding of their audit clients' systems of internal controls when conducting an audit in accordance with GAAS. With this insight, accountants often become involved in diagnosing, assessing, and recommending to audit committees and management ways in which their audit clients' internal controls can be improved or strengthened. The resulting improvements in the audit clients' controls not only result in improved financial reporting to investors but also can facilitate the performance of high quality audits. As a result, the Title II Rules allow accountants to assess the effectiveness of an audit client's internal controls and to recommend improvements in the design and implementation of internal controls and risk management controls.

Designing and implementing internal accounting and risk management controls is fundamentally different from obtaining an understanding of the controls and testing the operation of the controls, which is an integral part of any audit of a company's financial statements. Likewise, design and implementation of these controls involves decision-making and, therefore, is different from recommending improvements in the internal accounting and risk management controls of an audit client (which is permissible, if pre-approved by the audit committee).

[78] 17 C.F.R. § 210.2-01(c)(4)(vii) (2004). The Title II Rules provide that an accountant's independence is impaired with respect to an audit client when the accountant searches for or seeks out prospective candidates for managerial, executive, or director positions; acts as negotiator on the audit client's behalf, such as determining position, status, compensation, fringe benefits, or other conditions of employment; or undertakes

(7) broker or dealer, investment adviser, or investment banking services;[79]

(8) legal services[80] and expert services unrelated to the audit;[81]

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reference checks of prospective candidates. Under the Title II Rules, an accountant's independence also is impaired when the accountant engages in psychological testing on behalf of the audit client, other formal testing or evaluation programs, or recommends or advises the audit client to hire a specific candidate for a specific job.

79 17 C.F.R. § 210.2-01(c)(4)(viii) (2004). The SEC considers selling–directly or indirectly–an audit client's securities to be incompatible with the accountant's responsibility of assuring the public that the company's financial condition is fairly presented. When an accountant, in any capacity, recommends to anyone (including non-audit clients) that they buy or sell the securities of an audit client or an affiliate of the audit client, the accountant has an interest in whether those recommendations were correct. That interest could affect the audit of the client whose securities, or whose affiliate's securities, were recommended.

80 17 C.F.R. § 210.2-01(c)(4)(ix) (2004). A lawyer's core professional obligation is to advance clients' interests. An individual cannot be both a zealous legal advocate for management or the client company and maintain the objectivity and impartiality that are necessary for an audit. Thus, under the Title II Rules, an accountant is prohibited from providing to an audit client any service that, under circumstances in which the service is provided, could be provided only by someone licensed, admitted, or otherwise qualified to practice law in the jurisdiction in which the service is provided.

81 17 C.F.R. § 210.2-01(c)(4)(x) (2004). The Title II Rules prohibit an accountant from providing expert opinions or other services to an audit client, or a legal representative of an audit client, for the purpose of advocating that audit client's interests in litigation, or regulatory or administrative investigations or proceedings. For example, under this rule, an auditor's independence would be impaired if the auditor were engaged to provide forensic accounting services to the audit client's legal representative in connection with the defense of an investigation by the SEC's Division of Enforcement. Additionally, an accountant's independence would be impaired if the audit client's legal counsel, in order to acquire the requisite expertise, engaged the accountant to provide such services in connection with any litigation, proceeding, or investigation.

The Title II Rules do not, however, preclude an audit committee or, at its direction, its legal counsel, from engaging the accountant to perform internal investigations or fact-finding engagements. These types of engagements may include, among others, forensic or other fact-finding work that results in the issuance of a report to the audit client. The involvement by the accountant in this capacity generally requires performing procedures that are consistent with, but more detailed or more comprehensive than, those required by generally accepted auditing standards (*"GAAS"*). Performing such procedures is consistent with the role of the independent auditor and could improve audit quality. If, subsequent to the completion of such an engagement, a proceeding or investigation is initiated, the accountant may allow its work product to be utilized by the audit client and its legal counsel without impairing the accountant's independence. The accountant, however, may not then provide additional services, but may provide factual accounts or testimony about the work performed.

Accordingly, the Title II Rules do not prohibit an accountant from assisting the audit committee in fulfilling its responsibilities to conduct its own investigation of a potential accounting impropriety. For example, if the audit committee is concerned about the accuracy of the inventory accounts at a subsidiary, it may engage the auditor to conduct a thorough inspection and analysis of those accounts, the physical inventory at the subsidiary, and related matters without impairing the auditor's independence.

Recognizing that auditors have obligations under SOX and GAAS to search for fraud that is material to an issuer's financial statements and to make sure the audit committee and others are informed of their findings, the Title II Rules permit auditors to conduct these procedures whether they become aware of a potential illegal act as a result of audit, review, or attestation procedures they have performed or as a result of the audit committee expressing concerns about a part of the company's operations or compliance with the company's financial reporting system. Should litigation arise or an investigation commence during the time that the auditors are conducting such procedures, the SEC would not deem the completion of these procedures to be prohibited

With respect to other non-audit services, SOX Section 201 states that "A registered public accounting firm may engage in any non-audit service, *including tax services*, that is not described in any of paragraphs (1) through (9) [listed above] . . . for an audit client, only if the activity is approved in advance by the audit committee of the issuer[.]"[82] There has been considerable debate regarding whether an accountant's provision of tax services for an audit client can impair the accountant's independence.[83]

The Title II Release reiterates the SEC's long-standing position that an accounting firm can provide tax services to its audit clients without impairing the firm's independence, and states that accountants may continue to provide tax services such as tax compliance, tax planning, and tax advice to audit clients, subject to the normal audit committee pre-approval requirements.[84]

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expert services so long as the auditor remains in control of his or her work and that work does not become subject to the direction or influence of legal counsel for the issuer.

82 SOX § 201, *supra* note 70 (emphasis added).

83 *See* Title II Release, *supra* note 68.

84 With respect to accounting firm-developed income tax preparation software, the Staff commented in response to Questions 18 and 19:

Question 18

Q: Some accounting firms have developed their own proprietary income tax preparation software. The software is used to facilitate the preparation of company income tax returns for various tax jurisdictions. Can an accounting firm license or sell its proprietary income tax preparation software to an audit client?

A: Licensing or selling income tax preparation software to an audit client would be subject to audit committee pre-approval requirements for permissible tax services. To the extent that the audit client's audit committee pre-approves the acquisition of the income tax preparation software from the accounting firm, it would be permissible for the accounting firm to license or sell its income tax preparation software to an audit client, so long as the functionality is, indeed, limited to preparation of returns for filing of tax returns. If the software performs additional functions, each function should be evaluated for its potential effect on the auditor's independence (see Question 19).

Question 19

Q: Some accounting firms have developed software modules which extend the functionality of the proprietary income tax preparation software. One of the additional software modules that has been developed by some firms takes the information used in preparing the tax return and generates some or all of the information needed to prepare the tax accrual and disclosures related to income taxes that will appear in the company's financial statements. Can the accounting firm license or sell this type of module to an audit client either concurrently with or subsequent to the licensing or sale of its income tax preparation software?

A: No. Since the purpose of the module is to develop the information needed to prepare a significant element of the company's financial statements, licensing or selling the module to an audit client would constitute the design and implementation of a financial information system, which is a prohibited non-audit service. It should be noted that the prohibition exists whether or not the module is integrated with, linked to, feeds the company's general ledger system, or otherwise prepares entries on behalf of the audit client (even if those entries are required to be manually recorded by client personnel). The output of the module aggregates source data or generates information that can be significant to the company's financial statements taken as a whole.

Office of SEC Chief Accountant Application of the January 2003 Rules on Auditor Independence; Frequently Asked Questions, *at* http://www.sec.gov/info/accountants/ocafaqaudind080703.htm (August 13, 2003) [hereinafter *"Auditor Independence FAQ"*].

Additionally, the Title II Rules require issuers to disclose the amount of fees paid to the accounting firm for tax services.[85]

The Title II Release further comments that merely labeling a service as a "tax service" will not necessarily eliminate its potential to impair auditor independence and that audit committees and accountants should understand that providing certain tax services to an audit client could impair the independence of the accountant.[86] Specifically, accountants would impair their independence by representing an audit client before a tax court, district court, or federal court of claims.[87] In addition, audit committees are cautioned to scrutinize carefully the retention of an accountant in a tax-avoidance transaction initially recommended by the accountant, the tax treatment of which may be dicey.[88]

The SEC's principles of independence with respect to non-audit services provided by auditors are largely predicated on three basic principles, violations of which would impair the auditor's independence: (1) an auditor cannot function in the role of management; (2) an auditor cannot audit his or her own work; and (3) an auditor cannot serve in an advocacy role for his or her client.[89]

Recognizing that audit clients may need a period of time to exit existing contracts, the Title II Rules apply only to contracts entered into on or after May 6, 2003, and provide that the provision of the newly prohibited non-audit services would not impair an accountant's independence if those services were pursuant to contracts in existence on May 6, 2003 and were completed before May 6, 2004.[90]

Audit Committee Pre-Approval of All Audit and Non-Audit Services. SOX Section 202 requires audit committee pre-approval of all auditing services (including providing comfort letters in connection with securities underwritings or statutory audits required for insurance companies for purposes of state law) and all non-audit services provided by the auditor.[91] The audit committee may delegate the pre-approval responsibility to a subcommittee of one or more independent directors.[92] 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 five 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

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85 Title II Release, *supra* note 68, at 6017.

86 *Id*.

87 *Id*.

88 *Id*.

89 *Id*. at 6010.

90 *Id*. at 6006.

91 SOX § 202, *amending* 15 U.S.C.A. § 78j-1(i) (West Supp. 2004) [hereinafter "SOX § 202"]. The audit committee of a parent company may serve as the audit committee of the parent company and the wholly-owned subsidiaries. In this situation, the subsidiary's disclosure should include the pre-approval policies and procedures of the subsidiary and, also should include the pre-approval policies and procedures of the parent company. *See* Auditor Independence FAQ, *supra* note 84, at Question 20.

92 SOX § 202, *supra* note 91.

recognized as non-audit services by the issuer at the time of the engagement; 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 one or more members of the audit committee to whom authority to grant such approvals has been delegated by the audit committee.[93]

The Title II Release recognizes that management has historically retained the accounting firm, negotiated the audit fee, and contracted with the accounting firm for other services, but the Release comments that SOX Section 202 changes that practice by requiring audit committees to pre-approve the services – both audit and permitted non-audit – of the accounting firm.[94] The SEC believes that the SOX Section 202 change may both facilitate communications among the board of directors, management, internal auditors, and independent accountants, and enhance auditor independence from management by vesting in the audit committee the power and responsibility of appointing, compensating, and overseeing the work of the independent accountants.[95]

As adopted, the Title II Rules require that the audit committee pre-approve all permissible non-audit services and all audit, review, or attest engagements required under the securities laws.[96] Specifically, the rules require that before the accountant is engaged by the issuer or its subsidiaries to render the service, the engagement is:

- Approved by the issuer's audit committee; or
- Entered into pursuant to pre-approval policies and procedures established by the audit committee of the issuer, provided the policies and procedures are detailed as to the particular service, the audit committee is informed of each service, and such policies and procedures do not include delegation of the audit committee's responsibilities to management.[97]

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93 *Id*.

94 Title II Release, *supra* note 68, at 6022.

95 *Id*.

96 *Id*.

97 Title II Release, *supra* note 68, at 6022. The SEC Chief Accountant has commented that pre-approval policies may not be based on monetary limits and must be detailed enough for the audit committee to know precisely what services are being pre-approved and the impact thereof on auditor independence. *See* Auditor Independence FAQ, *supra* note 81. Under Questions 22, 23, and 24 the Staff wrote:

Question 22

Q: The Commission's rules require the audit committee to pre-approve all services provided by the independent auditor. In doing so, the audit committee can pre-approve services using pre-approval policies and procedures. Can the audit committee use monetary limits as the basis for establishing its pre-approval policies and procedures?

A: The Commission's rules include three requirements that must be followed in the audit committee's use of pre-approval through policies and procedures. First, the policies and procedures must be detailed as to the particular services to be provided. Second, the audit committee must be informed about each service. Third, the policies and procedures cannot result in the delegation of the audit committee's authority to management. Pre-approval policies and procedures that do not comply with all three of these requirements are in contravention of the Commission's rules. Therefore, monetary limits cannot be the only basis for the pre-approval policies and procedures. The establishment of monetary limits would not, alone, constitute policies

As adopted, the Title II Rules recognize audit services to be broader than those services required to perform an audit pursuant to GAAS.[98] For example, SOX Section 202 identifies services related to the issuance of comfort letters and services related to statutory audits required for insurance companies for purposes of state law as audit services.[99]

Furthermore under the Title II Rules, audit services also would include services performed to fulfill the accountant's responsibility under GAAS.[100] For example, in some situations, a tax partner may be involved in reviewing the tax accrual that appears in the company's financial statements as part of the audit process. Consultation with "national office" or other technical reviewers to reach an audit judgment also constitutes an audit service.

In contrast, where an issuer is evaluating a proposed transaction and asks the independent accountant to evaluate the accounting for the proposed transaction, those services would not be considered to be audit services.

Although the audit committee must pre-approve all services, SOX Section 202 permits the audit committee to establish policies and procedures for pre-approval "provided they are detailed as to the particular service and designed to safeguard the continued independence of the accountant."[101] For example, SOX Section 202 allows for one or more audit committee members who are

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that are detailed as to the particular services to be provided and would not, alone, ensure that the audit committee would be informed about each service.

Question 23

Q: Can the audit committee's pre-approval policies and procedures provide for broad, categorical approvals (e.g., tax compliance services)?

A: No. The Commission's rules require that the pre-approval policies be detailed as to the particular services to be provided. Use of broad, categorical approvals would not meet the requirement that the policies must be detailed as to the particular services to be provided.

Question 24

Q: How detailed do the pre-approval policies need to be?

A: The determination of the appropriate level of detail for the pre-approval policies will differ depending upon the facts and circumstances of the issuer. However, a key requirement is that the policies cannot result in a delegation of the audit committee's responsibility to management. As such, if a member of management is called upon to make a judgment as to whether a proposed service fits within the pre-approved services, then the pre-approval policy would not be sufficiently detailed as to the particular services to be provided. Similarly, pre-approval policies must be designed to ensure that the audit committee knows precisely what services it is being asked to pre-approve so that it can make a well-reasoned assessment of the impact of the service on the auditor's independence. For example, if the audit committee is presented with a schedule or cover sheet describing services to be pre-approved, that schedule or cover sheet must be accompanied by detailed back-up documentation regarding the specific services to be provided.

98 Title II Release, *supra* note 68, at 6022.

99 *Id*.

100 *Id*. at 6030.

101 *Id*. at 6022.

independent directors to pre-approve the service. Decisions made by the designated audit committee members must be reported to the full audit committee at each of its scheduled meetings.[102]

Like SOX Section 202, the Title II Rules include a de minimis exception which waives the pre-approval requirements for non-audit services provided that: (1) all such services do not aggregate to more than five percent of total revenues paid by the audit client to its accountant in the fiscal year when services are provided; (2) the services were not recognized as non-audit services at the time of the engagement; and (3) the 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 one or more designated representatives.[103] The audit committee's policies for pre-approval of services should be disclosed in the issuer's Form 10-K annual reports.

Until the adoption of the Title II Rules, proxy disclosure rules required that an issuer disclose, for the most recent fiscal year, the professional fees paid for both audit and non-audit services to its principal independent accountant. As a result of the requirements of SOX and partly in response to public comment received by the SEC on proxy disclosure requirements since their adoption in 2000, the Title II Rules now require issuers to report fees spent on: (1) Audit Fees; (2) Audit-Related Fees; (3) Tax Fees; and (4) All Other Fees.[104] Additionally, other than for the audit category, the issuer is required to describe, in qualitative terms, the types of services provided under the remaining three categories.[105] This information is now required for the two most recent years, and must be provided either in the issuer's proxy statement or its Form 10-K annual report.[106]

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102 *Id*.

103 *Id*. at 6023.

104 Previously, issuers were required to disclose only "Audit Fees," "Financial Systems Design and Implementation Fees," and "All Other Fees."

105 To provide guidance to issuers in making the required audit fee disclosures, the SEC has provided some guidance as to fee disclosures. Auditor Independence FAQ, *supra* note 84. The Staff responded to questions 30, 31, and 32 as follows:

Question 30

Q: What fee disclosure category is appropriate for professional fees in connection with an audit of the financial statements of a carve-out entity in anticipation of a subsequent divestiture?

A: The release establishes a new category, "Audit-Related Fees," which enables registrants to present the audit fee relationship with the principal accountant in a more transparent fashion. In general, "Audit-Related Fees" are assurance and related services (*e.g.*, due diligence services) that traditionally are performed by the independent accountant. More specifically, these services would include, among others: employee benefit plan audits, due diligence related to mergers and acquisitions, accounting consultations and audits in connection with acquisitions, internal control reviews, attest services related to financial reporting that are not required by statute or regulation and consultation concerning financial accounting and reporting standards. Fees for the above services would be disclosed under "Audit-Related Fees."

Question 31

Q: Would fees paid to the audit firm for operational audit services be included in "Audit-Related Fees"?

A: No. "Audit-Related Fees" are fees for assurance and related services by the principal accountant that are traditionally performed by the principal accountant and which are "reasonably related to the performance of the **audit or review of the registrant's financial statements.**" Operational audits would not be related to the audit or review of the financial statements and, therefore, the fees for these services should be included in "All Other

As noted above, the issuer must provide disclosure of the audit committee's pre-approval policies and procedures. Additionally, to the extent that the audit committee has applied the de minimis exception, the issuer must disclose the percentage of the total fees paid to the independent accountant where the de minimis exception was used.[107] This information should be provided by category.[108] The information must be included in an issuer's Form 10-K annual report.[109] However, because the SEC views the information as relevant to a decision to vote for a particular director or to elect, approve, or ratify the choice of an independent public accountant, the SEC is also requiring that the disclosure discussed above be included in an issuer's proxy statement. Since the information is included in Part III of annual reports on From 10-K, domestic companies are able to incorporate the required disclosures from the proxy or information statement into the annual report on Form 10-K.

Audit Partner Rotation. SOX Section 203 mandates rotation every five years of both the lead audit partner working for the audit client and the audit partner responsible for reviewing the audit,[110] but does not require rotation of registered public accounting firms, although the PCAOB may end up requiring such rotation.[111] The Title II Rules expand SOX Section 203 by requiring not only that both the lead and the concurring partners rotate after five years, but that they also are subject to a five-year time-out period after the rotation.[112] Further, the Title II Rules require rotation after seven years, with a two year post-rotation time-out, for other partners on the audit engagement team who have responsibility for decision-making on significant auditing, accounting, and reporting matters that affect the financial statements or who maintain regular contact with management or the audit committee (together with the lead and concurring partner, "*audit partners*").[113] The

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Fees." As required by the rules, the registrant would need to include a narrative description of the services included in the "All Other Fees" category.

Question 32

Q: The Commission's new independence rules require companies to disclose fees paid to the principal auditor in four categories ("audit", "audit-related', "tax", and "all other") for the two most recent years. Previously, companies were required to disclose fees paid to the principal auditor in three categories and only for the most recent year. When are the new fee disclosure requirements effective?

A: The release text indicates that the new disclosure requirements are effective for periodic annual filings and proxy or information statement filings for the first fiscal year **ending after December 15, 2003.** Thus, the new disclosure requirements are not mandatory until the calendar-year 2003 periodic annual filings are made in 2004. However, the release text also indicates that "we encourage issuers . . . to adopt these disclosure provisions earlier." Thus, companies may, but are not required, to provide the new disclosures for proxies and other periodic annual filings that are made prior to the effective date for the new disclosures.

106 Title II Release, *supra* note 68, at 6031.

107 *Id*.

108 *Id*.

109 *Id*.

110 SOX § 203, *amending* 15 U.S.C.A. 78j-1(j) (West Supp. 2004) [hereinafter "SOX § 203"]; *Id*. at 6017.

111 Title II Release, *supra* note 68 at 6018.

112 *Id*.

113 Tax and other partners are deemed "audit partners" under this definition if they are "relationship partners" with a high degree of contact with the issuer's management or audit committee. *See* Auditor Independence FAQ, *supra* note 84. In response to questions 10 and 11 the Staff commented:

mandatory audit partner rotation does not extend to less important partners on the audit engagement teams, specialty partners, and national office partners.[114]

The rotation requirements applicable to the lead partner are effective for the first fiscal year ending after the effective date of the Title II Rules.[115] Furthermore, in determining when the lead partner must rotate, time served in the capacity of lead partner prior to the effective date of these rules is included.[116] For example, for a lead partner serving a calendar year audit client, if 2004 was that partner's fifth year as lead partner for that audit client, the partner would be able to complete the current year's audit but must rotate off for the 2005 engagement.

The rotation requirements for the concurring partner are effective as of the end of the second fiscal year after the effective date of the rules.[117] For other audit partners, the rotation requirements begin counting at the inception of the client's first fiscal year beginning after the effective date of the Title II Rules, and that year will be deemed the partner's first year of service (i.e., there is no look-back).[118]

Auditor Reports to Audit Committees. SOX Section 204 requires 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 for financial reporting in the U.S. (*"GAAP"*) that have been discussed with management.[119] In response

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Question 10

Q: Generally, a tax or other specialty partner is not included within the definition of "audit partner." Are there circumstances where a tax or other specialty partner would be included within the definition of "audit partner"? If so, what are the consequences?

A: The term "audit partner" is significant in that it establishes the partners who are subject to the partner rotation requirements and the partner compensation requirements. The discussion of "audit partner" in the release text states: "the term audit partner would include the 'lead' and 'concurring' partners, partners such as 'relationship' partners who serve the client at the issuer or parent level." "Relationship" partners have a high level of contact with management and the audit committee of the issuer. Therefore, a tax or other specialty partner who serves as the "relationship" partner would be included within the scope of the definition of "audit partner."

Question 11

Q: What are the rotation requirements for the "relationship" partner who is not the "lead" or "concurring" partner?

A: As discussed in question 10, the "relationship" partner meets the definition of an "audit partner" and, therefore, is subject to the partner rotation requirements. "Lead" and "concurring" partners are required to rotate off an engagement after a maximum of five years in either capacity and, upon rotation, must be off the engagement for five years. Other "audit partners" are subject to rotation after seven years on the engagement and must be off the engagement for two years. A "relationship" partner who is not the "lead" or "concurring" partner would, therefore, be subject to the seven years of service, two years time out rotation requirement.

114 Title II Release, *supra* note 68, at 6019-20.

115 *Id*. at 6021.

116 *Id*.

117 *Id*.

118 *Id*. at 6021.

119 SOX § 204, *amending* 15 U.S.C.A. § 78j-1(k) (West Supp. 2004) [hereinafter *"SOX § 204"*]; *Id*. at 6007.

to SOX Section 204, the SEC amended Regulation S-X to require each registered public accounting firm that audits an issuer's financial statements to report, prior to the filing of such report with the SEC, to the issuer's audit committee: (1) all critical accounting policies and practices used by the issuer;[120] (2) all alternative accounting treatments of financial information within GAAP that have been discussed with management, including the ramifications of the use of such alternative treatments and disclosures and the treatment preferred by the accounting firm;[121] and (3) other material written communications between the accounting firm and management of the issuer.[122]

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[120] In December 2001, the SEC issued cautionary advice regarding each issuer disclosing in the Management's Discussion and Analysis section of its Form 10-K annual report those accounting policies that management believes are most critical to the preparation of the issuer's financial statements. Action: Cautionary Advice Regarding Disclosure About Critical Accounting Policies, Securities Act Release No. 8040, Exchange Act Release No. 45,149, 66 Fed. Reg. 65,013 (December 17, 2001), *available at* http://www.sec.gov/rules/other/33-8040.htm [hereinafter the "*December 2001 Cautionary Guidance*"]. The December 2001 Cautionary Guidance indicated that "critical" accounting policies are those that are both most important to the portrayal of the company's financial condition and results and require management's most difficult, subjective, or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.

Reference should be made to the December 2001 Cautionary Guidance to determine the types of matters that should be communicated to the audit committee under the Title II Rules. While there is no requirement that the discussions follow a specific form or manner, the Title II Release expects, at a minimum, that the discussion of critical accounting estimates and the selection of initial accounting policies will include the reasons why estimates or policies meeting the criteria in the Guidance are or are not considered critical and how current and anticipated future events impact those determinations. In addition, it is anticipated that the communications regarding critical accounting policies will include an assessment of management's disclosures along with any significant proposed modifications by the accountants that were not included.

[121] Title II Release, *supra* note 68, at 6027. The Title II Rules require communication, either orally or in writing, by accountants to audit committees of all alternative treatments within GAAP for policies and practices related to material items that have been discussed with management, including the ramifications of the use of such alternative treatments and disclosures and the treatment preferred by the accounting firm, including recognition, measurement, and disclosure considerations related to the accounting for specific transactions as well as general accounting policies.

Communications regarding specific transactions should identify, at a minimum, the underlying facts, financial statement accounts impacted, and applicability of existing corporate accounting policies to the transaction. In addition, if the accounting treatment proposed does not comply with existing corporate accounting policies, or if an existing corporate accounting policy is not applicable, then an explanation of why the existing policy was not appropriate or applicable and the basis for the selection of the alternative policy should be discussed. Regardless of whether the accounting policy selected preexists or is new, the entire range of alternatives available under GAAP that were discussed by management and the accountants should be communicated along with the reasons for not selecting those alternatives. If the accounting treatment selected is not, in the accountant's view, the preferred method, the reasons why the accountant's preferred method was not selected by management also should be discussed.

Communications regarding general accounting policies should focus on the initial selection of and changes in significant accounting policies, as required by GAAS, and should include the impact of management's judgments and accounting estimates, as well as the accountant's judgments about the quality of the entity's accounting principles. The discussion of general accounting policies should include the range of alternatives available under GAAP that were discussed by management and the accountants along with the reasons for selecting the chosen policy. If an existing accounting policy is being modified, then the reasons for the change also should be communicated. If the accounting policy selected is not the accountant's preferred policy, then

In describing the role and responsibilities of the audit committee, the Title II Release includes the following quotation from Warren Buffett:

> Their function . . . is to hold the auditor's feet to the fire. And, I suggest . . . the audit committee ask [questions] of the auditors [including]: if the auditor were solely responsible for preparation of the company's financial statements, would they have been prepared in any way differently than the manner selected by management? They should inquire as to both material and non-material differences. If the auditor would have done anything differently than management, then explanations should be made of management's argument and the auditor's response.[123]

Prohibited Employment Relationships. SOX Section 206 prohibits a registered public accounting firm from performing audit services for a public company if the issuer's chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for the issuer 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.[124]

To implement SOX Section 206, the Title II Rules require that when the lead partner, the concurring partner, or any other member of the audit engagement team who provides more than ten hours of audit, review, or attest services for the issuer accepts a position with the issuer in "a financial reporting oversight role" within the one year period[125] preceding the commencement of audit procedures for the year that included employment by the issuer of the former member of the audit engagement team, the accounting firm is not independent with respect to that issuer.[126] The

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the SEC expects the discussions to include the reasons why the accountant considered one policy to be preferred but that policy was not selected by management.

122 *Id*. at 6029. Examples of additional written communications that the Title II Release expects will be considered material to an issuer include:

- Management representation letter;
- Reports on observations and recommendations on internal controls;
- Schedule of unadjusted audit differences, and a listing of adjustments and reclassifications not recorded, if any;
- Engagement letter; and
- Independence letter.

123 *Id*. at 6027 (quoting Warren Buffett, Comments During SEC "Roundtable Discussion on Financial Disclose and Auditor Oversight" (Mar. 4, 2002)).

124 SOX § 206, *amending* 15 U.S.C.A. § 78j-1(l) (West Supp. 2004) [hereinafter *"SOX § 206"*].

125 Title II Release, *supra* note 68, at 6008. Under the Title II Rules, the accounting firm must have completed one annual audit subsequent to when an individual was a member of the audit engagement team before the individual would be eligible for employment by the issuer.

126 *Id*. at 6009. While the employment prohibition applies broadly to members of the audit engagement team, there are accommodations for certain unique situations. For example, in a situation where an individual complied fully with the rule and, subsequent to his or her beginning employment with an issuer, the issuer merged with or was acquired by another entity resulting in he or she becoming a person in a financial reporting oversight role of the combined entity and the combined entity being audited by the individual's previous employer, unless the employment was taken in contemplation of the combination, and, as long as the audit committee is aware of this conflict, the audit firm would continue to be independent under the Title II Rules.

Title II Rules cover employment in any "financial reporting oversight role," which would encompass any individual who has direct responsibility for oversight over those who prepare the issuer's financial statements and related information that are included in SEC filings and is not limited to the four named positions in SOX Section 206 (chief executive officer, controller, chief financial officer and chief accounting officer).[127]

Prohibited Compensation. The Title II Rules provide that an accountant is not independent of an audit client if, at any point during the audit and professional engagement period, any audit partner earns or receives compensation based on the audit partner procuring engagements with that audit client to provide any products or services other than audit, review, or attest services.[128] The Title II Rules do not preclude an audit partner from sharing in the overall firm profits.[129] Non-audit partners can be compensated for selling their respective areas of expertise.[130] The Title II Release suggests that an audit committee may wish to ascertain the audit firm's compensation policies regarding senior staff members, as well as partners, when pre-approving non-audit services.

IV.
CORPORATE RESPONSIBILITY (SOX TITLE III)

Audit Committees. SOX Section 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 auditors.[131] Under SOX Section 301, 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.[132] Although the audit committee must 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 SOX Section 302 and criminal certification in SOX Section 906. Audit committees must also establish procedures to ensure that their members are independent, and they must hear and act on employee

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127 SOX § 206, *supra* note 124.

128 Title II Release, supra note 68, at 6025.

129 *Id.*

130 *Id.*

131 SOX § 301, *amending* 15 U.S.C.A. § 78j-1(m) (West Supp. 2004) [hereinafter *"SOX § 301"*].

132 *Id*. Under Section 3(a)(58) of the 1934 Act as added by SOX Section 205, the term "*audit committee*" is defined as:

> (A) A committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of **overseeing** the accounting the financial reporting **processes** of the issuer and **audits** of the issuer; and
>
> (B) If no such committee exists with respect to an issuer, the entire board of directors of the issuer.
>
> SOX § 205, *amending* Section 3(a) of the 1934 Act, 15 U.S.C.A. § 78c (West Supp. 2004) (emphasis added).
>
> Under this statutory definition of audit committee, the responsibility of the audit committee members is one of "oversight," not management or doing, of "processes" and "audits." The audit committee role is one of understanding and monitoring processes and procedures, rather than supervising the preparation of financial statements.

complaints regarding questionable accounting or auditing matters. These rules are the complement to the restrictions on registered accounting firms' activities in SOX Section 201, and are considered an important step in ensuring auditor independence and preserving the integrity of the audit process.

On April 9, 2003, the SEC issued Release No. 33-8220 to implement SOX Section 301.[133] The SOX Section 301 Rule requires that each national stock exchange, including NASDAQ, must adopt rules conditioning the listing of any securities of an issuer upon the issuer being in compliance with the standards specified in the SOX Section 301, which may be summarized as follows:

- *Oversight*—The audit committee must have direct responsibility for the appointment, compensation, and oversight of the work (including the resolution of disagreements between management and the auditors regarding financial reporting) of any registered public accounting firm employed to perform audit services, and the auditors must report directly to the audit committee.

- *Independence*—The audit committee 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, directly or indirectly, 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 questionable accounting or auditing matters.

- *Funding and Authority*—The audit committee must have the authority to hire independent counsel and other advisers to carry out its duties, and the 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.[134]

SROs may adopt additional listing standards regarding audit committees as long as they are consistent with SOX and the SEC SOX Section 301 Rule.

Effective Dates. Under the SOX Section 301 Rule, which took effect April 25, 2003, each SRO must have provided to the SEC its proposed rules or rule amendments that comply with the

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133 SOX § 301 Release, *supra* note 6. Entitled the "Standards Relating to Listed Company Audit Committees[,]" it adopted, effective April 25, 2003, 1934 Act Rule 10A-3, titled "Listing Standards Relating to Audit Committees."

134 *Id*. Noncompliance would result in delisting, although the SRO rules must provide procedures to permit issuers an opportunity to cure defects that would otherwise result in delisting.

SOX Section 301 Rule no later than July 15, 2003.[135] Under SOX, final SRO rules or rule amendments had to be approved by the SEC no later than December 1, 2003.[136]

Listed issuers must have been in compliance with the new listing rules' audit committee standards by the earlier of (i) their first annual shareholders meeting after January 15, 2004, or (ii) October 31, 2004.[137] Foreign private issuers and small business issuers[138] are given until July 31, 2005, to comply with the new audit committee requirements.[139]

Additional analysis regarding the SOX Section 301 Rule follows:

Audit Committee Member Independence. To be "independent" and thus eligible to serve on an issuer's audit committee, (i) audit committee members may not, directly or indirectly, accept any consulting, advisory or other compensatory fee from the issuer or a subsidiary of the issuer, other than in the member's capacity as a member of the board of directors and any board committee (this prohibition would preclude payments to a member as an officer or employee, as well as other compensatory payments; indirect acceptance of compensatory payments includes payments to spouses, minor children or stepchildren or children or stepchildren sharing a home with the member, as well as payments accepted by an entity in which an audit committee member is a general partner, managing member, executive officer or occupies a similar position and which provides accounting, consulting, legal, investment banking, financial, or other advisory services or any similar services to the issuer or any subsidiary; receipt of fixed retirement plan or deferred compensation is not prohibited)[140] and (ii) a member of the audit committee of an issuer may not be an "affiliated person" of the issuer or any subsidiary of the issuer apart from his or her capacity as a member of the board and any board committee (subject to the safe harbor described below).[141]

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135 SOX § 301 Release, *supra* note 6.

136 *Id*.

137 *Id*.

138 A small business issuer is defined in 1934 Act Rule 12b-2 as a U.S. or Canadian issuer with less than $25 million in revenues and common equity float that is not an investment company. *See* 17 C.F.R. § 240.12b-2 (2004).

139 SOX § 301 Release, *supra* note 6.

140 SOX § 301 Release, *supra* note 6. The SOX §301 Rule restricts only current relationships and does not extend to a "look back" period before appointment to the audit committee, although SRO rules may do so.

141 SOX § 301, *supra* note 131; SOX § 301 Release, *supra* note 6. In the SOX §301 Release, the SEC commented:

> [W]e are defining the terms "affiliate" and "affiliated person" consistent with our other definitions of these terms under the securities laws, such as in Exchange Act Rule 12b-2 and Securities Act Rule 144, with an additional safe harbor. We are defining "affiliate" of, or a person "affiliated" with, a specified person, to mean "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified." We are defining the term "control" consistent with our other definitions of this term under the Exchange Act as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."
>
> . . .

Since it is difficult to determine whether someone controls the issuer, the SOX Section 301 Rule creates a safe harbor regarding whether someone is an "affiliated person" for purposes of meeting the audit committee independence requirement. Under the safe harbor, a person who is not an executive officer, director, or 10% shareholder of the issuer would be deemed not to control the issuer. A person who is ineligible to rely on the safe harbor, but believes that he or she does not control an issuer, still could rely on a facts and circumstances analysis. This test is similar to the test used for determining insider status under Section16 of the 1934 Act.[142]

The SEC has authority to exempt from the independence requirements particular relationships with respect to audit committee members, if appropriate in light of the circumstances. Because companies coming to market for the first time may face particular difficulty in recruiting members that meet the proposed independence requirements, the SOX Section 301 Rule provides an exception for non-investment company issuers that requires only one fully independent member at the time of the effectiveness of an issuer's initial registration statement under the 1933 Act or the

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> Our definition of "affiliated person" for non-investment companies, like our existing definitions of this term for these issuers, requires a factual determination based on a consideration of all relevant facts and circumstances. To facilitate the analysis on facts and circumstances where we are presumptively comfortable, we are adopting a safe harbor for that aspect of the definition of "affiliated person," with minor modifications from the original proposal. Under the safe harbor as adopted, a person who is not an executive officer or a shareholder owning 10% or more of any class of voting equity securities of a specified person will be deemed not to control such specified person. * * * We have clarified * * * that the ownership prong should be based on ownership of any class of voting equity securities, instead of any class of equity securities.
>
> . . .
>
> The safe harbor is designed to identify a group of those that are not affiliates so as to provide comfort to those individuals or entities that no additional facts and circumstances analysis is necessary. It only creates a safe harbor position for non-affiliate status. Failing to meet the 10% ownership threshold has no bearing on whether a particular person is an affiliate based on an evaluation of all facts and circumstances. A director who is not an executive officer but beneficially owns more than 10% of the issuer's voting equity could be determined to be not an affiliate under a facts and circumstances analysis of control.
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> . . .
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> [C]alculations of beneficial ownership are to be made consistent with Exchange Act Rule 13d-3.
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> The proposed rules would have deemed a director, executive officer, partner, member, principal or designee of an affiliate to be an affiliate. * * * Under the final rule, only executive officers, directors that are also employees of an affiliate, general partners and managing members of an affiliate will be deemed to be affiliates. The limitation on directors will exclude outside directors of an affiliate from the automatic designation.
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> . . .
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> For issuers that are investment companies, we are adopting, as proposed, the requirement that a member of the audit committee of an investment company may not be an "interested person" of the investment company, as defined in Section 2(a)(19) of the Investment Company Act.

SOX § 301 Release, *supra* note 6, at 18,793-94.

142 17 C.F.R. § 240.12b-2 (2004).

1934 Act, a majority of independent members within 90 days, and a fully independent audit committee within one year.[143]

For companies that operate through subsidiaries, the composition of the boards of the parent company and subsidiaries are sometimes similar, given the control structure between the parent and the subsidiaries. If an audit committee member of the parent is otherwise independent, merely serving on the board of a controlled subsidiary should not adversely affect the board member's independence, assuming that the board member also would be considered independent for purposes of the subsidiary except for the member's seat on the parent's board. Therefore, the SOX Section 301 Rule exempts from the "affiliated person" requirement a committee member that sits on the board of directors of both a parent and a direct or indirect subsidiary or other affiliate, if the committee member otherwise meets the independence requirements for both the parent and the subsidiary or affiliate, including the receipt of only "ordinary-course" compensation for serving as a member of the board of directors, audit committee, or any other board committee of the parent, subsidiary, or affiliate.[144] Any issuer taking advantage of any of the exceptions described above would have to disclose that fact.

Responsibilities Relating to Registered Accounting Firms. The SOX Section 301 Release states that one of the audit committee's primary functions is to enhance the independence of the audit function, thereby furthering the objectivity of financial reporting. It is the SEC's view that the auditing process may be compromised when a company's outside auditors view their main responsibility as serving the company's management rather than its full board of directors or its audit committee. Therefore, under the SOX Section 301 Rule, the audit committee must be directly responsible for the appointment, compensation, retention, and oversight of the work of the independent auditor engaged (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work or performing other audit, review ,or attest services for the issuer, and the independent auditor would have to report directly to the audit committee.[145] The oversight responsibilities contemplated include the authority to retain the outside auditor, which would include the power not to retain (or to terminate) the outside auditor.[146] The SEC states in the SOX Section 301 Release that, in connection with the oversight responsibilities contemplated, the audit committee would need to have ultimate authority to approve all audit engagement fees and terms, as well as all significant non-audit engagements of the independent auditor.[147] In this regard, the requirement would

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143 SOX § 301 Release, *supra* note 6.

144 *Id*.

145 SOX § 301, *supra* note 131; *Id*. The SOX Section 301 Release proposes to exempt investment companies from the requirement that the audit committee be responsible for the selection of the independent auditor because 1940 Act Section 32(a) already requires that independent auditors of registered investment companies be selected by majority vote of the disinterested directors.

146 SOX § 301; SOX § 301 Release, *supra* note 6.

147 SOX § 301 Release, *supra* note 6.

reinforce the requirement in SOX Section 202 that auditing and non-auditing services be pre-approved by the audit committee.[148]

The requirement will not affect any requirement under a company's governing law or documents or other home country requirements that require shareholders to elect, approve or ratify the selection of the issuer's auditor.[149] The requirement instead relates to the assignment of responsibility to oversee the auditor's work as between the audit committee and management. However, if the issuer provides a recommendation or nomination of an auditor to its shareholders, the audit committee of the issuer must be responsible for making the recommendation or nomination.[150]

Procedures for Handling "Whistleblower" Complaints. The SOX Section 301 Release states that because the audit committee is dependent to a degree on the information provided to it by management and internal outside auditors, it is important for the committee to cultivate open and effective channels of information. In order to ensure that these channels remain open, the SOX Section 301 Release provides that the audit committee must establish procedures for:

- The receipt, retention and treatment of complaints received by the issuer regarding accounting, internal accounting controls or auditing matters, and

- The confidential, anonymous submission by employees of the issuer concerns regarding questionable accounting or auditing matters.[151]

The SEC has not mandated specific procedures that the audit committee must establish. Each audit committee is encouraged to develop procedures that work best, consistent with its company's individual circumstances.

Authority to Engage Advisors. The SOX Section 301 Release notes that to perform its role effectively, an audit committee may need the authority to engage its own outside advisors, including experts in particular areas of accounting, as it determines necessary apart from counsel or advisors hired by management, especially when potential conflicts of interest with management may be apparent.[152] The SOX Section 301 Rule specifically requires an issuer's audit committee to have the authority to engage outside advisors, including counsel, as it determines necessary to carry out its duties.[153]

Funding. The SOX Section 301 Rule requires the issuer to provide for appropriate funding, as determined by the audit committee, for payment of compensation:

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148 *See* SOX § 202, *supra* note 91.

149 SOX § 301 Release, *supra* note 6, at 18,797.

150 *Id*.

151 *Id*. at 18,798; *cf.* SOX Section 806, *infra.* notes 561-565.

152 *Id*.

153 *Id*.

- To any registered public accounting firm engaged for the purpose of rendering or issuing an audit report [or related work] or performing other audit, review or attest services for the listed issuer; and

- To any advisors employed by the audit committee.[154]

This rule is designed to prevent the audit committee's effectiveness from being compromised by its dependence on management's discretion to compensate the independent auditor or the advisors employed by the committee, especially when potential conflicts of interest with management may be apparent.

Trading Markets Affected. SOX Section 301 by its terms applies to all stock exchanges and NASDAQ, and, to the extent that their listing standards do not already comply with the proposals, they will be required to issue or modify their rules, subject to SEC review, to conform their listing standards.[155] The SOX Section 301 Rule does not preclude stock exchanges and NASDAQ from adopting additional listing standards regarding audit committees, as long as they are consistent with the SOX Section 301 Release. [156]

The OTC Bulletin Board, the Pink Sheets and the Yellow Sheets will not be affected by the proposed requirements in the SOX Section 301 Release. [157] Therefore, issuers whose securities are quoted on these interdealer quotation systems similarly would not be affected, unless their securities also are listed on an exchange or NASDAQ.[158]

Issuers and Securities Affected. SOX Section 301 prohibits the listing of "any security" of an issuer that does not meet the new standards for audit committees.[159] Therefore, the proposed SOX Section 301 rules apply not just to voting equity securities, but to any listed security, regardless of its type, including debt securities, derivative securities and other types of listed securities.[160] The SOX Section 301 Rule applies to foreign companies as well as domestic issuers, subject to certain exceptions.[161]

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154 *Id*. At 18,799.

155 SOX § 301 Release, *supra* note 6, at 18,799; *see also* New York Stock Exchange and National Association of Securities Dealer Order Approving Proposed Rule Changes, Exchange Act Release 34-48475 (Nov. 4, 2003) available at http://www.sec.gov/rules/sro/34-48475.htm.

156 *Id*.

157 *Id*. at 18,800.

158 *Id*.

159 *Id*.

160 *Id*.

161 *See infra* Section XIII.

Small Businesses. SOX Section 301 makes no distinction based on an issuer's size, except that small business issuers are given until July 31, 2005, to comply with the new audit committee requirements.[162]

Investment Companies. The SOX Section 301 Rule covers closed-end investment companies and exchange-traded, open-end investment companies, but excludes exchange-traded unit investment trusts from the proposed SOX Section 301 requirements.[163]

Determining Compliance with Standards. SOX Section 301 does not establish specific mechanisms for a national securities exchange or NASDAQ to ensure that issuers comply with the standards on an ongoing basis. SROs are required to comply with SEC rules pertaining to SROs and to enforce their own rules, including rules that govern listing requirements and affect their listed issuers. The SOX Section 301 Release directs the SROs to require a listed issuer to notify the applicable SRO promptly after an executive officer of an issuer becomes aware of any material noncompliance by the listed issuer with the requirements.[164]

Opportunity to Cure Defects. The SOX Section 301 Rule specifies that the SRO rules must provide for appropriate procedures for an issuer to have an opportunity to cure any defects that would be the basis for a prohibition of the continued listing of the issuer's securities as a result of its failure to meet the SRO audit committee standards before the imposition of such a prohibition.[165] The SRO rules may provide that an audit committee member who ceases to be independent for reasons outside his control may, with notice by the issuer to the SRO, remain on the audit committee until the earlier of (i) the next annual meeting of shareholders or (ii) the first anniversary of the event which caused him not to be independent.[166]

Audit Committee Charters. Issuers should review their audit committee charters and amend them to comply with the SOX Section 301 Rule and any applicable SRO rules.[167]

Disclosure Changes Regarding Audit Committees

- Disclosure Regarding Exemptions. Because exemptions from the rules adopted in the SOX Section 301 Release would distinguish certain issuers from most other listed issuers, the exempted issuers would need to disclose their reliance on an exemption and their assessment of whether, and if so, how, such reliance would materially adversely affect the ability of their audit committee to act independently and to satisfy the other requirements of the proposed rules.[168] Such disclosure would need to appear in, or be incorporated by reference into, (i) annual reports filed with

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162 SOX § 301 Release, *supra* note 6, at 18,790.

163 *Id*. at 18,797.

164 *Id*. at 18,805.

165 *Id*. at 18,806.

166 *Id*.

167 *Id*. at 18,808.

168 SOX § 301 Release, *supra* note 6, at 18,806.

the SEC and (ii) proxy statements or information statements for shareholders' meetings at which elections for directors are held.[169]

- Identification of the Audit Committee in Annual Reports. Currently, an issuer subject to the SEC proxy rules is required to disclose in its proxy statement or information statement, if action is to be taken with respect to the election of directors, whether the issuer has a standing audit committee, the names of each committee member, the number of committee meetings held by the audit committee during the last fiscal year, and the functions performed by the committee.[170] The SOX Section 301 Release requires disclosure of the members of the audit committee to be included or incorporated by reference in the listed issuer's annual report.[171] Also, since in the absence of an audit committee the entire board of directors will be considered to be the audit committee, the SEC requires a listed issuer that has not separately designated or has chosen not to separately designate an audit committee to disclose that the entire board of directors is acting as the issuer's audit committee.[172]

- Updates to Existing Audit Committee Disclosure. A listed issuer will be required to disclose whether the members of its audit committee are independent using the definition of independence for audit committee members included in the applicable listing standards.[173] Non-listed issuers that have separately designated audit committees would still be required to disclose whether their audit committee members were independent, but in determining whether a member was independent, non-listed issuers would be allowed to choose any definition for audit committee member independence of a national securities exchange or national securities association that has been approved by the SEC.[174]

CEO/CFO Certifications. SOX contains two separate certification requirements, which are applicable to all public companies, regardless of size, and are in addition to the one-time 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.[175]

SOX §906 Certification. SOX Section 906 amended Federal criminal law to require the CEO and CFO to furnish a written certification with each SEC periodic report filed containing financial statements certifying that the financial statements and the disclosures therein fairly present,

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169 *Id*.

170 *Id*. at 18,807.

171 *Id*.

172 *Id*.

173 *Id*. at 18,808.

174 SOX § 301 Release, *supra* note 6, at 18,808.

175 Order Requiring the Filing of Sworn Statements Pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934, SEC File No. 4-460 (June 27, 2002), *at* http://www.sec.gov/rules/other/4-460.htm.

in all material aspects, the operations and financial condition of the issuer.[176] The required form of the SOX Section 906 certification follows:[177]

> 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]

The criminal penalties applicable to a false SOX Section 906 certification are (1) 20 years in prison for a willful violation; and (2) ten years for a reckless and knowing violation.[178] The Section 906 certification requirement was effective July 30, 2002, and was not predicated on any SEC rulemaking.

SOX §302 Certification. The SEC has adopted rules pursuant to SOX Section 302 requiring the CEO and CFO of each public company filing a Form 10-Q or 10-K to certify that the financial statements filed with the SEC fairly present, in all material respects, the operations and financial condition of the issuer, as to the adequacy of the issuer's "disclosure controls and procedures" and "internal controls," and as to certain other matters.[179] The mandated CEO/CFO certification under SOX Section 302 is as follows:

> I, [identify the certifying individual], certify that:
>
> 1. I have reviewed this [specify report] of [identify registrant];

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176 SOX § 906, 18 U.S.C.A. § 1350 (West Supp. 2004) [hereinafter *"SOX § 906"*]; Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 8238, Exchange Act Release No. 47,986, 68 Fed. Reg. 36,636 (June 18, 2003), *available at* http://www.sec.gov/rules/final/33-8238.htm.

177 SOX § 906, *supra* note 176.

178 *Id*.

179 SOX § 302, 15 U.S.C.A. § 7241 (West Supp. 2004) [hereinafter *"SOX § 302"*]; Securities Act Release No. 8238, *supra* note 176. Note that certain portions of the Section 302 certification are not mandatory for a particular issuer until the final rules relating to Internal Controls over Financial Reporting are fully in effect for that issuer. *See infra* Section V.

2. Based on my knowledge, this 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 report;

3. Based on my knowledge, the financial statements, and other financial information included in this 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 report;

4. The [registrant]'s other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)[180]) [and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)[181])][182] for the [registrant] and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, 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 report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

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180 For purposes of this certification, the term "*disclosure controls and procedures*" is defined in Rule 13a-15(e) under the 1934 Act as 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 and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. 17 C.F.R. § 240.13a-15(e) (2004).

181 For purposes of this certification, the term "*internal control over financial reporting*" is defined in Rule 13a-15(f) and 15d-15(f) under the 1934 Act as a process designed by, or under the supervision of, the issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer's board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

(1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;

(2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and

(3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer's assets that could have a material effect on the financial statements.

17 C.F.R. § 240.13a-15(f); *see infra* "Internal Controls" in Section V at notes 462-470 and related text.

182 The bracketed language regarding internal control is not applicable to an issuer until its first Form 10-K that is required to contain a management report on internal control over financial reporting requirements. Generally, accelerated filers were required to include a management report on internal control over financial reporting requirements in their Forms 10-K for their fiscal years ending on or after November 15, 2004, and all other domestic issuers are required to comply for their Forms 10-K for their fiscal years ending on or after July 15, 2007. *See infra* "Internal Controls" in Section V at notes 462-470 and related text.

(c) Evaluated the effectiveness of the [registrant]'s disclosure controls and procedures and presented in this report our conclusion about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the [registrant]'s internal control over financial reporting that occurred during the [registrant]'s most recent fiscal quarter (the [registrant]'s fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the [registrant]'s internal control over financial reporting; and[183]

5. The [registrant]'s other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the [registrant]'s auditors and the audit committee of the [registrant]'s board of directors (or persons performing the equivalent function):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

To implement SOX Section 302's directive that the SOX Section 302 certifications be "in" each periodic report, the SEC originally required the certifications to appear immediately after the signature block at the end of these reports. Because the certifications are part of the text of the report to which they relate, however, the SEC found that investors are not able to easily access the certifications through its EDGAR system and that the SEC staff must review the actual text of a quarterly or annual report to confirm that the certifications have been filed. As a result, the SEC amended its rules and forms to require issuers both to (i) file the SOX Section 302 certifications as an exhibit to the periodic reports to which they relate[184] and (ii) furnish the SOX Section 906 certifications as an exhibit to the periodic reports to which they relate.[185]

Enforcement Actions. The SEC is using the SOX certification requirements as an independent basis for enforcement action. In *SEC v. Rica Foods*, the SEC settled civil injunctive

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183 This certification mirrors the requirements in new 1934 Act Rules 13a-15 and 15d-15 which require an issuer to establish and maintain an overall system of disclosure controls and procedures and internal control over financial reporting 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. In the SEC's view, "internal controls" has a meaning which both overlaps and is narrower than "disclosure controls." *See infra* "Internal Controls" in Section V at notes 462-470 and related text.

184 Securities Act Release No. 8238, *supra* note 176, at 36,638.

185 In Securities Act Release No. 8238, the SEC noted that SOX § 906 merely requires that the SOX § 906 certifications "accompany" a periodic report to which they relate, in contrast to SOX § 302, that requires the certifications to be included "in" the periodic report. In recognition of this difference, the SEC requires issuers to "furnish," rather than "file," the SOX §906 certifications with the SEC. Thus, the certifications would not be subject to liability under 1934 Act § 18 and would not be subject to automatic incorporation by reference to an issuer's 1933 Act registration statements, which are subject to liability under 1933 Act § 11, unless the issuer takes steps to include the certifications in a registration statement. Issuers are to submit the SOX § 906 certifications as exhibits to the periodic reports to which they relate and designate the certifications as an "Additional Exhibit" under Item 99 of Item 601(b) of Regulation S-K. *See id*.; SOX § 302, *supra* note 179; SOX § 906, *supra* note 176.

actions against a company headquartered in Costa Rica and the officers who personally signed certifications in a Form 10-K Report.[186] The predicate of the SEC action was that the officers signed their certifications and filed the Form 10-K Report despite the company's lack of a signed report of its independent auditors and material classification errors in the financial statements.[187] In *SEC v. Irving Paul David*, the SEC filed an enforcement action, and the U.S. Attorney for the Southern District of New York simultaneously announced an indictment, against a financial officer of two mutual funds for embezzling funds to which the investment companies were entitled and for filing SOX-mandated certificates that did not disclose his fraud.[188]

Misleading Statements to Auditors. SOX Section 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.[189] On May 20, 2003, the SEC amended and expanded Rule 13b2-2 under the 1934 Act (which already prohibited the falsification of books, records and accounts, and false or misleading statements, or omissions to make certain statements to accountants[190]) by adding (i) new subsection (b)(1) that specifically prohibits officers and directors and "persons acting under [their] direction,"[191]

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186 *SEC v. Rica Foods et. al.*, Civil Action No. 03-22191-Civ-King (S.D. Fla. filed August 15, 2003), SEC Litigation Release No. 18,293 (August 18, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr18293.htm.

187 *Id*.

188 *SEC v. Irving Paul David*, 03 Civ. 6305 (S.D.N.Y.) (KMW), SEC Litigation Release No. 18300 (August 1, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr18300.htm.

189 SOX § 303, 15 U.S.C.A. § 7242 (West Supp. 2004) [hereinafter *"SOX § 303"*].

190 See *Securities and Exchange Commission v. Vincent Steckler*, Complaint for Permanent Injunction and Other Legal and Equitable Relief, filed in U.S. District Court for Northern District of California, San Jose Division, on September 8, 2003, in which the SEC charged a vice president of sales of a public company with aiding and abetting his employer in improperly recognizing revenue in violation of Rules 10b-5 and pre-amendment 13b2-1 under the 1934 Act by arranging for an undisclosed side letter that made an otherwise unconditional order for the purchase of software provided to the issuer's legal and accounting departments subject to cancellation. The SEC's Complaint stated that under GAAP the side letter made the sale a contingent sale, which should not be recognized as revenue, and that the defendant concealed the side letter from the legal and accounting departments, thereby causing the improper revenue recognition. *SEC v. Vincent Steckler*, Complaint, Civil Action No. C-03-4067 RMW (N.D. Cal. Filed Sept. 8, 2003), *available at* http://www.sec.gov/litigation/complaints/comp18327.htm.

191 In adopting Exchange Act Release No. 47,890, the SEC commented:

> "[N]ew rule 13b2-2(b)(1) covers the activities of not only officers and directors of the issuer who engage in an attempt to misstate financial statements but also "any other person acting under the direction thereof." Activities by such "other persons" currently may constitute violations of the anti-fraud or other provisions of the securities laws or aiding or abetting or causing an issuer's violations of the securities laws. Section 303(a) and the new rule provide the Commission with an additional means of addressing efforts by persons acting under the direction of an officer or director to improperly influence the audit process and the accuracy of the issuer's financial statements.
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> As noted in the proposing release, we interpret Congress' use of the term "direction" to encompass a broader category of behavior than "supervision." In other words, someone may

from coercing, manipulating, misleading, or fraudulently influencing (collectively referred to herein as "*improperly influencing*") an auditor "engaged in the performance of an audit"[192] of the issuer's financial statements when the officer, director, or other person "knew or should have known"[193] that

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> be "acting under the direction" of an officer or director even if they are not under the supervision or control of that officer or director. **Such persons might include not only the issuer's employees but also, for example, customers, vendors or creditors who, under the direction of an officer or director, provide false or misleading confirmations or other false or misleading information to auditors, or who enter into "side agreements" that enable the issuer to mislead the auditor.** In appropriate circumstances, persons acting under the direction of officers and directors also may include not only lower level employees of the issuer but also other partners or employees of the accounting firm (such as consultants or forensic accounting specialists retained by counsel for the issuer) and **attorneys**, securities professionals, or other advisers who, for example, pressure an auditor to limit the scope of the audit, to issue an unqualified report on the financial statements when such a report would be unwarranted, to not object to an inappropriate accounting treatment, or not to withdraw an issued audit report on the issuer's financial statements. (emphasis added)
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> . . .
>
> Some commenters were concerned that including customers, vendors and creditors in the discussion of those persons who, in appropriate circumstances, might be considered to be acting under the direction of an officer or director would have a chilling effect on communications between those persons and the auditors. Other commenters noted that this chilling effect would be enhanced by the Commission's position in the proposing release that **negligently misleading** the auditor was sufficient conduct to trigger application of the rule. * * * We believe that third parties providing information or analyses to an auditor should exercise reasonable attention and care in those communications. A primary purpose for enactment of the Sarbanes-Oxley Act is the restoration of investor confidence in the integrity of financial reports, which will require the cooperation of all parties involved in the audit process. We do not intend to hold any party accountable for honest and reasonable mistakes or to sanction those who actively debate accounting or auditing issues. We do believe, however, that those third parties who, under the direction of an issuer's officers or directors, mislead or otherwise improperly influence auditors when they know or should know that their conduct could result in investors being provided with misleading financial statements or a misleading audit report, should be subject to sanction by the Commission. [emphasis added]

Improper Influence on Conduct of Audits, Exchange Act Release No. 47,890, 68 Fed. Reg. 31,820, 31,821-22 (May 28, 2003) (*codified at* 17 C.F.R. 240 (2004)), *available at* http://www.sec.gov/rules/final/34-47890.htm (emphasis added).

[192] Amended Rule 13b2-2's applicability is not limited to the formal engagement period of the issuer's current outside auditor. In adopting Release No. 47,890 (May 20, 2003), the SEC commented that

> [T]he phrase "engaged in the performance of an audit" should be given a broad reading. . . [and] encompass the professional engagement period and any other time the auditor is called upon to make decisions or judgments regarding the issuer's financial statements, including during negotiations for retention of the auditor and subsequent to the professional engagement period when the auditor is considering whether to issue a consent on the use of prior years' audit reports.

[193] Amended Rule 13b2-2 can be violated without any specific intent to render the issuer's financial statements materially misleading and without the prohibited action achieving its desired end or actually resulting in misleading financial statements. In adopting Release No. 47,890 (May 20, 2003), the SEC commented that

the action, if successful, could result in rendering the issuer's financial statements filed with the SEC materially misleading and (ii) a new subsection (b)(2) that provides examples of actions that improperly influence an auditor that could result in "rendering the issuer's financial statements materially misleading."[194]

The types of conduct that the SEC suggests could constitute "improperly influencing" 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** [emphasis added],
- 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.[195]

> [T]he phrase "knew or should have known," . . . historically has indicated the existence of a negligence standard . . . . [that] is consistent with the Commission's enforcement actions in this area [and] . . . . particularly in the absence of any private right of action under the rule, best achieves the purpose of restoring investor confidence in the audit process.

Id. at 31,826.

Amended Rule 13b2-2 departs from the text of SOX Section 303 by using "knew or should have known," a negligence standard, in place of the statutory "for the purpose of" language, which would require specific intent. Thus, the SEC will not be required to show that a person's actions were intended to render the issuer's financial statements materially misleading, but only that the person knew or was negligent in not knowing that his or her actions could achieve that result. *Id.* The distinction is illustrated by an example in the adopting release:

> For example, if an officer of an issuer coerces an auditor not to conduct certain audit procedures required by generally accepted auditing standards ("GAAS") because the officer wants to conceal his embezzlement of funds from the issuer, then it is possible that his actions might not be found to be for the "purpose of rendering the financial statements misleading." If that officer, however, knew or should have known that not performing the procedures could result in the auditor not detecting and seeking correction of material errors in the financial statements, then we believe the officer's conduct should be subject to the rule.

Id. at 31,826.

194 *See* Exchange Act Release No. 47,890, *supra* note 191.

195 *Id*. at 31,823.

Rule 13b2-2 applies 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.[196] Conducting reviews of interim financial statements and issuing consents to use past audit reports are within the scope of Rule 13b2-2.[197]

SOX Section 303(b) provides the SEC with sole civil enforcement authority with respect to SOX Section 303 and any rule or regulation issued under SOX Section 303, thereby precluding a private right of action.[198]

A violation of Rule 13b2-2 is an "illegal act" within the meaning of Section 10A(b) of the 1934 Act and, therefore, must be reported by auditors under that section.[199] Attorneys also should be aware that evidence of a violation of Rule 13b2-2 may be reportable under SOX Section 307 if it amounts to "evidence of a material violation" as defined in SOX Section 307 Rules.[200]

There is no exemption or qualification in amended Rule 13b2-2 excluding foreign private issuers from its application.[201]

CEO/CFO Reimbursement to Issuer. SOX Section 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.[202]

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 and regulators about the poor heath of the company."[203] Because there is no relationship between the financial 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, and how to measure profits.[204]

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196 *Id*. at 31,825.

197 *Id*.

198 SOX § 303(b), *supra* note 189.

199 Exchange Act Release No. 47,890, *supra* note 191, at 31,827.

200 SOX § 307, 15 U.S.C.A. § 7245 (West Supp. 2004) [hereinafter *"SOX § 307"*].

201 Exchange Act Release No. 47,890, *supra* note 191, at 31,821 n.12.

202 SOX § 304, 15 U.S.C.A. § 7243 (West Supp. 2004) [hereinafter *"SOX § 304"*].

203 S. REP. NO. 107-205, at 26 (2002).

204 *Id*. In *Neer v. Pelino*, 2005 WL 2434685 (E.D. Pa. Sept. 27, 2005), the court held that the disgorgement is limited to SEC action and that no new private cause of action was created by SOX § 304, etc.

D&O Bars. SOX Section 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-SOX standard was "substantial unfitness").[205]

Insider Trading Freeze During Plan Blackout. SOX Section 306 prohibits any director or executive officer of an issuer of any equity security from, directly or indirectly, purchasing, selling, or otherwise acquiring or transferring any equity security of the issuer during a pension plan blackout period that temporarily prevents plan participants or beneficiaries from engaging in equity securities transactions through their plan accounts, if the director or executive officer acquired the equity security in connection with his or her service or employment as a director or executive officer.[206] Under SOX Section 306, profits realized from such trades shall inure to and be recoverable by the issuer irrespective of the intent of the parties to the transaction.[207]

The Enron scandal provided impetus for SOX Section 306(a) when insiders were able to liquidate their Enron 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.[208] SOX Section 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.[209] The SEC was required to adopt implementing rules within 180 days of the effective date of SOX (January 26, 2003).[210]

Regulation BTR. On January 22, 2003, the SEC adopted Regulation Blackout Trading Restriction ("*Regulation BTR*") to implement SOX Section 306(a) and to prevent evasion of the statutory trading prohibition.[211] Regulation BTR incorporates a number of concepts developed under 1934 Act Section 16 to take advantage of "a well-established body of rules and interpretations concerning the trading activities of corporate insiders and, as to directors and executive officers of domestic issuers, facilitate enforcement of the SOX Section 306(a) trading prohibition through monitoring of the reports publicly filed by directors and executive officers pursuant to 1934 Act Section 16(a).[212]

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205 SOX § 305, *modifying* 15 U.S.C.A. § 78u. (West Supp. 2004).

206 SOX § 306 (a)(1), 15 U.S.C.A. § 7244(a)(1) (West Supp. 2004) [hereinafter *"SOX § 306"*].

207 *Id*. at (a)(2)(A).

208 Thomas O. Gorman & Heather J. Stewart, *Is There a New Sheriff in Corporateville? The Obligations of Directors, Officers, Accountants, and Lawyers After Sarbanes-Oxley of* 2002, 56 ADMIN. L. REV. 135, 150 (2004).

209 S. Rep. No. 107-205, at 27 (2002).

210 SOX § 208, 15 U.S.C.A. § 7233 (West Supp. 2004).

211 Insider Trades During Pension Fund Blackout Periods, Exchange Act Release No. 47,225, 68 Fed. Reg. 4338 (Jan. 28, 2003), *available at* http://www.sec.gov/rules/final/34-47225.htm.

212 *Id*. At 4339.

Persons Subject to Trading Prohibition. SOX Section 306(a) and Regulation BTR apply to the directors[213] and executive officers[214] of domestic issuers, foreign companies,[215] small business issuers[216] and, in rare instances, registered investment companies.[217]

Securities Subject to Trading Prohibition. SOX Section 306(a) applies to any equity security of an issuer other than an exempt security.[218]

Transactions Subject to Trading Prohibition. SOX Section 306(a) is interpreted to make it unlawful for a director or executive officer of an issuer of any equity security, directly or indirectly, to purchase, sell, or otherwise acquire or transfer any equity security of the issuer during a pension

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213 Under Regulation BTR, the term "director" has the meaning set forth in 1934 Act §3(a)(7). *Id*. at 4339. As the SEC has previously noted, this definition reflects a functional and flexible approach to determining whether a person is a director of an entity. Improper Influence on Conduct of Audits, Exchange Act Release No. 47,890 (May. 20, 2003), *available at* http://www.sec.gov/rules/final/34-47890.htm. Thus, for purposes of SOX Section 306(a) and Regulation BTR, an individual's title is not dispositive as to whether he or she is a director. As under 1934 Act Section 16, attention must be given to the individual's underlying responsibilities or privileges with respect to the issuer and whether he or she has a significant policy-making role with the issuer. *See* Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Exchange Act Release No. 28,869, 56 Fed. Reg. 7242, at § II.A.1 (Feb. 21, 1991). An individual may hold the title "director" and yet, because he or she is not acting as such, not be deemed a director. *See* Ownership Reports and Trading by Officers, Directors and Principal Stockholders, Exchange Act Release No. 26,333, 53 Fed. Reg. 49,997, at § III.A.2 (Dec. 13, 1988).

214 Under Regulation BTR, the term "executive officer" has the same meaning as the term "officer" in 1934 Act Rule 16a-1(f).

215 *See infra* Section XIII.

216 SOX Section 306(a) does not distinguish between large and small issuers.

217 Exchange Act Release No. 47,225, *supra* note 211, at 4339.

218 SOX §306(a), *supra* note 206. Rule 100(i) of Regulation BTR defines the term "exempt security" by reference to the definition in 1934 Act Section 3(a)(12). 17 C.F.R. § 245.100(i) (2004). Rule 100(f) provides that the term "equity security of the issuer" includes any equity security or derivative security relating to an issuer, whether or not issued by that issuer. 17 C.F.R. § 245.100(f). Rule 100(d) provides that the term "derivative security" has the same meaning as in 1934 Act Rule 16a-1(c), which defines the term "derivative securities" to mean

> any option, warrant, convertible security, stock appreciation right, or similar right with an exercise or conversion privilege at a price related to an equity security, or similar securities with a value derived from the value of an equity security, but shall not include: (1) Rights of a pledgee of securities to sell the pledged securities; (2) Rights of all holders of a class of securities of an issuer to receive securities pro rata, or obligations to dispose of securities, as a result of a merger, exchange offer, or consolidation involving the issuer of the securities; (3) Rights or obligations to surrender a security, or have a security withheld, upon the receipt or exercise of a derivative security or the receipt or vesting of equity securities, in order to satisfy the exercise price or the tax withholding consequences of receipt, exercise or vesting; (4) Interests in broad-based index options, broad-based index futures, and broad-based publicly traded market baskets of stocks approved for trading by the appropriate federal governmental authority; (5) Interests or rights to participate in employee benefit plans of the issuer; or (6) Rights with an exercise or conversion privilege at a price that is not fixed; or (7) Options granted to an underwriter in a registered public offering for the purpose of satisfying over-allotments in such offering.

17 C.F.R. § 240.16a–1(c) (2004).

plan blackout period with respect to the equity security if the director or executive officer acquired such equity security in connection with his or her service or employment as a director or executive officer.[219]

(a) *"Acquired in Connection with Service or Employment as a Director or Executive Officer."* Regulation BTR defines the phrase "acquired such equity security in connection with service or employment as a director or executive officer" to include equity securities acquired by a director or executive officer:

- At a time when he or she was a director or executive officer under a compensatory plan, contract, authorization, or arrangement, including, but not limited to, plans relating to options, warrants or rights, pension, retirement or deferred compensation or bonus, incentive or profit-sharing (whether or not set forth in any formal plan document), including a compensatory plan, contract, authorization, or arrangement with a parent, subsidiary or affiliate;[220]

- At a time when he or she was a director or executive officer as a result of any transaction or business relationship described in paragraph (a) or (b) of Item 404 of Regulation S-K[221] to the extent that he or she has a pecuniary interest in the equity securities;[222]

- At a time when he or she was a director or executive officer, as "directors' qualifying shares" or other securities that he or she must hold to satisfy minimum ownership requirements or guidelines for directors or executive officers;[223]

- Prior to becoming, or while, a director or executive officer where the equity security was acquired as a direct or indirect inducement to service or employment as a director or executive officer;[224] or

- Prior to becoming, or while, a director or executive officer where the equity security was received as a result of a business combination in respect of an equity security of an entity involved in the business combination that he or she had acquired in connection with service or employment as a director or executive officer of such entity.[225]

(b) *Service or Employment Presumption*. Regulation BTR provides that any equity securities sold or otherwise transferred during a blackout period by a director or executive officer of an issuer will be considered to have been "acquired in connection with service or employment as a director or executive officer" to the extent that the director or executive officer had a pecuniary

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219 17 C.F.R. § 245.101(a) (2004).

220 17 C.F.R. § 245.100(a)(1) (2004).

221 17 C.F.R. § 229.404 (2004).

222 17 C.F.R. § 245.100(a)(2) (2004).

223 17 C.F.R. § 245.100(a)(3) (2004).

224 17 C.F.R. § 245.100(a)(4) (2004).

225 17 C.F.R. § 245.100(a)(5) (2004).

interest in such securities at the time of the transaction, unless he or she establishes that the equity securities were not "acquired in connection with service or employment as a director or executive officer."[226] To establish this defense, a director or executive officer must specifically identify the origin of the equity securities in question and demonstrate that this identification of the equity securities is consistent for all purposes related to the transaction (such as tax reporting and any applicable disclosure and reporting requirements).[227] In other words, to the extent that directors and executive officers are able to specifically identify, or trace, the source of equity securities sold or otherwise transferred during a blackout period, the transaction will not be considered to involve securities "acquired in connection with service or employment as a director or executive officer."[228]

(c) *Transitional Situations*. Equity securities acquired by an individual before he or she becomes a director or executive officer are not "acquired in connection with service or employment as a director or executive officer."[229] Thus, equity securities acquired under a compensatory plan, contract, authorization, or arrangement while an individual is an employee, but not a director or executive officer, will not be subject to SOX Section 306(a) trading prohibition. However, equity securities acquired by an employee before becoming a director or executive officer will be considered "acquired in connection with service or employment as a director or executive officer" if the equity securities are part of an inducement award.[230]

In contrast, equity securities acquired by an individual in connection with service or employment as a director or executive officer before an entity becomes an "issuer" are considered "acquired in connection with service or employment as a director or executive officer" for purposes of SOX Section 306(a) and Regulation BTR and are subject to the statutory trading prohibition.[231] Similarly, equity securities acquired by a director or executive officer in connection with his or her service or employment as a director or executive officer of an issuer before the effective date of SOX Section 306(a) are subject to that section and Regulation BTR.[232]

(d) *Exempt Transactions*. Regulation BTR exempts from the statutory trading prohibition:

- Acquisitions of equity securities under dividend or interest reinvestment plans;[233]
- Purchases or sales of equity securities pursuant to a trading arrangement that satisfies the affirmative defense conditions of 1934 Act Rule 10b5-1(c);[234]

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226 17 C.F.R. § 245.101(b) (2004).

227 *Id*.

228 *Id*.

229 17 C.F.R. § 245.100(a) (2004).

230 17 C.F.R. § 245.100(a)(4) (2004).

231 17 C.F.R. § 245.100(a) (2004).

232 *Id*.

233 17 C.F.R. § 245.101(c)(1) (2004).

234 17 C.F.R. § 245.101(c)(2) (2004).

- Purchases or sales of equity securities, other than discretionary transactions, pursuant to certain "tax-conditioned" plans;[235]

- Increases or decreases in the number of equity securities held as a result of a stock split or stock dividend applying equally to all equity securities of that class;[236]

- Compensatory grants and awards of equity securities (including options and stock appreciation rights) pursuant to a plan that, by its terms, permits directors or executive officers to receive grants or awards, provides for grants or awards to occur automatically, and specifies the terms and conditions of the grants or awards;[237]

- Exercises, conversions, or terminations of derivative securities that were not written or acquired by a director or executive officer during the blackout period in question or while aware of the actual or approximate beginning or ending dates of the blackout period, and where (i) the derivative security, by its terms, may be exercised, converted, or terminated only on a fixed date, with no discretionary provision for earlier exercise, conversion, or termination, or (ii) the derivative security is exercised, converted, or terminated by a counterparty and the director or executive officer does not exercise any influence on the counterparty with respect to whether or when to exercise, convert, or terminate the derivative security;[238]

- Acquisitions or dispositions of equity securities involving a *bona fide* gift or a transfer by will or the laws of descent and distribution;[239]

- Acquisitions or dispositions of equity securities pursuant to a domestic relations order;[240]

- Sales or other dispositions of equity securities compelled by the laws or other requirements of an applicable jurisdiction;[241] and

- Acquisitions or dispositions of equity securities in connection with a merger, acquisition, divestiture, or similar transaction occurring by operation of law.[242]

The exemption in Regulation BTR does not extend to "discretionary transactions," such as an intra-plan transfer involving an issuer equity securities fund or a cash distribution funded by a volitional disposition of an issuer equity security,[243] that occur during a blackout period.[244]

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235 17 C.F.R. § 245.101(c)(3) (2004).

236 17 C.F.R. § 245.101(c)(10) (2004).

237 17 C.F.R. § 245.101(c)(4) (2004).

238 17 C.F.R. § 245.101(c)(5) (2004).

239 17 C.F.R. § 245.101(c)(6) (2004).

240 17 C.F.R. § 245.101(c)(7) (2004).

241 17 C.F.R. § 245.101(c)(8) (2004).

242 17 C.F.R. § 245.101(c)(9) (2004).

243 17 C.F.R. § 240.16b–3(b)(4) (2004).

However, it would cover acquisitions or dispositions of equity securities made in connection with death, disability, retirement or termination of employment, or transactions involving a diversification or distribution required by the Internal Revenue Code to be made available to plan participants because these transactions are not "discretionary transactions."[245]

Blackout Period. SOX Section 306(a)(4)(A) defines the term "*blackout period*" to mean any period of more than three consecutive business days during which the ability of not fewer than 50% of the participants or beneficiaries under all "*individual account plans*" maintained by an issuer to purchase, sell, or otherwise acquire or transfer an interest in any equity security of the issuer held in such an individual account plan is temporarily suspended by the issuer or by a fiduciary of the plan.[246]

(a) *Individual Account Plan*. The Regulation BTR definition of "*individual account plan*" encompasses a variety of pension plans, including 401(k) plans, profit-sharing and savings plans, stock bonus plans, and money purchase pension plans, but excludes one-participant retirement plans and pension plans, in which participation is limited to directors of the issuer.[247]

(b) *Blackout Period*. Regulation BTR defines "*blackout period*" such that, in determining whether a temporary trading suspension in issuer equity securities constitutes a "*blackout period*," the individual account plans to be considered are individual account plans maintained by an issuer that permit participants or beneficiaries located in the U.S. to acquire or hold equity securities of the issuer.[248]

(c) *Determining Participants and Beneficiaries*. Once an issuer has identified the relevant individual account plans, it must determine whether the temporary suspension of trading in its equity securities affects 50% or more of the participants or beneficiaries under these plans.[249] This is accomplished by comparing the number of participants or beneficiaries located in the U.S. who are subject to the temporary trading suspension in issuer equity securities to the number of participants or beneficiaries located in the U.S. under all individual account plans maintained by the issuer.[250] In the case of a domestic issuer, where this percentage is 50% or more, the temporary trading suspension constitutes a "blackout period," so the SOX Section 306(a) trading prohibition applies to the issuer's directors and executive officers.[251]

On any day, it may be difficult for an issuer to know precisely how many participants and beneficiaries are covered by all of its individual account plans. As a result, issuers will need to apply

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244 17 C.F.R. § 245.101(c)(3) (2004).

245 17 C.F.R. § 240.16b–3(b)(4) (2004).

246 SOX § 306(a)(4)(A), *supra* note 206.

247 17 C.F.R. § 245.100(j) (2004).

248 17 C.F.R. § 245.100(b)(1) (2004).

249 *Id*.

250 *Id*.

251 With respect to foreign private issuers, *see infra* Section XIII.

the "50% test" on the basis of estimates. Regulation BTR contains provisions for making reasonable estimates.

(d) *Exceptions to Definition of Blackout Period*. SOX Section 306(a)(4)(B) expressly excludes from the definition of the term "blackout period" two types of temporary trading suspensions:

- A regularly scheduled period in which the participants and beneficiaries may not purchase, sell, or otherwise acquire or transfer an interest in any equity security of an issuer, if such period is—
  - Incorporated into the individual account plan; and
  - Timely disclosed to employees before they become participants under the individual account plan or as a subsequent amendment to the plan;[252] or
- Any temporary trading suspension [that would otherwise be a "blackout period"] that is imposed solely in connection with persons becoming participants or beneficiaries, or ceasing to be participants or beneficiaries, in an individual account plan by reason of a corporate merger, acquisition, divestiture, or similar transaction involving the plan or plan sponsor.[253]

Remedies. SOX Section 306(a) contains two distinct sets of remedies: (i) a violation of the statutory trading prohibition in SOX Section 306(a)(1) is treated as a violation of the 1934 Act and subject to all resulting sanctions, including SEC enforcement action, and (ii) where a director or executive officer realizes a profit from a prohibited transaction during a blackout period, SOX Section 306(a)(2) permits an issuer, or a security holder of the issuer on its behalf, to bring an action to recover that profit.[254] Under the latter provision, an issuer, or a security holder on its behalf, may

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252 Regulation BTR provides that the requirement that the regularly scheduled period be incorporated into the individual account plan may be satisfied by including a description of the regularly scheduled trading suspension in issuer equity securities, including the suspension's frequency and duration and the plan transactions to be suspended or otherwise affected, in either the official plan documents or other documents or instruments that govern plan operations. In the latter case, these documents or instruments may include an ERISA Section 404(c) notice or an advance notice in either the plan's summary plan description or any other official plan communication. *See* Exchange Act Release No. 47,225, *supra* note 211, at 4347.

The disclosure of the regularly scheduled trading suspension will be considered timely if the employee is notified of the trading suspension at any time prior to, or within 30 calendar days after, the employee's formal enrollment in the plan, or, in the case of a subsequent amendment to the plan, within 30 calendar days after adoption of the amendment. *Id*.

253 17 C.F.R. § 245.102 (2004). In the case of a temporary trading suspension in issuer equity securities imposed in connection with a merger, acquisition, divestiture, or similar transaction, Regulation BTR provides that the temporary suspension will not constitute a "blackout period" for purposes of SOX Section 306(a) if: (i) its principal purpose is to enable individuals to become participants or beneficiaries in an individual account plan by reason of the transaction, or to terminate participation in the plan, even though the suspension is also used to effect other administrative actions that are incidental to the admission or withdrawal of plan participants or beneficiaries and (ii) the persons becoming participants or beneficiaries are not permitted to participate in the same class of equity securities after the merger, acquisition, divestiture, or similar transaction as before the transaction. *See* Exchange Act Release No. 47,225, *supra* note 211, at 4348.

254 SOX § 306(a)(1)-(2), *supra* note 206.

initiate an action only if a director or executive officer realized a profit as a result of a prohibited purchase, sale or other acquisition, or transfer of an equity security during a blackout period.[255] As under 1934 Act Section 16(b), this concept of "realized profits" means that the director or executive officer must have received a direct or indirect pecuniary benefit from the transaction.[256]

To provide guidance to the courts regarding SOX Section 306(a)(2) private actions against directors and executive officers who have violated the statutory trading prohibition, Regulation BTR provides that where a transaction involves a purchase, sale or other acquisition, or transfer of a listed equity security (other than a grant, exercise, conversion, or termination of a derivative security), profit is to be measured by comparing the difference between the amount paid or received for the equity security on the date of the transaction during the blackout period and the average market price of the equity security calculated over the first three trading days after the ending date of the blackout period.[257] Otherwise, profit is to be measured in a manner that is consistent with the objective of identifying the amount of any gain realized or loss avoided as a result of the transaction taking place during the blackout period rather than taking place outside of the blackout period.[258] To mitigate the effect of large fluctuations in the market price of an issuer's equity securities after a blackout period and deter attempts to manipulate this market price, Regulation BTR uses a three-day average trading price to determine the amount that a director or executive officer would have paid or received if the transaction had occurred after the end of the blackout period.[259]

Notice of Blackout Period. SOX Section 306(a)(6) requires that an issuer provide timely notice to its directors and executive officers[260] and to the SEC on Form 8-K of the imposition of a blackout period that triggers the trading prohibition of SOX Section 306(a).[261]

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255 SOX § 306(a)(2)(A), *supra* note 206.

256 17 C.F.R. § 240.16a-1(a)(2) (2004).

257 Exchange Act Release No. 47,225, *supra* note 211, at 4357.

258 *Id*.

259 *Id*. at 4349.

260 SOX § 306(a)(6), *supra* note 206. Regulation BTR requires that the notice specify the length of the blackout period, using either the actual or expected beginning date and ending date of the blackout period, or the calendar week or weeks during which the blackout period is expected to begin and end, provided that during such week or weeks information as to whether the blackout period has begun or ended is readily available without charge (such as via a toll-free telephone number or access to a specified web site), to affected directors and executive officers and that the notice describes how to access the information. Regulation BTR further permits the length of the blackout period to be described in the notice to the SEC using the calendar week or weeks during which the blackout period is expected to begin and end, provided that the notice also describes how a security holder or other interested person may obtain, without charge, the actual beginning and ending dates of the blackout period. Under the rule, it is permissible to use a "week of _____" beginning date and a "week of _____" ending date. It also is permissible to use a specific beginning date and a "week of _____" ending date, or the converse. For purposes of the rule, a calendar week is defined to mean a seven-day period beginning on Sunday and ending on Saturday. If an issuer elects to provide the actual or expected beginning and ending dates of a blackout period in the required notice, and either or both of those dates change, the issuer is required to provide directors and executive officers and the SEC with an updated notice identifying the change in date or dates, explaining the reasons for the changes and identifying all material changes in the information contained in the prior notice. The updated notice is required to be provided as soon as reasonably practicable.

Enhanced Attorney Responsibilities. SOX Section 307 mandates that the SEC 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 officer (*"CLO"*) or the equivalent, if the issuer has a CLO, or to both the CLO and the CEO, of the company, and (2) if corporate executives do not respond appropriately, requiring the attorney to report to the board of directors or an appropriate committee thereof.[262] On January 23, 2003, the SEC complied with the mandate by adopting the rules implementing provisions of SOX Section 307 that prescribe minimum standards of professional conduct for attorneys appearing and practicing before the SEC in any way in the representation of issuers (*"SOX Section 307 Release"*).[263] These rules adopted under SOX Section 307 (*"SOX Section 307 Rules"*) constitute a new Part 205 to Title 17 of the Code of Federal Regulations, Standards of Professional Conduct for Attorneys Appearing and Practicing before the Commission, and became effective on August 5, 2003.[264] The rules also implement the SEC views that attorneys are "gatekeepers" – enforcers of the rules of the capital markets – who are important actors in keeping the market fair and honest, and should be responsible for insisting that the companies they represent comply with the law.

Generally, SOX Section 307 Rules require that, in the event that an attorney has *"credible evidence based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation [of any U.S. law or fiduciary duty] has occurred, is ongoing, or is about to occur,"* the attorney has a duty to seek to remedy the problem by "reporting up the ladder" within the issuer.[265] This standard, developed from the SEC's attempt to make objective rather than subjective the test of when a lawyer must report a violation, has a lower threshold than a "more likely than not" standard. An attorney's duty is not confined to matters as to which the attorney has formed a legal conclusion that there has been a material violation.

See Filing Guidance Related to: Conditions for Use of Non-GAAP Financial Measures; and Insider Trades During Pension Fund Blackout Periods, Securities Act Release No. 8216, Exchange Act Release No. 47,583, 68 FED. REG. 15,939 (April 2, 2003), *available at* http://www.sec.gov/rules/final/33-8216.htm.

Regulation BTR provides that the notice to directors and executive officers will be considered timely if an issuer provides it no later than five business days after the issuer receives the notice from the pension plan administrator required by the Department of Labor Rules. If the issuer does not receive such notice, the issuer must provide its notice to directors and executive officers at least 15 calendar days before the actual or expected beginning date of the blackout period. This provision is designed to ensure that an issuer will typically not be required to provide the notice under SOX Section 306(a)(6) to its directors and executive officers until it has received notice of an impending blackout period from the pension plan administrator. Notwithstanding this general requirement, Regulation BTR provides that advance notice is not required in any case where unforeseeable events or circumstances beyond the issuer's reasonable control prevent the issuer from providing advance notice to its directors and executive officers.

261 SOX § 306(a)(6), *supra* note 206.

262 SOX § 307, *supra* note 200.

263 *See* Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 8185, Exchange Act Release No. 47,276, 68 Fed. Reg. 6296 (Feb. 6, 2003) (*codified at* 17 C.F.R. § 205 (2004)), *available at* http://www.sec.gov/rules/final/33-8185.htm [hereinafter the *"SOX Section 307 Release"*].

264 17 C.F.R. § 205.1–.7 (2004).

265 17 C.F.R. § 205.2 (2004) (emphasis added).

Relationship to State Disciplinary Rules. SOX Section 307 Rules purport to set forth minimum standards of professional conduct for attorneys appearing and practicing before the SEC in the representation of an issuer.[266] SOX Section 307 standards are intended to supplement applicable standards of any jurisdiction where an attorney is admitted or practices and are not intended to limit the ability of any jurisdiction to impose additional obligations on an attorney not inconsistent with the application of SOX Section 307 Rules.[267] Where the standards of a state or other U.S. jurisdiction where an attorney is admitted or practices conflict with SOX Section 307 Rules, SOX Section 307 Rules provide that they shall govern.[268]

Attorneys Covered. The SOX Section 307 Rules apply to all attorneys, whether in-house counsel or outside counsel and those in foreign jurisdictions, "*appearing and practicing*" before the SEC.[269] The term "*appearing and practicing*" before the SEC is defined to include, without limitation: (1) transacting any business with the SEC, including communication in any form with the SEC; (2) representing an issuer in an SEC administrative proceeding or in connection with any SEC investigation, inquiry, information request, or subpoena; (3) providing advice in respect of the U.S. securities laws regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the SEC, including the provision of such advice in the context of preparing, or participating in the preparation of, any such document;[270] or (4) advising an issuer as to whether information or a statement, opinion, or other writing is required under the U.S. securities laws to be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the SEC; but does not include an attorney who (i) conducts these activities other than in the context of providing legal services to an issuer with whom the attorney has an attorney-client relationship;[271] or (ii) is a non-appearing foreign attorney.[272] The SEC intends that the issue of whether an attorney-client relationship exists for purposes of the SOX Section 307 Rules will be a federal question and, in general, will turn on the expectations and understandings between the attorney and the issuer.[273] Thus, whether the provision

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266 SOX Section 307 Release, *supra* note 263, at 6297.

267 *Id*.

268 *Id*.

269 17 C.F.R. § 205.2 (2004).

270 Mere preparation of a document that may be included as an exhibit to a filing with the SEC does not constitute "appearing and practicing" before the SEC unless the attorney has notice that the document will be filed with or submitted to the SEC *and* he or she provides advice on U.S. securities law in preparing the document. Thus, preparing an employment contract for an executive officer would not constitute "appearing and practicing" before the SEC, while drafting a description of the contract for a proxy statement would. SOX Section 307 Release, *supra* note 263, at 6297.

271 This portion of the definition of "appearing and practicing" before the SEC has the effect of excluding from coverage attorneys at public broker-dealers and other issuers who are licensed to practice law and who may transact business with the SEC, but who are not in the legal department and do not provide legal services within the context of an attorney-client relationship. *Id*.

272 The SOX Section 307 Rules incorporate a concept of "non-appearing foreign attorney" to address the situation of attorneys who are admitted outside of the U.S., do not give advice as to U.S. securities laws and whose involvement with SEC matters is either peripheral or through U.S. counsel, and to relieve such attorneys of the responsibilities of the SOX Section 307 Rules. *Id*.; *see also infra* Section XIII.

273 SOX Section 307 Release, *supra* note 263, at 6298.

of legal services under particular circumstances would or would not establish an attorney-client relationship under the state laws or ethics codes of the state where the attorney practices or is admitted may be relevant to, but will not be controlling on, the issue under SOX Section 307 Rules.

Who is the Client? SOX Section 307 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.[274] The attorney owes his or her professional and ethical duties to the issuer as an organization.[275] In the case of a large corporation with multiple subsidiaries, questions will arise as to whether the attorney represents the consolidated group or only a particular entity within, and the answers will vary depending on the unique facts of each situation.[276]

What Evidence Triggers Reporting Duty? SOX Section 307 reporting duties are triggered when an attorney has "*evidence of a material violation*," which is defined to mean "credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur."[277] "*Material violation*" in turn is defined to mean a material

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274 17 C.F.R. § 205.3 (2004).

275 Section 1.12(a) of the Texas Disciplinary Rules of Professional Conduct provides that "[a] lawyer employed or retained by an organization represents the entity" rather than the individuals to whom the lawyer reports in the ordinary course of working relationships. TEX. DISCIPLINARY R. PROF'L CONDUCT 1.12(a), *reprinted in* TEX. GOV'T. CODE ANN., tit. 2, subtit. G App. A (Vernon 1998).

276 Attorneys' engagement letters sometimes are very specific as to the representation being solely of a specified entity and not any parent or subsidiary entities or related persons; sometimes the client will want the attorneys to agree that the client is all of the members of the consolidated group.

277 SOX Section 307 Release comments that the definition of "evidence of a material violation" is an objective standard, instead of a subjective standard which would require "actual belief" that a material violation has occurred, is ongoing, or is about to occur before the attorney would be obligated to make an initial report within the client issuer. In explaining how the definition's objective standard should be interpreted, the SOX Section 307 Release states:

> Evidence of a material violation must first be credible evidence. An attorney is obligated to report when, based upon that credible evidence, "it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur." This formulation, while intended to adopt an objective standard, also recognizes that there is a range of conduct in which an attorney may engage without being unreasonable. The "circumstances" are the circumstances at the time the attorney decides whether he or she is obligated to report the information. These circumstances may include, among others, the attorney's professional skills, background and experience, the time constraints under which the attorney is acting, the attorney's previous experience and familiarity with the client, and the availability of other lawyers with whom the lawyer may consult. Under the revised definition, an attorney is not required (or expected) to report "gossip, hearsay, [or] innuendo." Nor is the rule's reporting obligation triggered by "a combination of circumstances from which the attorney, in retrospect, should have drawn an inference," as one commenter feared.
>
> On the other hand, the rule's definition of 'evidence of a material violation" makes clear that the initial duty to report up-the-ladder is not triggered only when the attorney "knows" that a material violation has occurred or when the attorney "conclude[s] there has been a violation, and no reasonable fact finder could conclude otherwise." That threshold for initial reporting within the issuer is too high. Under the Commission's rule, evidence of a material violation must be reported in all circumstances

violation of an applicable U.S. federal or state securities law, a material "breach of fiduciary duty" arising under U.S. federal or state law, or a similar material violation of any U.S. federal or state law.[278] The SOX Section 307 Release comments that SOX Section 307 Rules do not contain a separate definition of "material" because "that term has a well-established meaning under the federal securities laws and the [SEC] intends for that meaning to apply under" SOX Section 307 Rules.[279] SOX Section 307 Release, however, does comment that material violations must arise under U.S. law (federal or state) and do not include violations of foreign laws.[280] "*Breach of fiduciary duty*" under SOX Section 307 Rules "refers to any breach of fiduciary or similar duty to the issuer recognized under an applicable federal or state statute or at common law, including but not limited to misfeasance, nonfeasance, abdication of duty, abuse of trust, and approval of unlawful transactions."[281]

> in which it would be unreasonable for a prudent and competent attorney not to conclude that it is "reasonably likely" that a material violation has occurred, is ongoing, or is about to occur. To be "reasonably likely" a material violation must be more than a mere possibility, but it need not be "more likely than not." If a material violation is reasonably likely, an attorney must report evidence of this violation. The term "reasonably likely" qualifies each of the three instances when a report must be made. Thus, a report is required when it is reasonably likely a violation has occurred, when it is reasonably likely a violation is ongoing or when reasonably likely a violation is about to occur.

SOX Section 307 Release, *supra* note 263, at 6302.

278 17 C.F.R. § 205.2(i) (2004).

279 SOX Section 307 Release, *supra* note 263, at 6303. SOX Section 307 Release cites *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-36 (1988), and *TSC Indus. v. Northway, Inc.*, 426 U.S. 438 (1976) for the generally accepted definition of "material." Materiality is defined in those cases as follows:

> "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."

TSC Industries, 426 U.S. at 449, expressly adopted in *Basic, Inc.* 485 U.S. at 231-232.

280 17 C.F.R. § 205.2(i) (2004).

281 17 C.F.R. § 205.2(d) (2004). Both article 2.31 of the Texas Business Corporate Act and title 8, section 141(a) of the Delaware Code provide that the business and affairs of a corporation are to be managed under the direction of its board of directors. While the Texas and Delaware corporation statutes provide statutory guidance as to matters such as the issuance of securities, the payment of dividends, the conduct of meetings of directors and shareholders, and the ability of directors to rely on specified persons and information, the nature of a director's "fiduciary" duty to the corporation and the shareholders has been largely defined by the courts through damage and injunctive actions. In Texas, "[t]hree broad duties stem from the fiduciary status of corporate directors; namely the duties of obedience, loyalty, and due care." *Gearhart Industries, Inc. v. Smith International, Inc.*, 741 F.2d 707, 719 (5th Cir. 1984). *Gearhart* describes those duties as follows: (i) "the duty of obedience requires a director to avoid committing *ultra vires* acts, i.e., acts beyond the scope of the power of the corporation as defined by its articles of incorporation or the laws of the state of incorporation[;]" (ii) "the duty of loyalty dictates that a director must act in good faith and must not allow his personal interests to prevail over the interests of the corporation[;]" and (iii) the duty of due care requires that "a director must handle his corporate duties with such care as an ordinarily prudent man would use under similar circumstances." *Id*. at

Duty to Report Evidence of a Material Violation. If an attorney, appearing and practicing before the SEC "in the representation of an issuer,"[282] becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, SOX Section 307 Rules require the attorney to "*report*" [283] the evidence to the issuer's CLO (if the issuer has a CLO) or to both the issuer's CLO and its CEO forthwith.[284] By communicating such information to the issuer's officers or directors, an attorney does not reveal client confidences or secrets or privileged or otherwise protected information related to the attorney's representation of an issuer.[285]

The CLO is then obligated to cause such inquiry[286] into the evidence of a material violation as he or she "*reasonably believes*"[287] is appropriate to determine whether the material violation described in the report has occurred, is ongoing, or is about to occur.[288] If the CLO determines no material violation has occurred, is ongoing, or is about to occur, he or she shall notify the reporting attorney and advise the reporting attorney of the basis for such determination.[289] Unless the CLO reasonably believes that no material violation has occurred, is ongoing, or is about to occur, he or she shall take all reasonable steps to cause the issuer to adopt an "*appropriate response*,"[290] and shall

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719-20. In Delaware, the fiduciary duties include those of loyalty, care, candor, and oversight. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985); *In re Caremark International, Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996); s*ee also In re Abbott Laboratories Derivative Shareholders Litigation*, 293 F.3d 378 (7th Cir. 2002). Both Texas and Delaware have adopted a judicial rule of review of business decisions, known as the "business judgment rule," that is intended to protect disinterested directors from liability for decisions made by them when exercising their business judgment, but there are substantial differences in the Delaware and Texas judicial approaches to the business judgment rule. *See* Byron F. Egan & Curtis W. Huff, *Choice of State of Incorporation - Texas versus Delaware: Is It Now Time To Rethink Traditional Notions?*, 54 SMU L. Rev. 249, 287-88 (Winter 2001). The extent to which traditional business judgment rule analyses will be applicable in respect of SOX requirements is unclear.

282 SOX Section 307 Rules define "*in the representation of an issuer*" to mean providing legal services as an attorney for an issuer, regardless of whether the attorney is employed or retained by the issuer. 17 C.F.R. § 205.2(g) (2004).

283 SOX Section 307 Rules define "*report*" to mean to make known to directly, either in person, by telephone, by e-mail, electronically, or in writing. 17 C.F.R. § 205.2(n) (2004).

284 17 C.F.R. § 205.3(b) (2004).

285 *Id*.

286 An attorney conducting an inquiry into reported evidence of a material violation would be deemed appearing and practicing before the SEC in the representation of the issuer. The attorney reporting the evidence to the CLO could be a person commissioned by the CLO to conduct the inquiry into the evidence. The inquiry is important not only for what it finds about the possible violation which initiated the inquiry, but also for any additional possible violations which it may uncover.

287 SOX Section 307 Rules provide that "*reasonably believes*" means that an attorney believes the matter in question and that the circumstances are such that the belief is not unreasonable, and that "reasonable" or "reasonably" denote, with respect to the actions of an attorney, conduct that would not be unreasonable for a prudent and competent attorney. 17 C.F.R. § 205.2(m) (2004).

288 17 C.F.R. § 205.3(b)(2) (2004).

289 *Id*.

290 "*Appropriate response*" is defined by the SOX Section 307 Rules as a response to an attorney regarding reported evidence of a material violation as a result of which the attorney reasonably believes that: (1) no material violation has occurred, is ongoing, or is about to occur; (2) the issuer has, as necessary, adopted appropriate remedial measures, including appropriate steps or sanctions to stop any material violations that are

advise the reporting attorney thereof.[291] In lieu of causing such an inquiry, a CLO may refer a report of evidence of a material violation to a qualified legal compliance committee ("*QLCC*") if the issuer has duly established a QLCC prior to the report of evidence of a material violation.[292]

Unless an attorney who has made the report reasonably believes that the CLO or CEO has provided an appropriate response within a reasonable time, the attorney shall report the evidence of a material violation to: (i) the issuer's audit committee, (ii) another committee consisting solely of independent directors, or (iii) the board of directors.[293]

If an attorney reasonably believes that it would be futile to report evidence of a material violation to the issuer's CLO and CEO, the attorney may bypass them and report the evidence to the board or an appropriate committee.[294]

An attorney retained or directed by an issuer to investigate evidence of a reported material violation shall be deemed to be appearing and practicing before the SEC. Directing or retaining an

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ongoing, to prevent any material violation that has yet to occur, and to remedy or otherwise appropriately address any material violation that has already occurred and to minimize the likelihood of its recurrence; or (3) the issuer, with the consent of the issuer's board of directors, an appropriate committee thereof or a QLCC, has retained or directed an attorney to review the reported evidence of a material violation and either (i) has substantially implemented any remedial recommendations made by such attorney after a reasonable investigation and evaluation of the reported evidence or (ii) has been advised that such attorney may, consistent with his or her professional obligations, assert a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to the reported evidence of a material violation. 17 C.F.R. § 205.2(b) (2004).

291 17 C.F.R. § 205.3(b)(2) (2004).

292 *Id*.

293 *See* Patrick McGeehan, *Lawyers Take Suspicions On TV Azteca To Its Board*, N. Y. TIMES, December 24, 2003, at C1:

> In one of the first applications of a new provision of the Sarbanes-Oxley Act, outside lawyers for Mexico's second-largest broadcaster have told its board – and, possibly, federal regulators – that they think that the company violated United States securities laws.
>
> The company, TV Azteca, has had a long-running dispute with lawyers in New York about the need for greater disclosure about transactions that could have yielded a profit of more than $100 million to the company's billionaire chairman and controlling shareholder, Ricardo B. Salinas Pliego. When company executives refused to make the disclosures that the lawyers demanded, the lawyers cited the new provision of the act, which requires them to notify the company's board and permits them to contact regulators as well.
>
> . . . in a Dec. 12 letter to the boards of TV Azteca and its parent company, Azteca Holdings, [outside New York counsel citing SOX Section 307] told the boards that [the firm] was withdrawing as counsel to the company on a pending bond offering and that it might notify the Securities and Exchange Commission of its withdrawal and the reasons for it.

The SEC filed civil fraud charges TV Azteca, its parent company, and three of its officers and directors on January 4, 2005 alleging significant related party transactions which were undisclosed in TV Azteca's periodic reports. *See* SEC Litigation Release 19022 (Jan. 4, 2005). In the SEC Litigation Release, the SEC noted that the company's outside counsel withdrew from its representation pursuant to its duties under Section 307 of SOX.

294 17 C.F.R. § 205.3(b)(4) (2004).

attorney to investigate reported evidence of a material violation does not relieve an officer or director of the issuer to whom such evidence has been reported from a duty to respond to the reporting attorney.[295]

An attorney does not have any obligation to report evidence of a material violation if (i) the attorney was retained or directed by the issuer's CLO to investigate such evidence of a material violation and reports the results of such investigation to the CLO (and the CLO to the board or an appropriate committee) and both the attorney and the CLO reasonably believes that no material violation has occurred, is ongoing, or is about to occur, or (ii) the attorney was retained or directed by the CLO to assert, consistent with his or her professional obligations, a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to such evidence of a material violation, and the CLO provides reasonable and timely reports on the progress and outcome of such proceeding to the issuer's board or appropriate committee.[296]

An attorney does not have any obligation to report evidence of a material violation if the attorney was retained or directed by a QLCC to either investigate such evidence of a material violation or to assert a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to such evidence of a material violation.[297]

An attorney who receives what he or she reasonably believes is an appropriate and timely response to a report he or she has made need do nothing more under SOX Section 307 Rules with respect to his or her report.[298]

An attorney who does not reasonably believe that the issuer has made an appropriate response within a reasonable time to the report or reports made must explain the reason behind his or her belief to the CLO, the CEO, and the directors to whom the attorney reported the evidence of a material violation.[299] An attorney formerly employed or retained by an issuer who has reported

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295 17 C.F.R. § 205.3(b)(5) (2004).

296 17 C.F.R. § 205.3(b)(6) (2004). In a September 20, 2004 speech at UCLA, SEC Enforcement Director Stephen M. Cutler expressed concern that internal investigations were being used to further rather than remedy client misconduct:

> We are considering actions against lawyers, both in-house and outside counsel, who assisted their companies or clients in covering up evidence of fraud, or prepared, or signed off on, misleading disclosures regarding the company's condition. One area of particular focus for us is the role of lawyers in internal investigations of their clients or companies. We are concerned that, in some instances, lawyers may have conducted investigations in such a manner as to help hide ongoing fraud, or may have taken actions to actively obstruct such investigations.

Stephen M. Cutler, "*The Themes of Sarbanes-Oxley as Reflected in the Commission's Enforcement Program*," presented on September 20, 2004 at UCLA School of Law, Los Angeles California, which can be found at http://www.sec.gov/news/speech/spch092004smc.htm.

297 17 C.F.R. § 205.3(b)(7) (2004).

298 17 C.F.R. § 205.3(b)(8) (2004).

299 17 C.F.R. § 205.3(b)(9) (2004).

evidence of a material violation under SOX Section 307 Rules and reasonably believes that he or she has been discharged for so doing may notify the issuer's board of directors or any committee thereof that he or she believes that he or she has been discharged for reporting evidence of a material violation.[300] Discharging an attorney/employee for reporting under SOX Section 307 Rules would violate the whistleblower protections afforded by SOX Section 806.[301]

SOX Section 307 Rules are specific as to how reports thereunder must be made and how the recipient of the report must investigate and respond to the report. SOX Section 307 Rules do not restrict informal communication between the issuer representatives and the attorney to resolve the issue, but in the event that SOX Section 307 Rules are triggered, they should be promptly and literally complied with, even if it duplicates prior communications informally made to responsible issuer representatives.

Alternative Reporting Procedures For An Issuer That Has Established A QLCC. If an attorney, appearing and practicing before the SEC in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney may, as an alternative to the preceding reporting requirements, report such evidence directly to a QLCC, if the issuer has formed such a committee.[302] An attorney who reports evidence of a material violation to a QLCC has satisfied his or her obligation to report such evidence and is not required to assess the issuer's response to the reported evidence of a material violation.[303]

A CLO may refer a report of evidence of a material violation to a QLCC in lieu of causing an inquiry to be conducted and shall inform the reporting attorney if the report has been referred to a QLCC.[304] Thereafter, the QLCC shall be responsible for responding to the evidence of a material violation reported to it.[305]

Issuer Confidences. SOX Section 307 Rules provide that any report under or any response thereto (or any contemporaneous record of the report or the response) may be used by an attorney in connection with any investigation, proceeding, or litigation in which the attorney's compliance with SOX Section 307 Rules is in issue.[306] In the SOX Section 307 Release, the SEC states that it is making "clear that an attorney may use any records the attorney may have made in the course of fulfilling his or her reporting obligations under this part to defend himself or herself against charges of misconduct," and that SOX Section 307 Rules are "effectively equivalent to the ABA's present Model Rule 1.6(b)(3) and corresponding 'self-defense' exceptions to client-confidentiality rules in every state."[307]

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300 17 C.F.R. § 205.3(b)(10) (2004).

301 *See infra* "Whistleblower Protection" in Section IX.

302 17 C.F.R. § 205.3(c)(1) (2004).

303 *Id*.

304 17 C.F.R. § 205.3(c)(2) (2004).

305 *Id*.

306 17 C.F.R. § 205.3(d)(1) (2004).

307 The SOX Section 307 Release, *supra* note 263, at 6310.

SOX Section 307 Rules further provide that an attorney appearing and practicing before the SEC in the representation of an issuer may reveal to the SEC, without the issuer's consent, confidential information related to the representation to the extent the attorney reasonably believes necessary: (i) to prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors; (ii) to prevent the issuer from committing or suborning perjury or committing any act that is likely to perpetrate a fraud upon the SEC; or (iii) to rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used.[308] The SOX Section 307 Release comments that in permitting, but not requiring, an attorney to disclose, under specified circumstances, confidential information related to his appearing and practicing before the SEC in the representation of an issuer, SOX Section 307 Rules correspond to the ABA's Model Rule 1.6 as proposed by the ABA's Kutak Commission in 1981-1982 and by the ABA's Commission of Evaluation of the Rules of Professional Conduct ("*Ethics 2000 Commission*") in 2000, and as adopted in the vast majority of states.[309]

Responsibilities of Supervisory Attorneys. An attorney supervising or directing another attorney who is appearing and practicing before the SEC in the representation of an issuer is a

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Rule 1.05 of the Texas Disciplinary Rules of Professional Conduct provide as follows:

> RULE 1.05. CONFIDENTIALITY OF INFORMATION
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> (b) Except as permitted by paragraphs (c) and (d), or as required by paragraphs (e) and (f), a lawyer shall not knowingly:
>
> (1) Reveal confidential information of a client or a former client . . . .
>
> (c) A lawyer may reveal confidential information:
>
> . . . .
>
> (5) To the extent reasonably necessary to enforce a claim or establish a defense on behalf of the lawyer in a controversy between the lawyer and the client.
>
> (6) To establish a defense to a criminal charge, civil claim or disciplinary complaint against the lawyer or the lawyers associates based upon conduct involving the client or the representation of the client.
>
> (7) When the lawyer has reason to believe it is necessary to do so in order to prevent the client from committing a criminal or fraudulent act.
>
> (8) To the extent revelation reasonably appears necessary to rectify the consequences of a client's criminal or fraudulent act in the commission of which the lawyer's services had been used.
>
> (e) When a lawyer has confidential information clearly establishing that a client is likely to commit a criminal or fraudulent act that is likely to result in death or substantial bodily harm to a person, the lawyer shall reveal confidential information to the extent revelation reasonably appears necessary to prevent the client from committing the criminal or fraudulent act.

TEX. DISCIPLINARY R. PROF'L CONDUCT 1.05, *reprinted in* TEX. GOV'T. CODE ANN. tit. 2, subtit. G App. A (Vernon 1998).

308 17 C.F.R. § 205.3(d)(2) (2004).

309 SOX Section 307 Release, *supra* note 263, at 6310.

"*supervisory attorney*" and is required to make reasonable efforts to ensure that a subordinate attorney that he or she supervises or directs conforms to SOX Section 307 Rules.[310] Supervising an attorney in the representation of an issuer in non-SEC related matters, or overall management of a law firm, would not result in an attorney being considered a "supervisory attorney" for SOX Section 307 purposes.[311]

A supervisory attorney is responsible for complying with the reporting requirements when a subordinate attorney has reported to the supervisory attorney evidence of a material violation and may report evidence of a material violation from a subordinate attorney to the issuer's QLCC.[312]

Responsibilities of a Subordinate Attorney. An attorney who appears and practices before the SEC in the representation of an issuer on a matter under the supervision or direction of another attorney (other than under the direct supervision or direction of the issuer's CLO) is a "*subordinate attorney*" and is obligated to comply with SOX Section 307 Rules notwithstanding that the subordinate attorney acted at the direction of, or under the supervision of, another person.[313]

A subordinate attorney complies with SOX Section 307 Rules if the subordinate attorney reports to his or her supervising attorney evidence of a material violation of which the subordinate attorney has become aware in appearing and practicing before the SEC, but may "report up the ladder" if the subordinate attorney reasonably believes that the supervisory attorney to whom he or she has reported evidence of a material violation has failed to comply with SOX Section 307 Rules.[314]

Sanctions and Discipline. A violation of SOX Section 307 Rules by any attorney appearing and practicing before the SEC in the representation of an issuer shall subject such attorney to the civil penalties and remedies for a violation of the federal securities laws available to the SEC, regardless of whether the attorney may also be subject to discipline for the same conduct in a jurisdiction where the attorney is admitted or practices.[315]

An attorney who complies in good faith with the provisions of SOX Section 307 Rules is not subject to discipline or otherwise liable under inconsistent standards imposed by any state or other U.S. jurisdiction where the attorney is admitted or practices.[316]

Issues of compliance with SOX Section 307 Rules will likely arise when a corporate debacle emerges and the SEC staff investigates to find out who knew what and when, and then asks where the lawyers were. In that context, the staff will look at whether there was compliance with SOX Section 307 Rules. Under such circumstances, lawyers would be more comfortable if they could

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310 17 C.F.R. § 205.4(a)–(b) (2004).

311 SOX Section 307 Release, *supra* note 263, at 6313.

312 17 C.F.R. § 205.4 (2004).

313 17 C.F.R. § 205.5(a)–(b) (2004).

314 17 C.F.R. § 205.5(c)–(d) (2004).

315 17 C.F.R. § 205.6(a)–(b) (2004).

316 17 C.F.R. § 205.6(c) (2004).

point to strict compliance with SOX Section 307 Rules rather than trusting to prosecutorial discretion to conclude that substantial compliance was good enough.

In a preview of how the SEC may seek to enforce SOX Section 307 Rules, the SEC imposed a cease-and-desist order on a public company's general counsel for failing to report to the company's audit committee and outside auditors in a timely manner evidence of an improper termination of a retirement plan that enhanced the company's reported financial results.[317]

No SOX §307 Private Right of Action. SOX Section 307 Rules provide that nothing therein is intended to, or does, create a private right of action against any attorney, law firm, or issuer based upon compliance or noncompliance with its provisions.[318] Authority to enforce compliance with the SOX Section 307 Rules is vested exclusively in the SEC.[319]

Enron Civil Liability Fallout. Compliance with the requirements of SOX Section 307 Rules does not assure attorneys that they will not be subject to private claims based on other securities laws.[320] In her lengthy opinion on the motions to dismiss filed by Vinson & Elkins L.L.P. ("*V&E*"), Kirkland & Ellis ("*K&E*"), Arthur Andersen LLP, and nine banks in the *Newby v. Enron* case, Judge Melinda Harmon granted the motions to dismiss of K&E and Deutsche Bank, but denied in whole or in part the motions of V&E, Arthur Andersen, J.P. Morgan Chase, Citigroup, Credit Suisse, CIBC, Merrill Lynch, Barclays, Lehman Brothers, and Bank America.[321] In exploring the circumstances

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317 In *SEC v. John Isselmann, Jr.*, Lit. Release 18896, Case No. CV 04-1350 MO (D. Ore.) (Sept. 23, 2004), the issuer's chief financial officer and controller elected to terminate a retirement plan for the company's employees in Asia and reverse an accrual for pension benefits. The chief financial officer directed the general counsel to get a Japanese legal opinion about the termination without telling him that the accrual reversal had already occurred. When the Japanese opinion was received, it indicated that the pension benefits could not be eliminated unilaterally. The general counsel tried to raise the point at a disclosure meeting with the company's auditors prior to filing the company's financial statement, but he was cut off by the chief financial officer.

Five months after the foregoing events occurred, the general counsel learned what had occurred and immediately advised the company's audit committee and outside counsel, but the SEC concluded that his actions were too little-too late. While there is no allegation that the general counsel in any way participated in the scheme to falsify the company's numbers, the SEC found that the general counsel's failure to disclose the Japanese legal opinion to the audit committee, the board of directors and outside auditors allowed the chief financial officer to hide an ongoing fraud.

The attorney was eight years out of law school with no accounting background and only limited securities experience, was the company's only in-house lawyer and did not realize the consequences of the plan termination. He said he thought he was dealing with an employment matter, not an accounting issue. For their part the chief financial officer and controller were indicted on 17 counts of financial fraud and falsifying records.

See also, In the Matter of Google, Inc. and David C. Drummond, http://www.sec.gov/litigation/admin/33-8523.htm, in which the general counsel of Google was charged personally for recommending a legal strategy with respect to disclosure to recipients of employee stock options that was later deemed to violate the federal securities laws without explaining to the board of directors the legal risks of the strategy.

318 17 C.F.R. § 205.7(a) (2004).

319 17 C.F.R. § 205.7(b) (2004).

320 *See In re Enron Corp. Securities, Derivative and ERISA Litigation*, 235 F.Supp. 2d 549, 563 (S.D. Tex. 2002) (also known as *Newby v. Enron* or the *Newby* case).

321 *Id*. at 708.

under which law firms, accounting firms, and investment banks/integrated financial services institutions (lumped together by the Court as "*secondary actors in securities markets*") can be liable for the acts of companies they serve under SEC Rule 10b-5[322] and the Texas Securities Act, the Court noted that it was influenced by revelations of corporate corruption in other courts, Congress, investigations by the SEC and New York Attorney General Eliot Spitzer, and the media.[323]

While paying homage to the 1994 holding of the Supreme Court in *Central Bank of Denver v. First Interstate Bank of Denver*[324] that a private plaintiff may not bring an aiding and abetting claim under Rule 10b-5, the Court found that the Supreme Court had left open for it to determine when the conduct of a secondary actor makes it a primary violator subject to liability under Rule 10b-5.[325] Rejecting the "bright line" test that a defendant must actually make a false or misleading statement to be liable, the Court adopted the SEC's amicus position that a defendant can be liable if it "creates" a misleading document even though the defendant is not identified with it to the outside world, with "reliance" being established under the "fraud on the market" theory.[326] "Scienter" remains a crucial element, with the plaintiff having to show intent to deceive or extreme recklessness to sustain a Rule 10b-5 claim.[327]

The Court gave a broad reading to the liability provisions of the Texas Securities Act,[328] commenting that liability may be imposed against a defendant who constituted "any link in the chain of the selling process," and that proof of reliance or scienter is not required.[329] The court found that the Texas Securities Act "applies if any act in the selling process of securities . . . occurs in Texas."[330]

With respect to attorney liabilities, the Court acknowledged that Texas law requires privity for malpractice liability, but the Court found that claims for fraudulent or negligent misrepresentation can be made by those who the attorney had reason to know would rely on the information and who justifiably relied on it.[331] The Court concluded that "professionals, including

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322 17 C.F.R. § 240.10b–5 (2004).

323 *Newby*, 235 F. Supp. 2d at 688.

324 *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994) (in which the U.S. Supreme Court held that SEC Rule 10b-5 prohibits only the making of a material misstatement or omission (or the commission of a manipulative act) and does not prohibit the giving of aid to another who then commits a primary Rule 10b-5 violation).

325 *See Newby*, 235 F. Supp. 2d at 591.

326 The Court in *Newby* wrote:

> Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability . . . are met.

Id.

327 *Id*. at 571.

328 Texas Securities Act §33, TEX. REV. CIV. STAT. ANN. art. 581-33, (Vernon Supp. 2002).

329 *Newby*, 235 F. Supp. 2d at 566.

330 *Id*. at 692.

331 *Id*. at 607-08.

lawyers and accountants, when they take the affirmative step of speaking out, whether individually or as essentially an author or co-author in a statement or report, whether identified or not, about their client's financial condition, do have a duty to third parties not in privity not to knowingly or with severe recklessness issue materially misleading statements on which they intend or have reason to expect that those third parties will rely."[332]

In denying V&E's motion to dismiss, the Court recited V&E's involvement in structuring the partnerships and special purpose entities ("*SPEs*") that contributed to Enron's demise and in working on its SEC filings and other public disclosures, and found that V&E "was necessarily privy to its client's confidences and intimately involved in and familiar with the creation and structure of its numerous businesses, and thus, as a law firm highly sophisticated in commercial matters, had to know of the alleged ongoing illicit and fraudulent conduct." The Court wrote that V&E "was not merely a drafter, but essentially a co-author of the documents it created for public consumption . . . ."[333] The Court commented "[r]evelant to Vinson & Elkins undertaking of the investigation for Enron in the fall of 2001, [Texas Rule of Professional Conduct] 1.06(a)(2) bars a lawyer from representing a client where that representation 'reasonably appears to be or becomes limited . . . by the lawyer's or law firm's own interests. . . .' [and under such circumstances] a client's consent is not effective. . . ."[334]

However, the Court dismissed the lawsuit as to K&E, calling the charges against K&E "conclusory and general."[335] The Court said any documents K&E drafted were for private transactions, "were not included in or drafted for any public disclosure or shareholder solicitation[,]" and noted that K&E was not Enron's counsel for its securities or SEC filings.[336]

Attorney-Client/Work Product Privilege. The final SOX Section 307 Rules do not contain any provision to the effect that information reported by an attorney to the SEC does not constitute a waiver of any attorney-client or other privilege.[337] SOX Section 307 Release states that the SEC finds that allowing issuers to produce internal reports to the SEC, including those prepared in response to reports as a result of SOX Section 307 Rules, without waiving an otherwise applicable attorney-client or other privilege, enhances the SEC's investigatory and enforcement capabilities and, thus, is in the public interest.[338] SOX Section 307 Release further states that the SEC will continue to follow its policy of entering into confidentiality agreements where it determines that its receipt of information pursuant to those agreements will ultimately further the public interest, and

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332 *Id*. at 610.

333 *Id*. at 705.

334 *Id*. at 600.

335 *Newby*, 235 F. Supp. 2d at 706.

336 *Id*.

337 17 C.F.R. § 205.1–.7.

338 SOX Section 307 Release, *supra* note 263, at 6312.

the SEC will vigorously argue in defense of those confidentiality agreements where litigants argue that the disclosure of information pursuant to such agreements waives any privilege or protection.[339]

Differences From Proposed Rules. On November 21, 2002, the SEC issued Release No. 33-8150, which proposed rules under SOX Section 307.[340] After comment, the final SOX Section 307 Rules were issued on January 29, 2003, as the Section 307 Release and differ in a number of respects from the initially proposed rules.

The final SOX Section 307 Rules continue to emphasize, as did the proposed rules, that a lawyer for the corporation owes allegiance to the corporation and not to the individual who was responsible for retaining the lawyer or the lawyer's firm,[341] but differ from the proposed rules in at least three important respects. First, in a reluctant retreat from the proposed "noisy withdrawal" rule, which many felt would have involved a breach of the attorney-client privilege, securities lawyers will **not** be required, if company executives and the board do not respond appropriately to a lawyer's warning or expressed concern that a material securities violation has occurred or will occur, to resign representation, report to the SEC that their resignation is for "professional reasons," and disaffirm any "tainted" documents filed with or submitted to the SEC. [342]

Instead, the SEC extended for 60 days the comment period on the "noisy withdrawal" proposal, while proposing an alternative that still would require a lawyer to withdraw, but that would place instead upon the company the burden to report the lawyer's withdrawal.[343] Under the proposed alternative, the company would publicly disclose on a Form 8-K within two business days after the lawyer's withdrawal for professional considerations, or of having received a notice from its lawyer that the issuer did not appropriately respond to the lawyer's report of a material violation, either or both of such events.[344] If the company did not make the required disclosure, the lawyer would then be permitted (but not required) to inform the SEC that he or she had withdrawn. In-house counsel would be required only to cease participating in the matter involving the violation and notify the company in writing that he or she believed the company had not appropriately responded to the lawyer's report of a material violation.[345]

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339 *Id*. In *Saito v. McKesson HBOC, Inc.*, 2002 WL 31657622 (Del. Ch. Oct. 25, 2002), the Delaware Chancery Court, while acknowledging inconsistent holdings from other jurisdictions, held that the attorney work product privilege had not been waived as to private litigants in respect of documents furnished to the SEC pursuant to a confidentiality agreement during an SEC investigation, but had been waived as to documents furnished to the SEC before a confidentiality agreement had been executed.

340 Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 8150, Exchange Act Release No. 46,868, 67 Fed. Reg. 71,670 (proposed Nov. 21, 2002), *available at* http://www.sec.gov/rules/proposed/33-8150.htm.

341 SOX Section 307 Release, *supra* note 263, at 6305.

342 *Id.* at 6297.

343 Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 8186, 68 Fed. Reg. 6324, 6324-25 (proposed Jan. 29, 2003), *available at* http://www.sec.gov/rules/proposed/33-8186.htm.

344 *Id*. at 6328.

345 *Id*.

Second, the SEC changed the text of the rule specifying when lawyers must report "up the ladder."[346] Under proposed rules, a lawyer had to report up the ladder if he had *"evidence of a material violation of securities law or breach of fiduciary duty or similar violation"* by a client.[347] Under the final rules adopted, a lawyer must report *"credible evidence based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur."*[348] While this standard developed from the SEC's attempt to make objective rather than subjective the test of when a lawyer must report a violation, its tortured manner of expression, in terms of a double negative ("unreasonable . . . not to conclude that it is reasonably likely . . ."), may simply increase the SEC's burden of proving a lawyer has failed to comply. In response to questions regarding this "reasonably likely" standard, the SEC suggested that this standard has a lower threshold than a "more likely than not" standard.[349]

Third, the final SOX Section 307 Rules clarify that they cover lawyers providing legal services who have an attorney-client relationship, and then only if the lawyer has notice that documents they are preparing or assisting in preparing will be filed with or submitted to the SEC.[350]

Other highlights of the final SOX Section 307 Rules include (a) removal of the requirement that issuers and their lawyers document reports of violations and the related responses;[351] (b) clarification of coordination with state-mandated reporting obligations: namely that the final SOX Section 307 Rules control if they conflict with less rigorous reporting requirements under state law, but that more rigorous state-imposed up-the-ladder reporting obligations will control as long as they are not inconsistent with these rules;[352] and (c) affirmation that the final SOX Section 307 Rules are enforceable exclusively by the SEC and do not create any private right of action.[353]

Finally, the proposed SOX Section 307 Rules provided 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, but this was replaced in the final rule release with commentary that such is the SEC's view of good public policy.[354]

V.
ENHANCED FINANCIAL DISCLOSURES; PROHIBITION ON INSIDER LOANS (SOX TITLE IV)

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346 Securities Act Release No. 33-8150, *supra* note 340, at 71,673.

347 *Id.* at 71,680.

348 SOX Section 307 Release, *supra* note 263, at 6302.

349 *Id*.

350 *Id*. at 6298.

351 *Id*. at 6296.

352 *Id*. at 6297.

353 *Id*. at 6206.

354 SOX Section 307 Release, *supra* note 263, at 6303, 6313.

Off-Balance Sheet Transactions; Use of Non-GAAP Financial Measures. SOX Section 401 instructs the SEC to require by rule: (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[355] 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.[356] Also under SOX Section 401, each financial report must "reflect" all material adjustments proposed by the auditors, which we interpret to mean 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.[357]

MD&A Disclosures. On January 27, 2003, the SEC issued Release No. 33-8182 titled "Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations."[358] In the release, the SEC states that the principle behind the new rules is that the issuer should disclose information to the extent that it is necessary to reach an understanding of an issuer's material off-balance sheet arrangements and their material effects on financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures, or capital resources.[359] Consistent with the traditional principles applicable to the "Management's Discussion and Analysis of Financial Condition and Results of Operations" (*"MD&A"*) section in a company's disclosure documents, management has the responsibility to identify and address the key variables and other qualitative and quantitative factors that are peculiar to, and necessary for, an understanding and evaluation of the company.[360] In the SEC's view, as codified by the adopted rules, these items require disclosure of the following information to the extent necessary for an understanding of an issuer's off-balance sheet arrangements and their effects:

- The nature and business purpose of the issuer's off-balance sheet arrangements;
- The importance of the off-balance sheet arrangements to the issuer for liquidity, capital resources, market risk or credit risk support, or other benefits;
- The financial impact of the arrangements on the issuer (*e.g.*, revenues, expenses, cash flows or securities issued) and the issuer's exposure to risk as a result of the arrangements (*e.g.*, retained interests or contingent liabilities); and

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355 SOX § 401(a), *amending* 15 U.S.C.A. § 78m (West Supp. 2004) [hereinafter *"SOX § 401"*].

356 *Id*.

357 *Id*.

358 Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, Securities Act Release No. 8182, Exchange Act Release No. 47,264, 68 Fed. Reg. 5982, 5992 (Feb. 5, 2003), *available at* http://www.sec.gov/rules/final/33-8182.htm.

359 *Id*. at 5985.

360 *Id*.

- Known events, demands, commitments, trends or uncertainties that affect the availability or benefits to the issuer of material off-balance sheet arrangements.[361]

In addition, the [new rules] contain another principles-based requirement, similar to that used elsewhere in MD&A, that the [issuer] provide other information that it believes to be necessary for an understanding of its off-balance sheet arrangements and their material effects on the issuer's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.[362]

The rule requires an issuer to provide, in a separately captioned subsection of MD&A, a comprehensive explanation of its off-balance sheet arrangements.[363]

The rule also requires an issuer to provide an overview of its aggregate contractual obligations in a tabular format in the MD&A.[364] The following categories of contractual obligations must be included within the table:

- Long-term debt obligations;
- Capital lease obligations;
- Operating lease obligations;
- Purchase obligations; and
- Other long-term liabilities reflected on the issuer's balance sheet under GAAP.[365]

The new rules require disclosure of the amounts of an issuer's purchase obligations without regard to whether notes, drafts, acceptances, bills of exchange, or other commercial instruments will be used to satisfy such obligations because those instruments could have a significant effect on the issuer's liquidity.[366] The SEC's purpose in requiring this new disclosure item is to obtain enhanced disclosure concerning an issuer's contractual payment obligations.[367]

Issuers must comply with the off-balance sheet arrangement disclosure requirements in registration statements, annual reports, and proxy or information statements that are required to include financial statements for their fiscal years ending on or after June 15, 2003.[368] Issuers must include the table of contractual obligations in registration statements, annual reports, and proxy or

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361 *Id*.

362 *Id*.

363 *Id*. at 5991.

364 Securities Act Release No. 8182, *supra* note 358, at 5983.

365 *Id*. at 5986.

366 *Id*.

367 *Id*.

368 *Id*. at 5991.

information statements that are required to include financial statements for the fiscal years ending on or after December 15, 2003.[369]

Conditions for Use of Non-GAAP Financial Measures: Regulation G. On January 22, 2003, the SEC issued Release No. 33-8176 titled "Conditions for Use of Non-GAAP Financial Measures," adopting rule changes designed to address reporting companies' use of "non-GAAP financial measures" in various situations, including (i) Regulation G which applies whenever a reporting company publicly discloses or releases material information that includes a non-GAAP financial measure; (ii) amendments to Item 10 of Regulation S-K to include a statement concerning the use of non-GAAP financial measures in filings with the SEC; and (iii) amendments to Form 8-K to require issuers to furnish to the SEC all releases or announcements disclosing material non-public financial information about completed annual or quarterly periods.[370]

Regulation G applies whenever as of and after March 28, 2003,[371] an issuer[372] publicly discloses or releases material information that includes a non-GAAP financial measure.[373] Regulation G contains an exception for non-GAAP financial measures included in a disclosure relating to a proposed business combination transaction if the disclosure is contained in a communication that is subject to the SEC's communications rules applicable to business combination transactions.[374]

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369 *Id*.

370 Conditions for Use of Non-GAAP Financial Measures, Securities Act Release No. 8176, Exchange Act Release No. 47,226, 68 Fed. Reg. 4820 (Jan. 30, 2003), available at http://www.sec.gov/rules/final/33-8176.htm.

371 With regard to transition issues, the SEC discussed a case in which a report was filed with the Commission before the rule's effective date of March 28, 2003, and then was incorporated by reference into a registration statement that was filed after March 28, 2003, and the staff concluded that the registration statement must comply with Regulation G with respect to any non-GAAP financial measures. With regard to any non-GAAP material incorporated by reference, the staff advised that companies may provide the required reconciliation by (i) amending the previously filed report; (ii) including a section in the registration statement that identifies the non-GAAP financial measures contained in the incorporated reports and provides the required reconciliations; or (iii) filing a current report on Form 8-K or a periodic report that identifies the non-GAAP financial measures in the incorporated reports and provides the required reconciliations. A registration statement on Form S-8 filed after March 28, 2003, does not have to include the required reconciliation of non-GAAP financial measures included in a document filed before that date and incorporated by reference. *See* U.S. Securities Exchange Commission Frequently Asked Questions Regarding the Use of Non-GAAP Financial Measures, Transition Issues, Question 1 (June 13, 2003), *at* http://www.sec.gov/divisions/corpfin/faqs/nongaapfaq.htm.

372 See *infra* Section XIII with respect to the application of Regulation G to issuers that are foreign private issuers.

373 Securities Act Release No. 8176, *supra* note 370, at 4821.

374 *Id*. In an response to a "Frequently Asked Questions" dated June 13, 2003, the SEC discussed whether the exemption from Regulation G and Item 10(e) of Regulation S-K for disclosure of non-GAAP financial measures made in connection with a business combination transaction extended to non-GAAP financial measures contained in registration statements, proxy statements, and tender offer materials. The staff noted that disclosures of non-GAAP financial measures made in communications subject to 1933 Act Rule 425 or 1934 Act Rules 14a-12 or 14d-2(b)(2) are exempt from Regulation G and Item 10(e) of Regulation S-K. According to the staff, this exemption also was intended to apply to communications subject to Rule 14d-9(a)(2). This exemption does not extend beyond communications that are subject to those rules. Thus, if the same non-GAAP financial measure that was included in a communication filed under one of those rules was also disclosed in a 1933 Act registration statement or a 1934 Act proxy statement or tender offer statement, the

For purposes of Regulation G, a non-GAAP financial measure is a numerical measure of an issuer's historical or future financial performance, financial position, or cash flows that:

- Excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the most directly comparable measure calculated and presented in accordance with GAAP in the statement of income, balance sheet, or statement of cash flows (or equivalent statements) of the issuer; or

- Includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable measure so calculated and presented.[375]

The definition of "non-GAAP financial measures" does not capture measures of operating performance or statistical measures that fall outside the scope of the definition set forth above, such as:

- Operating and other statistical measures (such as unit sales, numbers of employees, numbers of subscribers, or numbers of advertisers); and

- Ratios or statistical measures that are calculated using exclusively one or both of:

  - Financial measures calculated in accordance with GAAP; and
  - Operating measures or other measures that are not non-GAAP financial measures.[376]

Non-GAAP financial measures also do not include financial information that does not have the effect of providing numerical measures that are different from the comparable GAAP measure, such as:

- Disclosure of amounts of expected indebtedness, including contracted and anticipated amounts;

- Disclosure of amounts of repayments that have been planned or decided upon but not yet made;

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exemption would be inapplicable to that disclosure. *See* U.S. Securities Exchange Commission Frequently Asked Questions Regarding the Use of Non-GAAP Financial Measures, Transition Issues, Question 2 (June 13, 2003), *at* http://www.sec.gov/divisions/corpfin/faqs/nongaapfaq.htm.

Disclosures subject to Item 1015 of Regulation M-A are also exempt from Regulation G and Item 10(e) of Regulation S-K. This exemption is not limited to pre-commencement communications and, accordingly, the exemption would also be available for Item 1015 disclosure found in registration statements, proxy statements, and tender offer statements. In addition, where reconciliation of a non-GAAP financial measure is required and the most directly comparable measure is a pro forma measure prepared and presented in accordance with Article 11 of Regulation S-X, companies may use that measure for reconciliation purposes instead of a GAAP financial measure.

375 Securities Act Release No. 8176, *supra* note 370, at 4822.

376 *Id*.

- Disclosure of estimated revenues or expenses of a new product line, so long as such amounts were estimated in the same manner as would be computed under GAAP; and

- Measures of profit or loss and total assets for each segment required to be disclosed in accordance with GAAP.[377]

The definition of non-GAAP financial measure is intended to capture all measures that have the effect of depicting either:

- A measure of performance that is different from that presented in the financial statements, such as income or loss before taxes or net income or loss, as calculated in accordance with GAAP; or

- A measure of liquidity that is different from cash flow or cash flow from operations computed in accordance with GAAP.[378]

An example of a non-GAAP financial measure would be a measure of operating income that excludes one or more expense or revenue items that are identified as "non-recurring."[379] Another example would be EBITDA, which could be calculated using elements derived from GAAP financial presentations but, in any event, is not presented in accordance with GAAP.[380] There is an exclusion from the definition of "non-GAAP financial measure" for financial measures required to be disclosed by GAAP, SEC rules, or a system of regulation of a government or governmental authority or self-regulatory organization that is applicable to the issuer.[381]

Whenever an issuer publicly discloses any material information that includes a non-GAAP financial measure, Regulation G requires the issuer to provide the following information as part of the disclosure or release of the non-GAAP financial measure:

- A presentation of the most directly comparable financial measure calculated and presented in accordance with GAAP; and

- A reconciliation (by schedule or other clearly understandable method), which shall be quantitative for historic measures and quantitative, to the extent available without unreasonable efforts, for prospective measures, of the differences between the non-GAAP financial measure presented and the most directly comparable financial measure or measures calculated and presented in accordance with GAAP.[382]

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377 *Id*.

378 *Id*.

379 *Id*.

380 *Id*.

381 Securities Act Release No. 8176, *supra* note 370, at 4822.

382 *Id*. at 4823.

If a non-GAAP financial measure is released orally, telephonically, by webcast, by broadcast, or by similar means, the issuer may provide the accompanying information required by Regulation G by: (1) posting that information on the issuer's web site and (2) disclosing the location and availability of the required accompanying information during its presentation.[383]

With regard to the quantitative reconciliation of non-GAAP financial measures that are forward-looking, Regulation G requires a schedule or other presentation detailing the differences between the forward-looking non-GAAP financial measure and the appropriate forward-looking GAAP financial measure.[384] If the GAAP financial measure is not accessible on a forward-looking basis, the issuer must disclose that fact and provide reconciling information that is available without an unreasonable effort.[385] Furthermore, the issuer must identify information that is unavailable and disclose its probable significance.[386]

Regulation FD and Regulation G are intended to operate in tandem.[387] A "private" communication of material, non-public information to, for example, an analyst or a shareholder triggers a requirement for broad public disclosure under Regulation FD.[388] If that public disclosure is of material information containing a non-GAAP financial measure, Regulation G will apply to that disclosure.[389]

The amendments to Item 10 of Regulation S-K require issuers using non-GAAP financial measures in filings with the SEC to provide:

- A presentation, with equal or greater prominence, of the most directly comparable financial measure . . . calculated and presented in accordance with . . . GAAP;

- A reconciliation (by schedule or other clearly understandable method), which shall be quantitative for historical non-GAAP measures presented, and quantitative, to the extent available without unreasonable efforts, for forward-looking information, of the differences between the non-GAAP financial measure disclosed or released with the most directly comparable financial measure or measures calculated and presented in accordance with GAAP . . . ;

- A statement disclosing the reasons why the [issuer's] management believes that presentation of the non-GAAP financial measure provides useful information to investors regarding the [issuer's] financial condition and results of operations; and

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383 *Id.*

384 *Id.*

385 *Id.*

386 *Id.*

387 Securities Act Release No. 8176, *supra* note 370, at 4823.

388 *Id*.

389 *Id*.

- To the extent material, a statement disclosing the additional purposes, if any, for which the [issuer's] management uses the non-GAAP financial measure that are not otherwise disclosed.[390]

In addition to these mandated disclosure requirements, amended Item 10 of Regulation S-K prohibits the following:

- Exclud[ing] charges or liabilities that required, or will require, cash settlement, or would have required cash settlement absent an ability to settle in another manner, from non-GAAP liquidity measures, other than the measures EBIT and EBITDA;

- Adjust[ing] a non-GAAP performance measure to eliminate or smooth items identified as non-recurring, infrequent or unusual, when (1) the nature of the charge or gain is such that it is reasonably likely to recur within two years, or (2) there was a similar charge or gain within the prior two years;

- Present[ing] non-GAAP financial measures on the face of the issuer's financial statements prepared in accordance with GAAP or in the accompanying notes;

- Present[ing] non-GAAP financial measures on the face of any pro forma financial information required to be disclosed by Article 11 of Regulation S-X; and

- Us[ing] titles or descriptions of non-GAAP financial measures that are the same as, or confusingly similar to, titles or descriptions used for GAAP financial measures.[391]

EBIT and EBITDA are exempted from this provision because of their wide and recognized existing use.[392] However, issuers must reconcile these measures to their most directly comparable GAAP financial measure.[393]

With regard to the quantitative reconciliation of non-GAAP financial measures that are forward-looking, Item 10 of Regulation S-K requires a schedule or other presentation detailing the differences between the forward-looking non-GAAP financial measure and the appropriate forward-looking GAAP financial measure.[394] If the GAAP financial measure is not accessible on a forward-looking basis, the issuer must disclose that fact and provide reconciling information that is available without an unreasonable effort.[395]

Form 8-K Filings of Earnings Releases. As discussed previously, the SEC has reworked the regulatory framework for current reports on Form 8-K required to be filed on or after August 23,

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390 *Id*. at 4824.

391 *Id*.

392 *Id*.

393 Securities Act Release No. 8176, *supra* note 370, at 4824.

394 *Id*. at 4825.

395 *Id*.

2004.[396] In addition to adding new disclosure items, the SEC also accelerated the filing deadlines for Form 8-K. Lastly, the SEC also renumbered and, in some cases, expanded the old Items 1-12. Item 2.02 under the numbering system (Item 12 under the previous numbering system), "Results of Operations and Financial Condition" was added in January, 2003.[397]

The addition of Item 2.02 to Form 8-K requires issuers to furnish to the SEC all releases or announcements disclosing material non-public financial information about completed annual or quarterly fiscal periods.[398] New Item 2.02 does not require that companies issue earnings releases or similar announcements. However, such releases and announcements will trigger the requirements of Item 2.02.[399]

Item 2.02 requires issuers to furnish to the SEC a Form 8-K, within four business days of any public announcement or release disclosing material non-public information regarding an issuer's results of operations or financial condition for an annual or quarterly fiscal period that has ended, that identifies the announcement or release and includes the text thereof as an exhibit.[400]

Repetition of information that was publicly disclosed previously or the release of the same information in a different form (for example in an interim or annual report to shareholders) would not trigger the Item 2.02 requirement.[401] This result would not change if the repeated information were accompanied by information that was not material, whether or not already public.[402] However, release of additional or updated material non-public information regarding the issuer's results of operations or financial condition for a completed fiscal year or quarter would trigger an additional Item 2.02 obligation.[403]

The requirement to furnish a Form 8-K under Item 2.02 would not apply to issuers that make these announcements and disclosures only in, or approximately contemporaneously with, their quarterly reports filed with the SEC on Form 10-Q or their annual reports filed with the SEC on Form 10-K.[404] An issuer could make the required Form 8-K Item 2.02 disclosure in the text of, and file the release as an exhibit to, a Form 10-K or 10-Q Report.[405] Thus, an issuer could release earnings within four business days prior to the filing of its Form 10-K or 10-Q Report without filing a Form 8-K with the Item 2.02 information, although in the Form 10-K or 10-Q it would have to disclose the substance of the release and file the release as an exhibit thereto.[406]

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396 Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, *supra* note 38.

397 Securities Act Release No. 8176, *supra* note 370.

398 *Id*.

399 *Id*.

400 *Id*.

401 Securities Act Release No. 8176, *supra* note 370, at 4825.

402 *Id*. at 4825-26.

403 *Id*. at 4826.

404 *Id*.

405 *Id*. at 4826-27. See Instruction 4 to Form 8-K Item 2.02.

406 *Id*. at 4825-26.

Item 2.02 includes an exception from its requirements where non-public information is disclosed orally, telephonically, by webcast, by broadcast, or by similar means in a presentation that is complementary to, and occurs within 48 hours after, a related, written release or announcement that triggers the requirements of Item 2.02.[407] In this situation, Item 2.02 would not require the issuer to furnish an additional Form 8-K with regard to the information that is disclosed orally, telephonically, by webcast, by broadcast, or by similar means if:

- The related, written release or announcement has been furnished to the [SEC] on Form 8-K pursuant to Item 2.02 prior to the presentation;

- The presentation is broadly accessible to the public by dial-in conference call, webcast or similar technology;

- The financial and statistical information contained in the presentation is provided on the issuer's web site, together with any information that would be required under Regulation G; and

- The presentation was announced by a widely disseminated press release that included instructions as to when and how to access the presentation and the location on the issuer's web site where the information would be available.[408]

Item 2.02 of Form 8-K will apply only to publicly disclosed or released material non-public information concerning an annual or quarterly fiscal period that has ended.[409] While such disclosure may also include forward-looking information, it is the material information about the completed fiscal period that triggers Item 2.02.[410] Item 2.02 does not apply to disclosure of earnings for future or ongoing fiscal periods which are not included in a disclosure of previously undisclosed information about completed periods.[411]

The most significant implications of "furnishing" a Form 8-K to the SEC, rather than "filing" a Form 8-K with the SEC, are:

- Information that is "furnished to the [SEC]" in such a Form 8-K is not subject to [1934 Act §18] unless the issuer specifically states that the information is to be considered "filed";

- Information that is "furnished to the [SEC]" in such a Form 8-K is not incorporated by reference into a registration statement, proxy statement or other report unless the issuer specifically incorporates that information into those documents by reference; and

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407 Securities Act Release No. 8176, *supra* note 370, at 4826.

408 *Id*.

409 *Id*.

410 *Id*.

411 *Id*.

- Information that is "furnished to the [SEC]" in such a Form 8-K is not subject to the requirements of amended Item 10 of Regulation S-K . . . while "filed" information would be subject to those requirements.[412]

Item 2.02 of Form 8-K requires that earnings releases or similar disclosures be furnished to the SEC rather than filed.[413] Regulation G would, of course, apply to these releases and disclosures.[414] In addition to the requirements already imposed by Regulation G, issuers would be required to disclose:

- The reasons why the [issuer]'s management believes that presentation of the non-GAAP financial measure provides useful information to investors regarding the issuer's financial condition and results of operations; and

- To the extent material, the additional purposes, if any, for which the [issuer]'s management uses the non-GAAP financial measure that are not otherwise disclosed.[415]

Issuers may satisfy this requirement by including the disclosure in Form 8-K or in the release or announcement that is included as an exhibit to Form 8-K.[416] As indicated above, issuers also may satisfy the requirement to provide these additional two statements by including the disclosure in their most recent annual report filed with the SEC (or a more recent filing) and by updating those statements, as necessary, no later than the time Form 8-K is furnished to the SEC.[417]

Earnings releases and similar disclosures that trigger the requirements of Item 2.02 are also subject to Regulation FD.[418] The application of Item 2.02 would differ from Regulation FD, however, in that the requirements of Item 2.02 would always implicate Form 8-K for those disclosures, while Regulation FD provides that Form 8-K is an alternative means of satisfying its requirements.[419]

Prohibition on Loans to Directors or Officers. SOX Section 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.[420] Four categories of personal loans by an issuer to its directors and officers are expressly exempt from SOX Section 402's prohibition:[421]

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412 *Id*.

413 Securities Act Release No. 8176, *supra* note 370, at 4826.

414 *Id*.

415 *Id*.

416 *Id*. at 4826-27.

417 *Id*. at 4827.

418 *Id*.

419 Securities Act Release No. 8176, *supra* note 370, at 4827.

420 SOX Section 402(a) provides:

> It shall be unlawful for any issuer (as defined in [SOX Section 2]), directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew

(1) any extension of credit existing before SOX's enactment as long as no material modification or renewal of the extension of credit occurs on or after the date of SOX's enactment (July 30, 2002);

(2) specified home improvement and consumer credit loans if:

- made in the ordinary course of the issuer's consumer credit business,
- of a type generally made available to the public by the issuer, and
- on terms no more favorable than those offered to the public;

(3) loans by a broker-dealer to its employees that:

- fulfill the three conditions of paragraph (2) above,
- are made to buy, trade or carry securities other than the broker-dealer's securities, and
- are permitted by applicable Federal Reserve System regulations; and

(4) "any loan made or maintained by an insured depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)), if the loan is subject to the insider lending restrictions of section 22(h) of the Federal Reserve Act (12 U.S.C. 375b)."[422]

This last exemption applies only to an "insured depository institution," which is defined by the Federal Deposit Insurance Act ("*FDIA*") as a bank or savings association that has insured its deposits with the Federal Deposit Insurance Corporation ("*FDIC*").[423] Although this SOX Section 402 provision does not explicitly exclude foreign banks from the exemption, under current U.S. banking regulations a foreign bank cannot be an "insured depository institution" and, therefore, cannot qualify for the bank exemption.[424] Since 1991, following enactment of the Foreign Bank Supervision Enhancement Act ("*FBSEA*"), a foreign bank that seeks to accept and maintain FDIC-insured retail deposits in the United States must establish a U.S. subsidiary, rather than a branch, agency, or other entity, for that purpose.[425] These U.S. subsidiaries of foreign banks, and the limited

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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.

SOX § 402, *amending* 15 U.S.C.A. § 78m (West Supp. 2004) [hereinafter *"SOX § 402"*].

421 *Id.*; *See also* Foreign Bank Exemption From the Insider Lending Prohibition of Exchange Act Section 13(k), Exchange Act Release No. 48,481, 68 Fed. Reg. 54,590, 54,590 (proposed Sept. 11, 2003), *available at* http://www.sec.gov/rules/proposed/34-48481.htm.

422 SOX § 402, *supra* note 420.

423 Exchange Act Release No. 48,481, *supra* note 421, at 54,590; Foreign Bank Exemption from the Insider Lending Prohibition of Exchange Act Section 13(k), Exchange Act Release 34-49616 (April 26, 2004), available at http://www.sec.gov/rules/final/34-49616.htm.

424 *Id*.

425 *Id*.

number of grandfathered U.S. branches of foreign banks that had obtained FDIC insurance prior to FBSEA's enactment, can engage in FDIC-insured, retail deposit activities and, thus, qualify as "insured depository institutions."[426] But the foreign banks that own the U.S. insured depository subsidiaries or operate the grandfathered insured depository branches are not themselves "insured depository institutions" under the FDIA.[427] The SEC, however, has proposed a rule to address this disadvantageous situation for foreign banks.[428]

The SEC to date has not provided guidance as to the interpretation of SOX Section 402, although a number of interpretative issues have surfaced. The prohibitions of SOX Section 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.[429] 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.[430]

SOX Section 402 raises issues with regard to cashless stock option exercises and has led a number of issuers to suspend cashless exercise programs.[431] 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 SOX Section 402.[432] The real question is whether a broker-administered same-day sale involves "an extension of credit in the form of a personal loan" made or arranged by the issuer. The nature of the arrangement can affect the analysis.[433]

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426 *Id*.

427 *Id*.

428 See *infra* "Prohibition on Loans to Directors and Officers" in Section XIII.

429 SOX § 402, *supra* note 420.

430 *See Sarbanes-Oxley Act: Interpretative Issues Under § 402 – Prohibition of Certain Insider Loans* (October 15, 2002) (an outline authored jointly by a group of 25 law firms), THE CORPORATE COUNSEL, October 15, 2002, *at* http://www.TheCorporateCounsel.net.

431 *Id*.; Edmond T. FitzGerald, et al., *Public Company CEO Compensation: A Review of the Recent Reforms*, in Advanced Doing Deals 2004: Dealmaking in the New Transactional Marketplace 441 (Practicing Law Institute ed., 2004).

432 See *Cashless Exercise and Other SOXmania*, THE CORPORATE COUNSEL September-October (2002).

433 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

Some practitioners have questioned whether SOX Section 402 prohibits directors and executive officers of an issuer from taking loans from employee pension benefit plans, which raised the further question of whether employers could restrict director and officer plan loans without violating the U.S. Labor Department's antidiscrimination rules.[434] On April 15, 2003, the Labor Department issued Field Assistance Bulletin 2003-1 providing that plan fiduciaries of public companies could deny participant loans to directors and officers without violating the Labor Department rules.[435]

Accelerated §16(a) Reporting. SOX Section 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 Form 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. . ..*"[436]

Two Business Days to File Form 4. On August 27, 2002, the SEC issued a release (the *"16(a) Release"*) adopting final amendments to its rules and forms implementing the accelerated filing deadlines described above for transactions subject to §16(a).[437] As anticipated, the rule amendments also subject all transactions between officers or directors and the issuer, exempted from §16(b) short swing profit recovery by Rule 16b-3, which were previously reportable on an annual

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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 SOX Section 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 SOX Section 402 assuming the issuer is not involved in arranging the credit.

Interpretative Issues Under § 402, *supra* note 430.

434 *See* Gaudreau, Jr., Russell A. & Solveig R. McShea, *Plan Loans to Participants and Beneficiaries*, in Advanced Law of Pensions, Welfare Plans, and Deferred Compensation 1547, 1570 (American Law Institute ed., 2004).

435 U.S. Department of Labor, *Field Assistance Bulletin 2003-1* (April 14, 2003), *at* http://www.dol.gov/ebsa/regs/fab_2003_1.html.

436 SOX § 403, *amending* 15 U.S.C.A. § 78p (West Supp. 2004) (emphasis added) [hereinafter *"SOX § 403"*]. Previously, Form 4 was required to be filed by the 10th day of the month following the month in which the transaction was executed.

437 Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Exchange Act Release No. 46,421, 67 Fed. Reg. 56,462 (Sept. 3, 2002), *available at* http://www.sec.gov/rules/final/34-46421.htm [hereinafter the *"16(a) Release"*].

basis on Form 5 (including stock option grants, cancellations, regrants, and repricings) to §16(a) and the new two business day reporting requirement on Form 4.[438]

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.[439] 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 dividend and interest reinvestment plans that are not already exempt from §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.[440] 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.[441] Other transactions exempt from §16(b) previously reportable on Form 5 will remain reportable on Form 5.[442] These transactions include small acquisitions not from the issuer and gifts.[443]

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 §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.[444]

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.[445] 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.[446]

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438 *Id*. at 56,463.

439 For example, the SEC pointed out in the 16(a) Release that transactions pursuant to a Rule 10b5-1(c) arrangement which specify a date for purchases for sales (e.g., the first business day of each month) would not qualify for this exception. *Id*. at 56,464.

440 *Id*. at 56,463-64.

441 *Id*. at 56,464-65.

442 *Id*. at 56,463.

443 16(a) Release, *supra* note 437, at 56,467.

444 *See e.g., id.* at 56,465.

445 *Id*. at 56,463.

446 *Id*.

Website Posting. On May 7, 2003, the SEC issued Release No. 33-8230 adopting rules titled "Mandated Electronic Filing and Website Posting for Forms 3, 4 and 5."[447] These rules, which went into effect on June 30, 2003, amend Regulation S-T to require insiders to file Forms 3, 4 and 5 (§16(a) reports) with the SEC on EDGAR.[448] The rules also require an issuer that maintains a corporate website[449] to post on its website all Forms 3, 4 and 5 filed with respect to its equity securities by the end of the business day after filing.[450] An issuer can satisfy this requirement whether it provides access directly or by hyperlinking to reports via a third-party service instead of maintaining the forms itself if the following conditions are met:

- The forms are made available in the required time frame;
- Access to the reports is free of charge to the user;
- The display format allows retrieval of all information in the forms;
- The medium to access the forms is not so burdensome that the intended users cannot effectively access the information provided;
- The access includes any exhibits or attachments;
- Access to the forms is through the issuer website address the issuer normally uses for disseminating information to investors; and
- Any hyperlink is directly to the Section 16 forms (or to a list of the Section 16 forms) relating to the posting issuer instead of just to the home page or general search page of the third-party service.[451]

The forms must remain accessible on the issuer's website (or through the hyperlink) for at least a 12-month period.[452]

In order to ease the administrative burdens on filers associated with switching to electronic filing of Forms 3, 4 and 5, the rules amend Regulation S-T to provide that any Form 3, 4 or 5 submitted by direct transmission on or before 10 p.m. Eastern time is deemed filed on the same business day.[453] However, filer support hours will not be correspondingly extended, so filer support

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447 Mandated Electronic Filing And Website Posting For Forms 3, 4 And 5, Securities Act Release No. 8230, Exchange Act Release No. 47,809, 68 Fed. Reg. 25,788 (May 13, 2003), *available at* http://www.sec.gov/rules/final/33-8230.htm.

448 *Id*. As amended, Regulation S-T also requires the electronic filing of any related correspondence and supplemental information pertaining to a document that is the subject of mandated EDGAR filing. These materials will not be disseminated publicly but will be available to the SEC staff.

449 The term "corporate website" refers to public (internet) sites, as opposed to private (intranet) sites.

450 Securities Act Release No. 8230, *supra* note 447, at 25,790.

451 *Id*. at 25,790.

452 *Id*.

453 *Id*. at 25,793. This extension applies only to Forms 3, 4 and 5.

will remain available only until 7:00 p.m.[454] The EDGAR system is programmed to provide that a form filed between 5:30 p.m. and 10:00 p.m. Eastern time will be assigned a filing date on the same business day and disseminated that evening.[455]

Recognizing that insiders may experience temporary difficulties in transitioning to mandated electronic filing, the SEC did not require issuers to disclose late Form 4 filings in their proxy statements and annual reports on Form 10-K so long as such Forms 4 were filed not later than one business day following the regular due date.[456] This temporary reliefexpired on June 30, 2004.

Temporary hardship exemptions will no longer be available in Forms 3, 4 and 5.[457] A filing date adjustment will remain if the filing is delayed due to technical difficulties beyond the filer's control; however, failure to obtain the necessary access codes and identification numbers will not justify such an adjustment.[458]

Insiders are required to send or deliver a duplicate of each Section 16 form to the issuer not later than the time the form is transmitted for filing with the Commission to the person designated by the issuer to receive such statements, or, in the absence of such designation, to the issuer's corporate secretary or person performing equivalent functions.[459] An issuer which wishes to post the Section 16 reports on its website directly should implement procedures to ensure that its insiders provide notice and electronic copies of filed Section 16 reports in time to meet the posting date. An issuer that uses a hyperlink to an appropriate third-party site can avoid this concern.

Procedures for Filing Section 16(a) Reports on EDGAR. 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 (under the old system, only one insider in a "group" needed to have the codes, but now each individual will be required to have his or her own set of codes). 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. Thus, it may be prudent to apply for a certificate for added security purposes.[460] One should also

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454 *Id*.

455 *Id*.

456 Securities Act Release No. 8230, *supra* note 447, at 25,792.

457 *Id*. at 25,791.

458 *Id*.

459 *Id*. at 25,790.

460 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.

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. If a written confirmation of the codes is desired, include either an e-mail address or a fax number with 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 into EDGAR, 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 financial printer or law firm.

These companies allow submissions to be reduced content filings. A reduced content filing is a filing that provides header information (e.g., form type) and data for mandatory fields that are specified and otherwise complies with the technical filing requirements. When using a reduced content filing, a filer is able to save material (enabling the filer to cut and paste from one form to the next), and the filer does not have to create the headings and instructions on the form, only the content. Reduced content filings will enable issuers and insiders to use third-party service providers for filings, if they wish to do so, just as they do today.

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, 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, in addition to this memorandum.[461] He or she will need to go to the EDGAR Login page at https://www.edgarfiling.sec.gov and enter the CIK and password and

[461] 17 C.F.R. § 232 (2004); EDGAR Filer Manual, *supra* note 460.

click the Login to EDGAR button. A button on the menu will give filers the option to create an on-line Form 3, 4 or 5, or an amendment to any of these forms. The filer should have all the necessary information (codes, etc.) available before going on-line to file. Due to cost and technical limitations, data entry must be performed quickly enough to avoid time-outs that end the session. A time-out will occur one hour following the user's *last* activity on the system. The system is not able to provide a way to save an incomplete form on-line from session to session. The system will validate as many fields as possible for date type and required fields while the filer fills in the form. Filers will have the chance to correct errors and verify the accuracy of the information before submitting the filing. An on-line help function is also available.

The filer can download and print the filing and add attachments before submission. Once the filing is submitted, the system will display the accession number of the filing or a message that says the accession number will follow in a return notification. An accession number is a unique number generated by EDGAR for each electronic submission. Assignment of an accession number does not mean that EDGAR has accepted a submission. A filer can obtain a return copy of the form shortly after filing and can view the filing on the SEC's website (www.sec.gov). Filers who submit their forms directly by entering information into the online templates must click the "transmit submission" button on or before 10:00 p.m. EST on a commission business day for the submission to be completed that day. Similarly, a reduced content filing must begin transmission on or before 10:00 p.m. EST to be completed the same 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:

- An individual cannot use a 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 two to three business days to receive EDGAR access codes. However, due to the new two-day requirement for Form 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 use the Submission Validation features on EDGAR.

- Keep a manually signed signature page (or equivalent document) on file for five years.

- Filer Support Staff are available each business day from 8:00 a.m. to 7:00 p.m. EST. They can be reached at (202) 942-8900.

Internal Controls. SOX Section 404 directs the SEC to prescribe rules mandating inclusion of an internal control report and assessment in Form 10-K annual reports.[462] On June 5, 2003, the SEC published SEC Release No. 33-8238, titled "Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports," which can be found at http://www.sec.gov/rules/final/33-8238.htm (the "*Internal Control Release*").[463] To implement SOX Section 404, the SEC requires each reporting company to include in its Form 10-K an internal control report of management that includes:

- A statement of management's responsibilities for establishing and maintaining adequate internal control over financial reporting for the [issuer];

- A statement identifying the framework used by management to conduct the required evaluation of the effectiveness of the [issuer]'s internal control over financial reporting;

- Management's assessment of the effectiveness of the issuer's internal control over financial reporting as of the end of the issuer's most recent fiscal year, including a statement as to whether or not the issuer's internal control over financial reporting is effective. The assessment must include disclosure of any "material weaknesses" in the issuer's internal control over financial reporting identified by management. Management is not permitted to conclude that the issuer's internal control over financial reporting is effective if there are one or more material weaknesses in the issuer's internal control over financial reporting; and

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462 SOX § 404, 15 U.S.C.A. § 7262 (West Supp. 2004) [hereinafter *"SOX § 404"*]. SOX § 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. SOX § 404 also requires the company's registered public accounting firm to attest to, and report on, management's assessment. The SOX § 404 requirements are not applicable until the SEC's implementing rules are applicable.

463 Securities Act Release No. 8238, *supra* note 176.

- A statement that the registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on management's assessment of the [issuer]'s internal control over financial reporting.[464]

Under these SOX Section 404 rules, management must disclose any material weakness and will be unable to conclude that the company's internal control over financial reporting is effective if there are one or more material weaknesses in such control.[465] Furthermore, the framework on which management's evaluation is based must be a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment.[466]

The rules implementing SOX Section 404 define the term "internal control over financial reporting" to mean

> a process designed by, or under the supervision of, the issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:
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> - Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the [issuer];
> - Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the [issuer] are being made only in accordance with authorizations of management and directors of the [issuer]; and
> - Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the [issuer]'s assets that could have a material effect on the financial statements.[467]

The SOX Section 404 rules require reporting companies to perform quarterly evaluations of changes that have materially affected, or are reasonably likely to materially affect, the company's internal control over financial reporting.[468]

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464 *Id*. at 36,649.

465 *Id*.

466 The SEC staff has indicated that the evaluative framework set forth in the 1992 Treadway Commission report on internal controls (also known as the "*COSO Report*") will be a suitable framework, and that foreign private issuers will be permitted to use the framework in effect in their home countries. The Treadway Commission report is available at http://www.coso.org.

467 17 C.F.R. § 240.13a-15 (2004) (with regard to Regulation 13A); 17 C.F.R. § 240.15d-15 (2004) (with regard to Regulation 15D).

Compliance with the rules regarding management's report on internal controls is required as follows: accelerated filers are required to comply with the management report on internal control over financial reporting requirements for fiscal years ending on or after November 15, 2004, and all other domestic issuers (including small business issuers) will be required to comply for their fiscal years ending on or after July 15, 2007.[469] These dates significantly defer the rule's compliance requirements from the originally proposed requirement that the report on internal control be filed in annual reports for fiscal years ending after September 15, 2003, but management remains subject to quarterly reporting on internal controls in the CEO/CFO certifications under SOX §302.[470]

Codes of Ethics. SOX Section 406 directs the SEC to issue rules requiring a code of ethics[471] for senior financial officers of an issuer applicable to the CFO, comptroller or principal accounting officer and to require disclosure on its Form 8-K within four days of any change in or waiver of the code of ethics for senior financial officers.[472]

Code of Ethics Disclosures. On January 23, 2003, the SEC issued Release No. 33-8177, adopting rules titled "Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act

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468 *Id*. §§ 13a-15(a), 15d-15(f).

469 Securities Act Release No. 8238, *supra* note 176, at 36,650. *"Accelerated filer"* is defined in the rules of the Securities Exchange Act of 1934 generally as an issuer which had a public common equity float of $75 million or more as of the last business day of the issuer's most recently completed second fiscal quarter and has been a reporting company for at least 12 months (other than foreign private issuers). 17 C.F.R. 240.12b-2 (2004). The dates were further extended to the dates set forth in the text by (i) Management's Report on Internal Controls over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, SEC Release 33-8392, 34-49312 (Feb. 24, 2004) *available at* http://www.sec.gov/rules/final/33-8392.htm; (ii) Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports of Non-Accelerated Filers and Foreign Private Issuers, SEC Release 33-8545, 34-51293 (March 2, 2005), which can be found at http://sec.gov/rules/final/33-8545.htm; and (iii) Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports of Non-Accelerated Filers and Foreign Private Issuers, SEC Release 33-8618, 34-52492 (Sept. 22, 2005), which can be found at http://sec.gov/rules/final/33-8618.pdf. *See also* Order Under Section 36 of the Securities Exchange Act of 1934 Granting an Exemption from Specified Provisions of Exchange Act Rules 13a-1 and 15d-1, SEC Release 50754 (November 30, 2004), which can be found at http://www.sec.gov/rules/exorders/34-50754.htm, in which the SEC gave certain smaller accelerated filers an additional 45 days after their Form 10-K is due to file their management's assessment of the internal controls and the related auditor's report thereon, and Division of Corporation Finance FAQ on Exemptive Order on Management's Report on Internal Control over Financial Reporting and Related Auditor Report Frequently Asked Questions, (January 21, 2005), which can be found at http://www.sec.gov/divisions/corpfin/faq012105.htm, in which that Order was interpreted.

470 *See* SOX § 302, *supra* note 179.

471 SOX § 406(c), 15 U.S.C.A. §7264(c) (West Supp. 2004) [hereinafter *"SOX § 406"*]. SOX § 406 defines a "code of ethics" to mean such standards as are reasonably necessary to promote:

(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.

472 SOX § 406(b), *supra* note 471.

of 2002," which can be found at http://www.sec.gov/rules/final/33-8177.htm (the "*SOX 406/407 Release*") and that require reporting companies to disclose on Form 10-K:

- whether the issuer has adopted a 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.[473]

In the adopted SOX Section 406 rules, "code of ethics" means a codification of written standards 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;

- 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;[474] and

- accountability for adherence to the code.[475]

The SOX §406 rules indicate that in addition to providing the required disclosure, an issuer may:

- file with the SEC a copy of its code of ethics that applies to the company's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions, as an exhibit to its Form 10-K annual report;[476]

- post the text of such code of ethics on its Internet website and disclose, in its Form 10-K annual report, its Internet address and the fact that it has posted its code of ethics on its Internet website;[477] or

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473 Disclosure Required by Sections 406 and 407 of the Sarbanes Oxley Act of 2002, Securities Act Release No. 8177, Exchange Act Release No. 47,235, 68 Fed. Reg. 5110 (Jan. 23, 2003) (*codified at* 17 C.F.R. 229.406(a) (2004)), *available at* http://www.sec.gov/rules/final/33-8177.htm [hereinafter "*SOX §§ 406/407 Release*"].

474 The company would retain discretion to choose the person to receive reports of code violations, but Securities Act Release No. 8138 (Exchange Act Release No. 46,701), *infra* note 489, 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.

475 17 C.F.R. § 229.406(b) (2004).

476 17 C.F.R. §§ 228.406(c)(1), 229.406(c)(1).

- undertake in its Form 10-K annual report filed with the SEC to provide to any person without charge, upon request, a copy of such code of ethics and explain the manner in which such request may be made.[478]

Form 8-K or Internet Disclosure Regarding Changes to, or Waivers From, the Code of Ethics. The SOX Section 406 code of ethics rules add an item to the list of Form 8-K triggering events to require disclosure of:

- the nature of any amendment to the company's code of ethics that applies to its principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions;[479] and

- the nature of any waiver, including an implicit waiver, from a provision of the code of ethics granted by the company to one of these specified officers, the name of the person to whom the company granted the waiver and the date of the waiver.[480]

Only amendments or waivers relating to the specified elements of the code of ethics and the specified officers must be disclosed.[481] In the SOX 406/407 Release, the SEC clarified that this limitation is intended to allow and encourage companies to retain broad-based business codes.[482] For example, if a company has a code of ethics that applies to its directors, as well as its principal executive officer and senior financial officers, an amendment to a provision affecting only directors would not require Form 8-K or Internet disclosure.

A company choosing to provide the required disclosure on Form 8-K must do so within four business days after it amends its code or grants a waiver.[483] As an alternative to reporting this information on Form 8-K, a company may use its Internet website as a method of disseminating this disclosure, but only if it previously has disclosed in its most recently filed annual report on Form 10-K:

- its intention to disclose these events on its Internet website; and

- its Internet website address.[484]

Effective Date. Companies must comply with the code of ethics disclosure requirements discussed above in their annual reports for fiscal years ending on or after July 15, 2003.[485] They also

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477 17 C.F.R. §§ 228.406(c)(2), 229.406(c)(2).

478 SOX §§ 406/407 Release, *supra* note 473, at 5127 (*codified at* 17 C.F.R. §§ 228.406(c)(3), 229.406(c)(3) (2004)).

479 *Id*. at 5119; *see generally* SOX § 406(b), *supra* note 471.

480 *Id*.

481 *Id*.

482 *Id*.

483 *Id*.

484 SOX §§ 406/407 Release, *supra* note 473, at 5119 (*codified at* 17 C.F.R. § 229.406(d) (2004)).

must comply with the requirements regarding disclosure of amendments to, and waivers from, their ethics codes on or after the date on which they file their first annual report in which the disclosure requirement is required.

Audit Committee Financial Experts. SOX Section 407 requires the SEC to promulgate rules mandating that each reporting company disclose whether (and, if not, why not) its audit committee includes at least one member who is a "financial expert."[486] On January 23, 2003, the SEC adopted the SOX 406/407 Release[487] containing rules regarding audit committee financial experts to implement SOX Section 407.[488] The final rule uses the term "audit committee financial expert," instead of the term "financial expert" used in SOX Section 407 and an earlier proposed rule because the SEC believes the former term suggests more pointedly that the designated person must have characteristics that are particularly relevant to the functions of the audit committee.[489] The rules under SOX Section 407 require reporting companies to disclose in their Form 10-K that [490]

- its board of directors has determined that the company *either* (i) has at least one "audit committee financial expert" serving on the company's audit committee[491] and the name of such person *or* (ii) does not have an audit committee financial expert serving on its audit committee and the reason it has no audit committee financial expert; and

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485 *Id*. at 5121.

486 SOX § 407, 15 U.S.C.A. § 7265 (West Supp. 2004) [hereinafter *"SOX § 407"*].

487 SOX §§ 406/407 Release, *supra* note 473.

488 SOX § 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." *Id*. at 5110.

489 *See* Proposed Rule: Disclosure Required by Sections 404, 406 and 407 of the Sarbanes Oxley Act of 2002, Securities Act Release No. 8138, Exchange Act Release No. 46,701, 67 Fed. Reg. 66,208 (Oct. 30, 2002), *available at* http://www.sec.gov/rules/proposed/33-8138.htm.

490 The 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 SOX 406/407 Release also adopted rules with similar requirements for investment companies. The disclosure regarding audit committee financial experts is required only in Form 10-K annual reports and may be incorporated therein by reference from the issuer's proxy statement. Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Securities Act Release No. 8177A, Exchange Act Release No. 47,235A, 68 Fed. Reg. 15,353 (Mar. 31, 2003), *available at* http://www.sec.gov/rules/final/33-8177A.htm.

491 SOX § 2(a), 15 U.S.C.A. § 7201 (West Supp. 2004) [hereinafter *"SOX § 2"*] defines the term "audit committee" as

> (A) 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
>
> (B) if no such committee exists with respect to an issuer, the entire board of directors of the issuer.

- if the company discloses that it has at least one audit committee financial expert serving on its audit committee, the company must identify the audit committee financial expert by name and disclose whether that person is "independent,"[492] and if not, an explanation.[493]

The rules under SOX Section 407 define the term "audit committee financial expert" to mean a person who has all of the following attributes:

- An understanding of generally accepted accounting principles and financial statements;
- The ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;
- Experience preparing, auditing, analyzing, or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the [company]'s financial statements, or experience actively supervising one or more persons engaged in such activities;
- An understanding of internal controls and procedures for financial reporting; and
- An understanding of audit committee functions.[494]

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492 "Independence" for these purposes is defined in Item 7(d)(3)(iv) of Schedule 14A under the 1934 Act, which makes reference to the definition of independence in the various listing standards of the NYSE, AMEX, and NASD. 17 C.F.R. § 228.401(e)(1)(ii) (2004); 17 C.F.R. § 229.401(h)(1)(ii) (2004).

493 17 C.F.R. § 228.401(h)(1)(iii) (2004); 17 C.F.R. § 229.401(e)(1)(iii) (2004).

494 SOX §§ 406/407 Release, *supra* note 473, at 5113; SOX § 407, *supra* note 486. The rules initially proposed under SOX § 407 would have used the term "financial expert" instead of "audit committee financial expert" and would have defined the term in a way that would have made it more difficult to obtain people with the requisite qualifications. As proposed initially, the term "financial expert" was defined as a person who was educated and experienced as a public accountant, auditor, principal financial officer, controller, or principal accounting officer of a company that was a reporting company at the time the person held such position. A "financial expert," or a person having 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), was required to possess 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 under the first proposed definition, an individual would have had to possess all of the five specified attributes, and exposure to the rigors of preparing or auditing financial statements of a reporting

company was very important. The board of directors, however, could have concluded that an individual possessed the required attributes without having the specified experience. If the board of directors made such a determination on the basis of alternative experience, the company would have had to disclose the basis for the board's determination.

In determining whether a potential financial expert has all of the requisite attributes, the proposed rules suggested the board of directors of an issuer should evaluate the totality of an individual's education and experience and, among others, the following:

- 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.

SOX §§ 406/407 Release, *supra* note 473, at 5113.

The fact that a person previously had served on the company's audit committee would not, by itself, have let one justify the board of directors in "grandfathering" that person as a financial expert under the originally proposed rules, and that concept is carried forward in the final rules. Securities Act Release No. 8138, *supra* note 489, at 66,212.

The less restrictive definition of "audit committee financial expert" was adopted by the SEC in response to widespread comments that the originally proposed definition of "financial expert" was too restrictive. SOX §§ 406/407 Release, *supra* note 473, at 5113.

Under the final SOX Section 407 rules, a person must have acquired such attributes through any one or more of the following:

- Education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions;

- Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions; or

- Other relevant experience.[495]

In allowing a person to qualify as an audit committee financial expert by having "other relevant experience," the SEC recognizes that an audit committee financial expert can acquire the requisite attributes of an expert in many different ways.[496] The SEC states in the SOX 406/407 Release that it believes that this expertise should be the product of experience and not merely education.[497] Under the final rules, if a person qualifies as an expert by virtue of possessing "other relevant experience," the company's disclosure must briefly list that person's experience.[498]

The SEC also found that it would be adverse to the interests of investors if the designation and identification of the audit committee financial expert affected the duties, obligations or liabilities to which any member of the company's audit committee or board is subject.[499] To codify that position, the SEC included in the adopting release a new safe harbor which clarifies that:

- A person who is determined to be an audit committee financial expert will not be deemed an "expert" for any purpose, including without limitation for purposes of § 11 of the [1934 Act], as a result of being designated or identified as an audit committee financial expert [by a company];

- The designation or identification of a person as an audit committee financial expert [by a company] does not impose on such person any duties, obligations or liability[ies] that are greater than the duties, obligations and liability[ies] imposed on such person as a member of the audit committee and board of directors in the absence of such designation and identification; and

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495 *Id*. at 5113 (*codified at* 17 C.F.R. §§ 228.401, 229.401 (2004)).

496 *Id*. at 5116.

497 *Id*.

498 *Id*.

499 *Id*.

- The designation or identification of a person as an audit committee financial expert [by a company] does not affect the duties, obligations or liability[ies] of any other member of the audit committee or board of directors.[500]

The safe harbor clarifies that any information in a registration statement reviewed by the audit committee financial expert is not "expertised" unless such person is acting in the capacity of some other type of traditionally recognized expert.[501] Similarly, because the audit committee financial expert is not an expert for purposes of § 11 of the 1934 Act, he or she is not subject to a higher level of due diligence with respect to any portion of the registration statement as a result of his or her designation or identification as an audit committee financial expert.[502]

SOX does not explicitly state who at the company should determine whether a person qualifies as an audit committee financial expert. The adopting release states that the SEC believes that the board of directors in its entirety, as the most broad-based body within the company, is best-equipped to make the determination.[503] The SEC also views it as appropriate that any such determination will be subject to relevant state law principles such as the business judgment rule.[504]

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 an audit committee financial expert under the adopted rules.[505]

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.[506] 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 SEC rules. Therefore, it is 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.

Companies must comply with the audit committee financial expert disclosure requirements promulgated under SOX Section 407 in their annual reports for fiscal years ending on or after July 15, 2003.[507]

Systematic SEC Review of 1934 Act Filings. SOX Section 408 requires the SEC to review disclosures made by listed companies on a regular and systematic basis and to review disclosures

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500 SOX §§ 406/407 Release, *supra* note 473 at 5116-17.

501 *Id*. at 5117.

502 *Id*. at 5117 (*codified at* 17 C.F.R. §§ 228.401(e)(4)(i), 229.401(h)(4)(i) (2004)).

503 *Id*. at 5117.

504 *Id*.

505 *Id*. at 5116.

506 17 C.F.R. §§ 228.401(e)(2)(i)-(v), 229.401(h)(2)(i)-(v) (2004).

507 SOX § 407, *supra* note 486.

made by a public company at least once every three years.[508] 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[.][509]

Accelerated Disclosure in Plain English. The 1934 Act is amended by SOX §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.[510]

On September 5, 2002, the SEC adopted amendments[511] to its rules and forms to accelerate the filing of quarterly and annual reports under the 1934 Act by domestic reporting companies that have a public float of at least $75 million, that have been subject to the Exchange Act's reporting requirements for at least 12 calendar months, and that previously have filed at least one annual report with the SEC ("*accelerated filers*").[512] The changes for these accelerated filers will be phased in over three years.[513] The Form 10-K annual report deadline will remain 90 days for year one and change from 90 days to 75 days for year two and from 75 days to 60 days for year three and thereafter.[514] The Form 10-Q quarterly report deadline will remain 45 days for year one and change from 45 days to 40 days for year two and from 40 days to 35 days for year three and thereafter.[515] The phase in period will begin for accelerated filers with fiscal years ending on or after December 15, 2002.[516] The filing deadlines for domestic issuers which are not accelerated filers were left at 90

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508 SOX § 408, 15 U.S.C.A. § 7266 (West Supp. 2004) [hereinafter *"SOX § 408"*].

509 SOX § 408(b), *supra* note 508.

510 SOX § 409, *amending* 15 U.S.C.A. § 78m (West Supp. 2004) (emphasis added).

511 Acceleration of Periodic Reporting Filing Dates and Disclosure Concerning Website Access to Reports, Securities Act Release No. 8128, Exchange Act Release No. 46,464, 67 Fed. Reg. 58,480 (September 16, 2002), *available at* http://www.sec.gov/rules/final/33-8128.htm. It should be noted that the SEC initially proposed these rules on April 12, 2002, which was prior to the enactment of SOX.

512 The accelerated filing deadlines do not apply to foreign private issuers.

513 Securities Act Release No. 8128, *supra* note 511, at 58,482.

514 *Id*. The final phase in from 75 days to 60 days was delayed by one year by Temporary Postponement of the Final Phase-In Period for the Acceleration of Periodic Report Filing Dates, SEC Release 33-8507, 34-50684 (Nov. 17, 2004), available at http://www.sec.gov/rules/final/33-8507.htm.

515 *Id*.

516 *Id*.

days and 45 days after the period end for Form 10-K and Form 10-Q Reports, respectively.[517] The SEC also adopted amendments to require accelerated filers to disclose in their Form 10-K annual reports explaining where investors can obtain access to their filings and whether the company provides access to its Forms 10-K, 10-Q and 8-K reports on its Internet website, free of charge. This is to be done as soon as reasonably practicable after those reports are electronically filed with or furnished to the Commission.[518]

VI.
ANALYST CONFLICTS OF INTEREST (SOX TITLE V)

SOX Section 501 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 those whose involvement in investment banking activities might potentially bias their judgment or supervision.[519]

On February 20, 2003, the SEC issued Release No. 33-8193 adopting rules titled "Regulation Analyst Certification," which implemented the SOX Section 501 requirements (the "*SOX § 501 Release*").[520] The SOX Section 501 Release adopts new Regulation Analyst Certification ("*Regulation AC*"), which requires brokers, dealers, and their associated persons that are "covered persons"[521] that publish, circulate, or provide research reports include in those research reports:

- a statement by the research analyst (or analysts) certifying that the views expressed in the research report accurately reflect such research analyst's personal views about the subject securities and issuers; and

- a statement by the research analyst (or analysts) certifying either (a) that no part of his or her compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report or (b) that part or all of his or her compensation was, is, or will be directly or indirectly related to the specific

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517 *Id*. at 58,481.

518 *Id*.

519 SOX § 501(a), 15 U.S.C.A. § 78o-6 (West Supp. 2004) [hereinafter *"SOX § 501(a)"*].

520 Regulation Analyst Certification, Securities Act Release No. 8193, Exchange Act Release No. 47,384, 68 Fed. Reg. 9482 (Feb. 27 2003) (*codified at* 17 C.F.R. § 242 (2004)), *available at* http://www.sec.gov/rules/final/33-8193.htm [hereinafter *"SOX § 501 Release"*].

521 Rule 500 of Regulation AC defines "covered person" of a broker or dealer to mean, subject to certain exceptions, an associated person of that broker or dealer as defined by 1933 Act Rule 405. *Id*. at 9484.

recommendations or views contained in the research report. If the analyst's compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report, the statement must include the source, amount, and purpose of such compensation, and further disclose that it may influence the recommendation in the research report.[522]

All certifications must be clear and prominent.[523] If the analyst is unable to certify that the report accurately reflects his or her personal views, distribution of the report by the broker-dealer or covered person would be in violation of Regulation AC.[524] Similarly, if the report does not contain one of the two alternative compensation certifications, distribution of the report by the broker-dealer or covered person would be in violation of Regulation AC.[525]

Under Regulation AC, broker-dealers must make and keep records related to public appearances by research analysts.[526] Specifically, if a broker-dealer publishes, circulates, or provides a research report prepared by a research analyst employed by the broker-dealer or a covered person, the broker-dealer is required to make a record within 30 days after each calendar quarter in which the research analyst made any public appearance, that includes:

- A statement by the research analyst attesting that the views expressed by the research analyst in all public appearances during the calendar quarter accurately reflected the research analyst's personal views at that time about any and all of the subject securities or issuers; and

- A written statement by the research analyst certifying that no part of such research analyst's compensation was, is, or will be directly or indirectly related to any specific recommendations or views expressed in any such public appearance.[527]

In cases where the broker-dealer does not obtain a statement by the research analyst in connection with public appearances as described above, the broker-dealer must promptly notify its examining authority that the analyst did not provide certification in connection with public appearances.[528] In addition, for 120 days following such notification, the broker-dealer must disclose in any research report it distributes authored by that analyst the fact that the analyst did not provide the certification.[529]

Investment advisers and brokers who provide financial services or advice ("*Providers*") to the State of Texas or its subdivisions (the "*State*") are subject to rules establishing ethical standards

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522 *Id*. at 9482-83.

523 *Id*. at 9483.

524 *Id*.

525 *Id*.

526 SOX § 501 Release, *supra* note 520, at 9483.

527 *Id*. at 9483 (*codified at* 17 C.F.R. § 242.502 (2004)).

528 *Id*.

529 *Id*.

of conduct under Senate Bill 1059, which became operative on September 1, 2003.[530] These Providers are required to disclose, in writing, to the administrative head of the applicable State governmental entity and the State auditor (1) any relationship the Provider has with any party to a transaction with the State that could reasonably be expected to diminish the Provider's independence of judgment in the performance of its duties to the State and (2) any direct or indirect pecuniary interest that the Provider has in any transaction with the State, in each case without regard to whether the relationship is direct, indirect, personal, private, commercial, or business.[531] Providers are required to file annual statements disclosing such relationships by April 15 of each year and to amend the filing whenever there is new information to report.[532]

VII.
SEC RESOURCES AND AUTHORITY (SOX TITLE VI)

SOX increases the SEC's budget under Section 601.[533] It also grants the SEC censure authority in connection with appearance and practice before the SEC 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 (Section 602).[534]

VIII.
STUDIES AND REPORTS (SOX TITLE VII)

SOX mandated various studies and reports to Congress regarding the consolidation of public accounting firms and the role and function of credit rating agencies. The SEC was required to report on (i) the role and function of credit rating agencies in the securities markets, including how well they are doing their job;[535] (ii) all enforcement actions over the last five years involving violations of reporting requirements and financial statement restatements, to identify the areas most susceptible to

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530 *See* Tex. S.B. 1059, 78th Leg., R.S. (2003), *available at* http://www.capitol.state.tx.us/cgi-bin/tlo/textframe.cmd?LEG=78&SESS=R&CHAMBER=S&BILLTYPE=B&BILLSUFFIX=01059&VERSION=5&TYPE=B.

531 TEX. GOV'T CODE ANN. § 2263.005 (Vernon Supp. 2004-05).

532 *Id*.

533 SOX § 601, *amending* 15 U.S.C.A. § 78kk (West Supp. 2004).

534 SOX § 602, 15 U.S.C.A. § 78d-3 (West Supp. 2004).

535 Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets (Jan. 24, 2003), *available at* http://www.sec.gov/news/studies/credratingreport0103.pdf (a report pursuant to SOX § 702 regarding the role and function of credit rating agencies in the operation of the securities markets, including the role of credit rating agencies in the evaluation of issuers of securities; the importance of that role to investors and the functioning of the securities markets; any impediments to the accurate appraisal by credit rating agencies of the financial resources and risks of issuers of securities; any barriers to entry into the business of acting as a credit rating agency, and any measures needed to remove such barriers; any measures which may be required to improve the dissemination of information concerning such resources and risks when credit rating agencies announce credit ratings; and any conflicts of interest in the operation of credit rating agencies and measures to prevent such conflicts or ameliorate the consequences of such conflicts).

fraud,[536] (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,[537] and (iv) a study of issuer filings to determine the extent to which off-balance sheet transactions and special purpose entities (*"SPE's"*) are used and whether GAAP results in financial statements of those issuers reflecting the off-balance sheet financing transactions in a transparent fashion.[538] The report on SPE's and off-balance sheet financing was due by July 31, 2004.[539]

On July 25, 2003, the SEC released a Staff study on the adoption by the U.S. financial reporting system of a principles-based accounting system conducted pursuant to SOX §108(d).[540] The Staff study recommends that accounting standards should be developed using a principles-based approach, rather than a rules-based approach,[541] and that such standards should have the following characteristics:

- Be based on an improved and consistently applied conceptual framework;
- Clearly state the accounting objective of the standard;
- Provide sufficient detail and structure so that the standard can be operationalized and applied on a consistent basis;
- Minimize exceptions from the standard;

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536 Report Pursuant to SOX § 704 (Jan. 24, 2003)), *available at* http://www.sec.gov/news/studies/sox704report.pdf (SEC enforcement actions involving violations of reporting requirements imposed under the securities laws, and restatements of financial statements over the past five years, to identify areas of reporting that are most susceptible to fraud, inappropriate manipulation, or inappropriate earnings management).

537 Study and Report on Violations by Securities Professionals (Jan. 24, 2003)), *available at* http://www.sec.gov/news/studies/sox703report.pdf (report pursuant to SOX § 703 regarding the number of securities professionals practicing before the SEC who (1) have aided and abetted a violation of the Federal securities laws but who have not been sanctioned, disciplined, or otherwise penalized as a primary violator in any administrative action or civil proceeding, and (2) have been primary violators of the Federal securities laws between 1998 and 2001).

538 SOX § 401, *supra* note 355.

539 SOX § 401 requires the SEC to provide final rules regarding the disclosure of off-balance sheet transactions within 180 days of enactment of the SOX. *See* 15 U.S.C.A. § 78m (West Supp. 2004). It goes on to then require that, no later than a year after these rules are enacted, the study be completed and that, six months after the study is completed, the report be completed and submitted. SOX § 401(c).

540 Study Pursuant to §108 (d) of SOX on Adoption by the U. S. Financial Reporting System of a Principles-Based Accounting System (July 25, 2003), *available at* http://www.sec.gov/news/studies/principlesbasedstand.htm.

541 The staff found that imperfections exist when standards are established on either a rules-based or a principles-only basis. Principles-only standards may present enforcement difficulties because they provide little guidance or structure for exercising professional judgment by preparers and auditors. Rules-based standards often provide a vehicle for circumventing the intention of the standard. As a result of its study, the staff recommended that those involved in the standard-setting process more consistently develop standards on a principles-based or objectives-oriented basis.

- Avoid use of percentage tests ("bright-lines") that allow financial engineers to achieve technical compliance with the standard while evading the intent of the standard.[542]

To distinguish the particular approach taken to implementing principles-based standard setting, the staff labels its approach "objectives-oriented."[543] Fundamental to this approach is that the standards would clearly establish the objectives and the accounting model for the class of transactions, while also providing management and auditors with a framework that is sufficiently detailed for the standards to be operational. The staff concludes in the study that an objectives-oriented approach should ultimately result in more meaningful and informative financial reporting to investors and also would hold management and auditors responsible for ensuring that financial reporting complies with the objectives of the standards.[544]

The staff acknowledges that the FASB has begun the shift to objectives-oriented standard setting and is doing so on a prospective, project-by-project basis. The staff expects that the FASB will continue to move towards objectives-oriented standard setting on a transitional or evolutionary basis.

IX.
CORPORATE AND CRIMINAL FRAUD ACCOUNTABILITY (SOX TITLE VIII)

Records Retention. Title VIII of SOX 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)[545] and (2) auditor failure to maintain for a five-year period all audit or review work papers pertaining to an issuer of securities.[546] The SEC is directed to promulgate regulations regarding the retention of audit records containing conclusions, opinions, analyses, or financial data.[547]

On January 24, 2003 the SEC adopted rules that would add §210.2-06 to Regulation S-X (under "Qualifications and Reports of Accountants"),[548] which would require accountants who review or audit an issuer's financial statements to retain, for seven years after the end of the completion of the audit or review, certain materials relevant to the audit or review, including workpapers[549] and other documents that form the basis of the audit or review of an issuer's financial

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542 *See* SEC Study on Principals-Based Accounting, *supra*, note 540.

543 *Id*.

544 *Id*.

545 SOX § 802(a), 18 U.S.C.A. § 1519 (West Supp. 2004).

546 SOX § 802(b), 18 U.S.C.A. § 1520 (West Supp. 2004).

547 *Id*.

548 Retention of Records Relevant to Audits and Reviews, Securities Act Release No. 8180, Exchange Act Release No. 47,241, 68 Fed. Reg. 4862 (January 30, 2003) (*codified in* 17 C.F.R. § 210 (2004)), *available at* http://www.sec.gov/rules/final/33-8180.htm.

549 "Workpapers" are defined as "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. *Id*. at 4864.

statements, 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[.]"[550]

Non-substantive materials that are not part of the workpapers, such as administrative records, and other documents that do not contain relevant financial data or the auditor's conclusions, opinions, or analyses would not meet the second of the criteria in Rule 2-06(a) and would not have to be retained.[551] The release adopting Rule 2-06 indicates that the following documents would not be considered substantive and would not have to be retained:

- [s]uperseded drafts of memoranda, financial statements or regulatory filings;
- [n]otes on superseded drafts of memoranda, financial statements or regulatory filings that reflect incomplete or preliminary thinking;
- [p]revious copies of workpapers that have been corrected for typographical errors or errors due to training of new employees;
- [d]uplicates of documents, or
- [v]oice-mail messages.[552]

However, these records would fall within the scope of new Rule 2-06 to the extent they contain information or data, relating to a significant matter, that is inconsistent with the auditor's final conclusions, opinions, or analyses on that matter or the audit or review.[553] For example, Rule 2-06 would require the retention of an item in this list if that item documented a consultation or resolution of differences of professional judgment.[554]

All of the issuer's financial information, records, databases, and reports that the auditor examines on the issuer's premises, but are not made part of the auditor's workpapers or otherwise currently retained by the auditor, are not deemed to be "received" by the auditor under Rule 2-06(a)(1) and do not have to be retained by the auditor.[555]

Note that the PCAOB is directed in SOX §103 to require auditors to retain, for a period of seven years, workpapers to support the auditor's conclusions.[556] Many documents may be subject to

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550 *Id*. at 4863.

551 *Id*.

552 *Id*.

553 *Id*.

554 Securities Act Release No. 8180, *supra* note 548, at 4863.

555 *Id*.

556 SOX § 103(a)(2)(A)(i), *supra* note 63.

both retention requirements, though the SEC's retention requirement applies to a broader range of documents that do not necessarily just support conclusions.[557]

Non-dischargeable Fraud Judgments. SOX Section 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.[558]

Extension of Statute of Limitation for Securities Fraud Claims. SOX Section 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.[559]

Sentencing Guidelines. SOX Section 805 directs the U.S. 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.[560]

Whistleblower Protection. Under SOX Section 806, whistleblower protection is extended to individuals who report (to particular federal agencies, to Congress, or to a supervisor) conduct the individual reasonably believes constitutes a violation of: (a) the federal securities laws; (b) SEC rules; or (c) any provision of federal law relating to fraud against shareholders.[561] SOX §806 forbids a public company and its officers, employees, contractors, subcontractors, and agents from discharging, demoting, suspending, threatening, harassing, or in any way discriminating against an employee because the employee provided information or assisted in an investigation the employee reasonably believed constituted a violation of SOX, any rule or regulation of the SEC, or any provision of federal law relating to fraud against shareholders.[562]

Furthermore, SOX Section 806 protects a whistleblower even if his or her report of wrongdoing is incorrect, provided the whistleblower reasonably believed that what he or she reported constituted a violation.[563] This means a company can prove that a complainant's understanding of an SEC rule was mistaken, and the allegation thus unwarranted, and yet still *lose* a SOX whistleblower case.

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557 17 C.F.R. § 210.2-06 (2004).

558 SOX § 803, *supra* note 53.

559 SOX § 804, *amending* 28 U.S.C.A. § 1658 (West Supp. 2004). *See* Jeffrey Q. Smith and James K. Goldfarb, *Circuit Courts Foreclose Retroactive Application of SOXA's New Statute of Limitations for Federal Securities Law Claims*, 37 BNA Securities Regulation & Law Rept. 236 (Feb. 7, 2005).

560 SOX § 805 (*ordering review pursuant to* 28 U.S.C.A. § 994 (West Supp. 2004)).

561 SOX § 806(a), 18 U.S.C.A. § 1514A (West Supp. 2004); *see* 29 C.F.R. § 1980 (2004).

562 *Id*.

563 *Id*.

Employees are also protected if they file, cause to be filed, testify in, participate in, or otherwise assist in a proceeding filed (or about to be filed) relating to any rule or regulation of the SEC or any provision of federal law relating to fraud against shareholders.[564] This means that employees are insulated from retaliation for testifying or participating in class action securities litigation, for example. Employers (and in some cases individuals) found to have retaliated against a whistleblower may be subject to administrative, civil, and criminal sanctions.[565]

Enhanced Fraud Penalties. SOX Section 807 subjects any person who defrauds shareholders of publicly traded companies to a fine and imprisonment for up to 25 years.[566]

X.
WHITE-COLLAR CRIME PENALTY ENHANCEMENTS (SOX TITLE IX)

Title IX of SOX is called the "White-Collar Crime Penalty Enhancement Act of 2002."[567] SOX Section 902 amends federal criminal law to provide that conspiracy to commit an offense is subject to the same penalties as the offense[568] and increase criminal penalties for mail and wire fraud from five years to 20 years.[569]

SOX Section 905 directs the U.S. 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 SOX, 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.[570]

SOX Section 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.[571] It provides that the criminal penalties are (1) twenty years in prison for a willful violation and (2) ten years for a reckless and knowing violation.[572]

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564 *Id*.

565 *See Id*.

566 SOX § 807(a), 18 U.S.C.A. § 1348 (West Supp. 2004).

567 SOX § 901, 116 Stat. 804 (2002).

568 SOX § 902(a), 18 U.S.C.A. § 1349 (West Supp. 2004).

569 SOX § 903, *amending* 18 U.S.C.A. §§ 1341, 1343 (West Supp. 2004).

570 SOX § 905 (2002). However, the validity of the federal sentencing guidelines has been called into question by the United States Supreme Court in two combined recent cases. In *United States v. Booker*, No 04-104 (decided January 14, 2004 and *United States v. Fanfan*, No 04-105 (decided January 14, 2004), the United States Supreme Court held that the United States Sentencing Guidelines were merely advisory and not mandatory upon federal judges.

571 SOX § 906, *supra* note 176; *see also* "CEO/CFO Certifications," *supra* in Section III (regarding the certifications mandated by SOX §§302, 906).

572 SOX § 906, *supra* note 176.

XI.
CORPORATE TAX RETURNS (SOX TITLE X)

SOX Title X 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.[573] This is not required by the Internal Revenue Code, and the effect of this provision by itself without any penalty provision is advisory only.

XII.
CORPORATE FRAUD ACCOUNTABILITY (SOX TITLE XI)

SOX Title XI, entitled the "Corporate Fraud Accountability Act of 2002," provides in § 1102 for up to twenty 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.[574] SOX Section 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.[575]

XIII.
EFFECT OF SOX ON FOREIGN COMPANIES

Which Foreign Companies are Subject to SOX. The provisions of SOX apply to public companies even if domiciled outside of the U.S.[576] Many of the SEC rules promulgated under SOX's directives provide limited relief from some SOX provisions for the "*foreign private issuer*," which the SEC defines as a private corporation or other organization incorporated outside of the U.S., as long as:

- more than 50% of the issuer's outstanding voting securities are not directly or indirectly held of record by U.S. residents;
- the majority of the executive officers or directors are not U.S. citizens or residents;
- more than 50% of the issuer's assets are not located in the U.S.; and
- the issuer's business is not administered principally in the U.S.[577]

A foreign private issuer may use Form 20-F both to register a class of its securities under the 1933 Act and as its SEC annual report under the 1934 Act, due within six months after the end of

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573 SOX § 1001.

574 SOX § 1102, *amending* 18 U.S.C.A. § 1512 (West Supp. 2004).

575 SOX § 1103, *amending* 15 U.S.C.A. § 78u-3 (West Supp. 2004).

576 *See* "To What Companies Does SOX Apply," *supra* Section I.

577 17 C.F.R. § 240.3b-4 (2004).

each fiscal year.[578] A number of the SOX provisions have exceptions applicable to foreign private issuers as discussed below.

What Differences Are There in the Application of SOX Provisions to Foreign Private Issuers?

Public Company Accounting Oversight Board – The Title I rules apply to foreign accounting firms that audit foreign corporations which are reporting companies under the 1934 Act or that are offering securities in a registered public offering under the 1933 Act.[579] The PCAOB may also determine by rule that a foreign public accounting firm that does not prepare or issue the audit report of such a foreign company, but that nonetheless plays such a substantial role in preparing or issuing its audit report, should be treated as a public accounting firm under SOX.[580]

Auditor Independence; Non-Audit Services – All of the Title II rules apply equally to foreign private issuers, effective May 6, 2003, except that record retention requirements were effective October 31, 2003.[581] Because in many foreign jurisdictions audit partners previously were not subject to rotation requirements, for all partners with foreign accounting firms who are subject to rotation requirements, the period of service does not include time served on the audit engagement team prior to the first day of issuer's fiscal year beginning on or after May 6, 2003.[582] A foreign private issuer is required to disclose in its Form 20-F or 40-F for fiscal years ending after December 15, 2003, the fees paid to its auditors for (1) audit services; (2) audit-related services; (3) tax services; and (4) other services.[583]

Corporate Responsibility

Audit Committee Independence Rules. SOX Section 301 rule applies to foreign private issuers, although the effective date for foreign private issuers is July 31, 2005.[584] Because the requirements for a U.S.-style audit committee may conflict with legal requirements, corporate governance standards, and the methods for providing auditor oversight in the home jurisdictions of some foreign private issuers, the SEC has provided some exceptions to the audit committee independence rules.[585] These exceptions provided by the SOX Section 301 Release are summarized below:

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578 17 C.F.R. § 249.220f (2004).

579 *See supra* Section II.

580 SOX §106(a)(1), 15 U.S.C.A. § 7216(a)(1) (West Supp. 2004) [hereinafter *"SOX § 106"*].

581 Title II Release, *supra* note 68, at 6006.

582 *Id*. at 6021.

583 *Id*. at 6024.

584 SOX § 301 Release, *supra* note 6, at 18,790.

585 For example, in some countries: (i) the auditors report to shareholders at the annual meeting and are responsible to them; (ii) there are no requirements to have an audit committee; (iii) if there is a requirement for an audit committee, there is no requirement its members are independent; and (iv) there are two tiers of board membership: a lower tier of employee members, either management or non-management, and an upper-tier of supervisory members.

- *Allowing Non-Management Employee to Serve*. Non-management employees will be allowed to serve on the audit committee of a foreign private issuer if the employee is elected or named to the board of directors or audit committee of the foreign private issuer pursuant to home country legal or listing requirements.[586]

- *Allowing Controlling Shareholder to Serve*. In foreign jurisdictions providing for audit committees, representation of controlling shareholders is common. The SEC suggests that in the case of foreign private issuers, one member of the audit committee could be a shareholder, or representative of a shareholder or group, owning more than 50% of the voting securities of the foreign private issuer, if the "no compensation" prong of the independence requirements is satisfied, the member in question has only observer status on, and is not a voting member or the chair of, and the member in question is not an executive officer of the issuer.[587]

- *Allowing Government Representative to Serve*. To accommodate foreign practices, one member of the audit committee of a foreign private issuer could be a representative of a foreign government or foreign governmental entity, as long as the "no compensation" prong of the independence requirement is satisfied and the member in question is not an executive officer of the issuer.[588]

- *No Independent Audit Committee Required if Board of Auditors*. Foreign private issuers' boards of auditors or similar bodies or statutory auditors, which operate under legal or listing provisions and are intended to provide oversight of outside auditors that are independent of management are exempted from the more demanding independence requirements in the SOX Section 301 Release, as long as membership on such a board excludes executive officers of the foreign private issuer and such board or body is (to the extent permitted by the law of its home jurisdiction) responsible for the appointment and retention of any registered public accounting firm engaged by the listed issuer.[589]

- *Audit Committee Financial Experts*. A foreign private issuer must disclose whether it has an audit committee financial expert who is independent, as that term is defined by the applicable listing standards for the issuer's exchange.[590] If a foreign company is not a listed issuer, it must choose one of the definitions of audit committee member independence used by a major stock exchange for purposes of determining whether its financial expert is independent.[591]

A foreign private issuer availing itself of any of the exemptions described above must disclose in, or incorporate by reference into, its annual report on Form 20-F or 40-F its (a) reliance

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586 SOX § 301 Release, *supra* note 6, at 18,802.

587 *Id*. at 18,802-03.

588 *Id*. at 18,803.

589 *Id*.

590 *Id*. at 18,808.

591 *Id*. at 18,808-09.

on the exemption; and (b) assessment of whether (and if so, how) such reliance would materially adversely affect the ability of their audit committee to act independently and to satisfy the other requirements of the proposed rules.[592]

In the case of a foreign private issuer with a two-tier board of directors, the term "board of directors" means the supervisory or non-management board.[593] That board may either form an audit committee that complies with the independence requirements, or if the entire board is independent, it may be designated as the audit committee. To the extent an audit committee is required to conduct oversight duties, establish procedures to receive complaints, have authority to hire independent counsel, identify and disclose the "financial expert" if there is one (and if not, why not), and if the foreign private issuer is not required to have an audit committee under one of the exemptions to the Title III Rules provided above (e.g., either because it has a two-tier board structure and the upper tier is independent, or because it has a board of auditors), then the board members represented by the alternatively allowed structure shall perform the duties of an audit committee.[594]

CEO/CFO Certifications under Sections 302 and 906. Calendar year foreign private issuers must include certifications in their annual Forms 20-F and 40-F filed after June 30, 2003.[595] Since foreign private issuers make no quarterly filings but report updated information from time to time during the year on Form 6-K, no quarterly certification would be required (Form 6-K, like Form 8-K, is not considered "filed" with the SEC).[596]

Misleading Statements to Auditors. Foreign companies are equally subject to SOX Section 303 and expanded Rule 13b2-2. In applying the rule to foreign private issuers, the terms "officer" and "director" would indicate those performing equivalent functions under the local laws and corporate governance practices where the issuer is domiciled.[597] "In addition, the term 'independent public or certified public accountant' includes accountants in foreign countries who engage in auditing or reviewing an issuer's financial statements or issuing attestation reports to be filed with the [SEC], regardless of the title or designation used in those countries."[598]

CEO/CFO Reimbursement. SOX Section 304 applies equally to foreign companies, with the same July 30, 2002, effective date, although, as in the case of U.S. issuers, it is unclear how Section 304 will be enforced in practice.[599]

Insider Trading Freeze During Plan Blackout. Regulation BTR limits SOX Section 306(a)'s application to the directors and executive officers of a foreign private issuer[600] to situations

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592 SOX § 301 Release, *supra* note 6, at 18,820.

593 *Id*. at 18,817.

594 *Id*. at 18,809.

595 Certification of Disclosure in Companies' Quarterly and Annual Reports, Exchange Act Release No. 46,079, 67 Fed. Reg. 41,877, 41,882 (June 20, 2002), *available at* http://www.sec.gov/rules/proposed/34-46079.htm.

596 *See id*.

597 Exchange Act Release No. 47,890, *supra* note 192, at 31,821 n.12.

598 *Id.* at 31,825 n.67.

599 SOX § 304, s*upra* note 202.

where (i) 50% or more of the participants or beneficiaries located in the U.S. in individual account plans maintained by the issuer are subject to a temporary trading suspension in issuer equity securities, (ii) the affected participants and beneficiaries represent an appreciable portion of the issuer's worldwide employees, and (iii) the issuer is considered to have a sufficient presence for purposes of applying the SOX Section 306(a) trading prohibition to its directors and executive officers.[601] A foreign private issuer will have sufficient presence for the trading prohibition if:

- the number of participants and beneficiaries located in the U.S. in individual account plans maintained by the issuer who are subject to a temporary trading suspension in issuer equity securities exceeds 15% of the number of employees of the issuer worldwide; or

- the number of participants and beneficiaries located in the U.S. in individual account plans maintained by the issuer who are subject to a temporary trading suspension in issuer equity securities does not exceed 15% of the number of employees of the issuer worldwide but exceeds 50,000 participants and beneficiaries.[602]

Likewise, if the number of participants and beneficiaries located in the U.S. in individual account plans maintained by the issuer who are subject to a temporary trading suspension in issuer equity securities does not exceed 15% of the issuer's employees worldwide and involves 50,000 or fewer participants and beneficiaries, the issuer's presence in the U.S. will be considered sufficiently small so that its directors and executive officers will not be subject to the SOX §306(a) trading prohibition.[603]

Enhanced Attorney Responsibilities. The SOX Section 307 Rules apply to all attorneys, whether in-house counsel or outside counsel or those in foreign jurisdictions, "*appearing and practicing*" before the SEC.[604] The term "appearing and practicing" before the SEC is defined to include, without limitation: (1) transacting any business with the SEC, including communication in any form with the SEC; (2) representing an issuer in an SEC administrative proceeding or in connection with any SEC investigation, inquiry, information request, or subpoena; (3) providing advice in respect of the U.S. securities laws regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the SEC, including the provision of such advice in the context of preparing, or participating in the preparation of, any such document; or (4) advising an issuer as to whether information or a statement, opinion, or other writing is required under the U.S. securities laws to be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the SEC; but does not include an attorney who (i) conducts these activities other than in the context of providing legal services to an issuer with whom the attorney has an attorney-client relationship; or (ii) is a non-

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600 For a foreign private issuer, a "director" is a director who is a management employee of the issuer, and an "executive officer" is the principal executive officer or officers, a principal financial officer or officers, and the principal accounting officer or officers. 17 C.F.R. § 245.100 (2004).

601 Exchange Act Release No. 47,225, *supra* note 211, at 4339.

602 *Id*. at 4346.

603 *Id*.

604 17 C.F.R. § 205.1 (2004).

appearing foreign attorney.[605] In recognition of the difficulties encountered by foreign lawyers and international law firms because applicable foreign standards might be incompatible with the attorney conduct rules,[606] the SOX Section 307 Rules exempt "non-appearing foreign attorneys" who:

- Are admitted to practice law in a jurisdiction outside the United States;
- Do not hold themselves out as practicing, and do not give legal advice regarding, U.S. federal or state securities or other laws; and either
  - (i) Conduct activities that would constitute appearing and practicing before the SEC only incidentally to, and in the ordinary course of, the practice of law in a jurisdiction outside the U.S.; or
  - (ii) Appear and practice before the SEC only in consultation with counsel, other than a non-appearing foreign attorney, admitted or licensed to practice in a state or other U.S. jurisdiction.[607]

Thus, foreign attorneys who provide legal advice regarding U.S. securities law, other than in consultation with U.S. counsel, are subject to the SOX Section 307 Rules if they conduct activities that constitute appearing and practicing before the SEC.[608] The SOX Section 307 Rules cite as an example an attorney licensed in Canada who independently advises an issuer regarding the application of SEC regulations to a periodic filing with the SEC, who would in those circumstances be subject to the SOX Section 307 Rules.[609]

In addition, the SEC adopted Paragraph 205.6(d) of the SOX Section 307 Rules to protect a lawyer practicing outside the U.S. in circumstances where foreign law prohibits compliance with the SOX Section 307 Rules:

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605 17 C.F.R. § 205.2 (2004).

606 In the SOX Section 307 Release, the SEC commented:

> The Commission respects the views of the many commenters who expressed concerns about the extraterritorial effects of a rule regulating the conduct of attorneys licensed in foreign jurisdictions. The Commission considers it appropriate, however, to prescribe standards of conduct for an attorney who, although licensed to practice law in a foreign jurisdiction, appears and practices on behalf of his clients before the Commission in a manner that goes beyond the activities permitted to a non-appearing foreign attorney. Non-United States attorneys who believe that the requirements of the rule conflict with law or professional standards in their home jurisdiction may avoid being subject to the rule by consulting with United States counsel whenever they engage in any activity that constitutes appearing and practicing before the Commission.

SOX Section 307 Release, *supra* note 263, at 6303.

607 *Id*.

608 *Id*. *See also* 17 C.F.R. § 205.1.

609 The SOX Section 307 Release, *supra* note 263, at 6303.

> (d) An attorney practicing outside the United States shall not be required to comply with the requirements of this part to the extent that such compliance is prohibited by applicable foreign law.[610]

Where the foreign attorney rules are not prescribed by statute but by bar association or court rules, the Paragraph 205.6(d) exception may not be available.[611] In any event, the SEC would require that the foreign lawyer comply with the SOX Section 307 Rules to the maximum extent not prohibited by applicable foreign law.[612]

Further, U.S. attorneys who work for foreign private issuers would be subject to the SOX Section 307 Rules[613] and applicable state bar disciplinary rules in respect of their service for foreign private issuers and could be held responsible under SEC Rule 13b2-2 under the 1934 Act for improperly influencing the auditor of a foreign private issuer's financial statements filed with the SEC.[614]

Enhanced Financial Disclosures; Prohibition on Insider Loans

Off-Balance Sheet Transactions; Use of Non-GAAP Financial Measures. Forms 20-F and 40-F have been amended to require foreign private issuers to make the same disclosures required

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610 17 C.F.R. § 205.6(d).

611 The SOX Section 307 Release, *supra* note 263, at 6314 ("paragraph 205.6(d) addresses the conduct of non-U.S. attorneys who are *subject to this part*. . .") (emphasis added).

612 17 C.F.R.§ 205.6(d).

613 In advising foreign private issuers with respect to U.S. securities law matters, U.S. counsel may encounter situations where, in their judgment, the U.S. securities laws and SOX § 307 Rules require them to take actions which would not be required under the laws of the jurisdiction in which the issuer is organized or principally conducts its business. *See* Patrick McGeehan, *Lawyers Take Suspicions On TV Azteca To Its Board*, N.Y. TIMES, Dec. 24, 2003, at C1:

> In one of the first applications of a new provision of the Sarbanes-Oxley Act, outside lawyers for Mexico's second-largest broadcaster have told its board – and, possibly, federal regulators – that they think that the company violated United States securities laws.
>
> The company, TV Azteca, has had a long-running dispute with lawyers in New York about the need for greater disclosure about transactions that could have yielded a profit of more than $100 million to the company's billionaire chairman and controlling shareholder, Ricardo B. Salinas Pliego. When company executives refused to make the disclosures that the lawyers demanded, the lawyers cited the new provision of the act, which requires them to notify the company's board and permits them to contact regulators as well.
>
> . . . in a Dec. 12 letter to the boards of TV Azteca and its parent company, Azteca Holdings, [outside New York counsel citing SOX § 307] told the boards that [the firm] was withdrawing as counsel to the company on a pending bond offering and that it might notify the Securities and Exchange Commission of its withdrawal and the reasons for it.

The SEC filed civil fraud charges TV Azteca, its parent company, and three of its officers and directors on January 4, 2005 alleging significant related party transactions which were undisclosed in TV Azteca's periodic reports. *See* SEC Litigation Release 19022 (Jan. 4, 2005). In the SEC Litigation Release, the SEC noted that the company's outside counsel withdrew from its representation pursuant to its duties under Section 307 of SOX.

614 *See* "Misleading Statements to Auditors" in Section IV, *supra*.

of domestic companies in respect of off-balance sheet items in filings made for fiscal years ending on or after June 15, 2003.[615] The table of contractual obligations is required in filings made for fiscal years ending on or after December 15, 2003.[616]

The SEC did not impose U.S. GAAP on foreign private issuers with respect to the preparation of their primary financial statements.[617] Thus, for a foreign private issuer that discloses a non-GAAP financial measure derived from a measure calculated in accordance with its home country or local GAAP, "GAAP" refers to its home country GAAP.[618] For those that disclose a non-GAAP financial measure derived from a measure calculated in accordance with U.S. GAAP, "GAAP" refers to U.S. GAAP, for purposes of applying Regulation G to the disclosure of that measure.[619] However, foreign private issuers whose primary financial statements are prepared in accordance with a non-U.S. GAAP were required pre-SOX to include in their management discussion and analysis (MD&A) a discussion of the reconciliation to U.S. GAAP and any differences between foreign and U.S. GAAP, if it would be necessary for an understanding of the financial statements as a whole.[620] Consistent with that pre-SOX MD&A requirement for foreign private issuers, the disclosure about off-balance sheet arrangements and the table of contractual obligations should focus on the primary financial statements presented in the document, while taking the reconciliation into account.[621]

Conditions for Use of Non-GAAP Financial Measures: Regulation G. Regulation G applies to any disclosures made in a Form 20-F filed with respect to a fiscal period ending after March 28, 2003, unless:

- the securities of the foreign company are listed or quoted on a securities exchange or inter-dealer quotation system outside the United States;
- the non-GAAP financial measure is not derived from or based on a measure calculated and presented in accordance with generally accepted accounting principles in the U.S.; and
- the disclosure is made by or on behalf of the foreign private issuer outside the U.S. or is included in a written communication that is released by or on behalf of the foreign private issuer outside the U.S.[622]

These exceptions apply even if one or more of the following circumstances exists:

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615 Securities Act Release No. 8182, *supra* note 358, at 5991.

616 *Id*. at 5992.

617 Securities Act Release No. 8176, *supra* note 370.

618 *Id*.

619 *Id*.

620 Securities Act Release No. 8182, *supra* note 358, at 5992.

621 *Id*.

622 Securities Act Release No. 8176, *supra* note 370, at 4821.

- a written communication is released in the United States as well as outside the United States, so long as the communication is released in the U.S. contemporaneously with or after the release outside the U.S. and is not otherwise targeted at persons in the U.S.;

- foreign journalists, U.S. journalists or other third parties have access to the information;

- the information appears on one or more websites maintained by the [foreign private issuer], so long as the websites, taken together, are not available exclusively to, or targeted at, persons located in the United States; or

- following the disclosure or release of information outside of the United States, the information is included in a submission to the [SEC] in a Form 6-K.[623]

There is no such exemption from Regulation G for disclosure of non-GAAP financial measures in Form 20-F. However, an otherwise impermissible non-GAAP financial measure will be allowed if it is affirmatively permitted (and not just not disallowed) by the standard-setter for GAAP used in the foreign private issuer's primary financial statements and it is included in the foreign private issuer's annual report of financial statements used in its home country jurisdiction.[624] Certain Canadian issuers who file annual reports with the SEC on Form 40-F under the Multi-Jurisdictional Disclosure System (the *"MJDS"*) are not subject to reconciliation of non-GAAP measures used in Form 40-F because the Canadian disclosure form dictates what must be disclosed in filings made with the SEC under the MJDS. However, those Canadian issuers are subject to Regulation G with respect to any public disclosures made in the U.S. that contain non-GAAP financial measures.[625]

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623 *Id*.

624 Frequently Asked Questions Regarding the Use of Non-GAAP Financial Measures (June 13, 2003), *available at* http://www.sec.gov/divisions/corpfin/faqs/nongaapfaq.htm. The staff discussed the note to Item 10(e) of Regulation S-K that permits a foreign private issuer to include in its filings a non-GAAP financial measure that otherwise would be prohibited if, among other things, the non-GAAP financial measure is required or expressly permitted by the standard setter that is responsible for establishing the GAAP used in the company's primary financial statements included in its filing with the SEC. In response to the question of what "expressly permitted" means, the staff advised that a measure would be considered "expressly permitted" if the particular measure "is clearly and specifically identified as an acceptable measure by the standard setter that is responsible for establishing the GAAP used in the company's primary financial statements included in its filing with the Commission." For example, some non-U.S. GAAP standard setters specify a minimum level of caption detail for financial statement presentation but require or permit additional caption detail, and sometimes the standard setter does not specify the particular additional captions to be presented. The staff stated that the "additional detail of the components of the financial statements determined in conformity with the GAAP used in the primary financial statements will generally be useful to U.S. investors and the 'expressly permitted' condition is not intended to prohibit the inclusion of those captions." Likewise, some non-U.S. GAAP standard setters permit or require subtotals in financial statements that are not calculated consistently with those permitted or required by U.S. GAAP, and provided that the subtotal is clearly derived from the appropriately classified financial statement captions that precede it, the staff advised that the "expressly permitted" condition was not intended to prohibit inclusion of those subtotals.

625 N. Adele Hogan, *Non-GAAP Financial Measures & "Real-Time" Reporting: Final Rules Pursuant to Sections 401(b) & 409 of the Sarbanes-Oxley Act*, in Understanding the Securities Laws, 93 (Practicing Law Institute 2003).

Internal Controls. While SOX Section 404(a) rules require management to base its assessment of the effectiveness of internal controls on a suitable, recognized control framework established by a group or body that has followed due process procedures (including the evaluative framework set forth in the COSO Report), foreign private issuers are permitted to use the framework in effect in their home country jurisdictions for this purpose.[626] For foreign private issuers that are accelerated filers, the SOX §404 rules are effective for fiscal years ending on or after July 15, 2006; and for foreign private issuers that are not accelerated filers, the SOX §404 rules are effective for fiscal years ending on or after July 15, 2007.[627]

Prohibition on Loans to Directors and Officers. SOX §402 applies equally to foreign companies, with the same July 30, 2002, effective date, but the exception for loans by banks whose deposits are insured by the Federal Deposit Insurance Corporation ("*FDIC*") disadvantages foreign banks whose deposits generally cannot be FDIC-insured even though they might be subject to insider lending restrictions similar to those applicable to FDIC-insured institutions. Under some foreign banking regulations, bank directors and executive officers are further prohibited from borrowing money from other banks and financial institutions.[628] In addition, although not required by local regulations, some foreign banks, like some of their U.S. counterparts, have implemented policies that prohibit senior insiders from borrowing money from other banks for the purpose of enhancing oversight and surveillance of financial transactions by insiders. The combination of these prohibitions and the provisions of SOX Section 402 would effectively foreclose a director or executive officer of a foreign bank whose securities are registered with the SEC from borrowing money.[629] To level the playing field, the SEC has adopted 1934 Act Rule 13k-1 that exempts from the SOX Section 402 insider lending prohibition an issuer that is a foreign bank[630] or the parent company of a foreign bank with respect to loans by the foreign bank to its insiders or the insiders of its parent company as long as:

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626 Securities Act Release No. 8238, *supra* note 176, at 36,642.

627 Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports of Non-Accelerated Filers and Foreign Private Issuers, SEC Release 33-8618, 34-52492 (Sept. 22, 2005), which can be found at http://sec.gov/rules/final/33-8618.pdf. *See* Note 469 and related text.

628 Foreign Bank Exemption From the Insider Lending Prohibition of Exchange Act Section 13(k), Exchange Act Release No. 48,481, 68 Fed. Reg. 54,590, 54,591 (Sept. 17, 2003), *available at* http://www.sec.gov/rules/proposed/34-48481.htm.

629 *Id*.

630 *See* SOX § 401. Rule 13k-1 employs a definition of "foreign bank" that is similar to the definition under Regulation K of the Federal Reserve Board. Under the Rule 13k-1 definition, a foreign bank is an institution that is:

(1) incorporated or organized under the laws of a country other than the United States or a political subdivision of a country other than the United States;

(2) regulated as a bank by that country's or subdivision's government; and

(3) engaged directly in the business of banking.

This definition also includes a provision explaining that, in order to be an institution engaged directly in the business of banking, a foreign entity must engage directly in banking activities that are usual for the business of banking in its home jurisdiction.

(1) either:

(i) the laws or regulations of the foreign bank's home jurisdiction require the bank to insure its deposits or be subject to a deposit guarantee or protection scheme; or

(ii) the Board of Governors of the U.S. Federal Reserve System has determined that the foreign bank or another bank organized in the foreign bank's home jurisdiction is subject to comprehensive supervision or regulation on a consolidated basis by the bank supervisor in its home jurisdiction under 12 CFR 211.24(c); and

(2) the loan by the foreign bank to any of its directors or executive officers or those of its parent or other affiliate:

(i) is on substantially the same terms as those prevailing at the time for comparable transactions by the foreign bank with other persons who are not executive officers, directors or employees of the foreign bank, its parent or other affiliate; or

(ii) is pursuant to a benefit or compensation program that is widely available to the employees of the foreign bank, its parent or other affiliate and does not give preference to any of the executive officers or directors of the foreign bank or its parent company over any other employees of the foreign bank, its parent or other affiliate over any other employees of the foreign bank, its parent or other affiliate; or

(iii) has received express approval by the bank's supervisor in the foreign bank's home jurisdiction.[631]

Accelerated §16(a) Reporting. Rule 3(a)12-3 under the 1934 Act provides that securities registered by a foreign private issuer are exempt from Section 16.[632]

Code of Ethics. A foreign private issuer is required to make disclosure regarding its Code of Ethics on Forms 20-F and 40-F filed for fiscal years ending on or after July 15, 2003.[633] Disclosure of waivers that have occurred during the past fiscal year must be made in the annual report, although the SEC encourages disclosure to be made more promptly on Form 6-K or on the company's website.[634]

Systematic Review of 1934 Act Filings. Like U.S. issuers, foreign private issuers can expect to have their annual reports reviewed by the SEC at least once every three years.[635]

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631 Foreign Bank Exemption from the Insider Lending Prohibition of Exchange Act Section 13(k), Exchange Act Release 34-49616 (Apr. 26, 2004), *available at* http://www.sec.gov/rules/final/34-49616.htm.

632 17 C.F.R. § 240.3a12-3 (2004).

633 SOX §§ 406/407 Release, *supra* note 473.

634 *Id*. at 5120-21.

635 SOX § 408, *supra* note 508.

Accelerated Disclosure in Plain English. Foreign private issuers filing annual reports on Form 20-F or 40-F are not required to make "real time" disclosure in plain English.[636] To the extent that a foreign private issuer has as class of its securities listed on a national securities exchange or NASDAQ, it may be required to make disclosures of material nonpublic information under such SRO's standards for continued listing.[637]

Accelerated Filing Deadlines. Foreign filers are not subject to the accelerated filing deadlines of 10-Ks and 10-Qs, but the SEC has indicated it is continuing to consider changes to the Form 20-F filing deadlines.[638]

Enhanced MD&A Disclosure. Foreign private issuers are subject to the same required enhanced MD&A disclosure requirements as U.S. issuers.[639] However, foreign private issuers are not required to file "quarterly" reports with the SEC. Thus, unless a foreign private issuer files a 1933 registration statement that must include interim period financial statements and related MD&A disclosure, it will not be required to update its MD&A disclosure more frequently than annually.

XIV.
EFFECT OF SOX ON PRIVATE COMPANIES AND BUSINESS COMBINATIONS

The impact of SOX is beginning to extend beyond the companies to which it is literally applicable to encompass private companies in which the owner's exit strategy may be sale to a public company or a public offering.[640] Those entities providing or arranging financing for public companies, or private companies whose exit strategy includes a public offering or being acquired by a public company, also will need to consider how the SOX requirements may affect the companies with which they deal.

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636 Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Securities Act Release No. 8400, Exchange Act Release No. 49,424, 69 Fed. Reg. 15,594 (Mar. 25, 2004), *available at* http://www.sec.gov/rules/final/33-8400.htm.

637 Selective Disclosure and Insider Trading, Securities Act Release No. 7881, Exchange Act Release No. 43,154, 65 Fed. Reg. 51,716, 51,724-25 (August 24, 2000), *available at* http://www.sec.gov/rules/final/33-7881.htm; *see also* Michael Gruson, *Global Shares of German Corporations and Their Dual Listings on the Frankfurt and New York Stock Exchanges*, 22 U. PA. J. INT'L ECON. L. 185, 189 n.7 (2001).

638 Securities Act Release No. 8128, *supra* note 511, at 58,488.

639 Securities Act Release No. 8182, *supra* note 358, at 5991.

640 American Institute of Certified Public Accountants (AICPA), *The State Cascade – An Overview of the State Issues Related to the Sarbanes-Oxley Act*, *at* http://www.aicpa.org/statelegis/index.asp (last visited Nov. 13, 2004). Legislation has been enacted or proposed in a number of states that would impose SOX like restrictions in respect of public accountants and corporate governance for private companies. At least one legislative proposal would amend the state's legal investment laws to restrict certain regulated entities from making investments in entities that are not SOX compliant. Legislation enacted by the Texas Legislature which became effective September 1, 2003 (S.B. 1059, *supra* note 530) creates a corporate integrity unit within the office of the Texas Attorney General to assist other state agencies, district attorneys, and county attorneys in the investigation of corporate fraud, and makes no distinction between public and private companies. TEX. GOV'T. CODE ANN. § 402.0231 (Vernon 1998 & Supp. 2004-05).

SOX will be applicable to the buyer if it will be a public company after the transaction, even through a class of high yield debt which may have been privately placed in an SEC Rule 144A transaction with a covenant to exchange the privately placed debt for SEC registered debt or to become and remain subject to the SEC reporting requirements.[641] Further, if the seller is a public company going private, SOX problems present while the company was public will follow the company's reputation into its private company life.

In the case of a private company being acquired, the acquiring public company will have to certify in its SEC reports as to its consolidated financial statements in its first periodic report after the combination, which will put the CEO and CFO of the buyer in the position of having to certify as to the financial statements and internal controls of the consolidated entity, including the acquired company.[642] Those certifications in turn will require the buyer to be sure of the seller's SOX conformity before the transaction is contemplated so that there will not be a post closing financial reporting surprise.

The foregoing results in increased emphasis on due diligence. This emphasis manifests itself through expanded representations and warranties in acquisition agreements and financing agreements, as well as through hiring auditors to review the work papers of the seller's auditors.[643] The target's auditors typically resist opening up their work papers, but ultimately may accede in exchange for a letter to the effect that the buyer acknowledges that the work papers are useless and will not be relying on them.[644] Sometimes the auditors ask for (but do not receive) an indemnification in exchange for access to the work papers.

Set forth below are sample representations as to financial statements, internal controls, SEC reports, CEO/CFO certifications, loans to directors and officers, and compliance with laws that have been modified to address SOX concerns and sample covenants dealing with certain SOX issues (provisions that are particularly relevant post-SOX are bold faced):[645]

> Financial Statements. The financial statements of the Company and its subsidiaries included in the Company SEC Documents (including the related notes) complied as to form, as of their respective dates of filing with the SEC, in all material respects with applicable accounting requirements and the published rules and regulations of the SEC with respect thereto (including, without limitation, Regulation S-X, **have**

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641 Gerald T. Nowak, Andrew J. Terry & William Chou, *In the Twilight Zone: The Unique Status of High Yield-Only Issuers*, 18 No. 8 INSIGHTS 10, 10 (August, 2004).

642 *See supra* Part III "CEO/CFO Certifications," in Section IV.

643 Robert J. Lowe, et al., *Employee Benefit Plans in Corporate Acquisitions, Dispositions and Mergers*, in Tax Strategies for Corporate Acquisition, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings 271, 289-90 (Practicing Law Institute ed., 2004).

644 *See* Sharon D. Stuart, *How Lawyers Use Financial Information*, in Basics of Accounting & Finance What Every Practicing Lawyers Needs to Know 711, 717 (Practicing Law Institute ed., 2004).

645 The sample provisions set forth herein to address SOX issues are derived in large part from Lee Walton and Joel Greenberg, "*The Impact of Sarbanes-Oxley on Merger and Acquisition Practices*" (February 19, 2003), which was presented at the Committee Forum of the ABA Negotiated Acquisitions Committee in Los Angeles on April 5, 2003.

been prepared in accordance with generally accepted accounting principles in the United States (*"GAAP"*) (except, in the case of unaudited statements, to the extent permitted by Regulation S-X for Quarterly Reports on Form 10-Q) applied on a consistent basis during the periods and at the dates involved (except as may be indicated in the notes thereto) **and fairly present the consolidated financial condition of the Company and its subsidiaries at the dates thereof and the consolidated results of operations and cash flows for the periods then ended** (subject, in the case of unaudited statements, to notes and normal year-end audit adjustments that were not, or with respect to any such financial statements contained in any Company SEC Documents to be filed subsequent to the date hereof are not reasonably expected to be, material in amount or effect). **Except (A) as reflected in the Company's unaudited balance sheet** at _____ or liabilities described in any notes thereto (or liabilities for which neither accrual nor footnote disclosure is required pursuant to GAAP) **or (B) for liabilities incurred in the ordinary course of business** since _____ consistent with past practice or in connection with this Agreement or the transactions contemplated hereby, **neither the Company nor any of its subsidiaries has any material liabilities or obligations of any nature. Part ____ of the Company Disclosure Statement lists, and the Company has delivered to Parent copies of the documentation creating or governing, all securitization transactions and *"off-balance sheet arrangements"* (as defined in Item 303(c) of Regulation S-K of the SEC) effected by the Company or its subsidiaries since _____. _____, which has expressed its opinion with respect to the financial statements of the Company and its subsidiaries included in Company SEC Documents (including the related notes), is and has been throughout the periods covered by such financial statements (x) a registered public accounting firm (as defined in Section 2(a)(12) of the Sarbanes-Oxley Act of 2002) [*"SOX"*], (y) "independent" with respect to the Company within the meaning of Regulation S-X and, with respect to the Company, and (z) in compliance with subsections (g) through (l) of Section 10A of the 1934 Act and the related Rules of the SEC and the Public Company Accounting Oversight Board. Part ____ of the Company Disclosure Schedule lists all non-audit services performed by _____ for the Company and its subsidiaries since _____, all of which have been duly approved as required by Section 202 of SOX.**

Internal Controls. The Company has implemented and maintains a system of internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the 1934 Act) sufficient to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP, including, without limitation, that (i) transactions are executed in accordance with management's general or specific authorizations, (ii) transactions are recorded as necessary to permit preparation of financial statements in conformity with GAAP and to maintain asset accountability, (iii) access to assets is permitted only in accordance with management's general or specific authorization,

and (iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

SEC Reports. The Company has on a timely basis filed all forms, reports and documents required to be filed by it with the SEC since _____. Part ____ of the Company Disclosure Schedule lists, and, except to the extent available in full without redaction on the SEC's web site through the Electronic Data Gathering, Analysis and Retrieval System (*"EDGAR"*) two days prior to the date of this Agreement. The Company has delivered to Parent copies in the form filed with the SEC of (i) the Company's Annual Reports on Form 10-K for each fiscal year of the Company beginning since _____, (ii) its Quarterly Reports on Form 10-Q for each of the first three fiscal quarters in each of the fiscal years of the Company referred to in clause ____ above, (iii) all proxy statements relating to the Company's meetings of stockholders (whether annual or special) held, and all information statements relating to stockholder consents since the beginning of the first fiscal year referred to in clause (i) above, **(iv) all certifications and statements required by (x) the SEC's Order dated June 27, 2002 pursuant to Section 21(a)(1) of the 1934 Act (File No. 4-460), (y) Rule 13a-14 or 15d-14 under the 1934 Act or (z) 18 U.S.C. §1350 (Section 906 of SOX) with respect to any report referred to in clause (i) or (iii) above,** (v) all other forms, reports, registration statements and other documents (other than preliminary materials if the corresponding definitive materials have been provided to Parent pursuant to this Section ____ filed by the Company with the SEC since the beginning of the first fiscal year referred to in clause (i) above (the forms, reports, registration statements and other documents referred to in clauses (i), (ii), (iii), (iv) and (v) above are, collectively, the *"Company SEC Reports"* and, to the extent available in full without redaction on the SEC's web site through EDGAR two days prior to the date of this Agreement, are, collectively, the *"Filed Company SEC Reports"*), **and (vi) all comment letters received by the Company from the Staff of the SEC since _____ and all responses to such comment letters by or on behalf of the Company**. The Company SEC Reports (x) were or will be prepared in accordance with the requirements of the 1933 Act and the 1934 Act, as the case may be, and the rules and regulations thereunder and (y) did not at the time they were filed with the SEC, or will not at the time they are filed with the SEC, contain any untrue statement of a material fact or omit to state a material fact required to be stated therein or necessary in order to make the statements made therein, in the light of the circumstances under which they were made, not misleading. No Subsidiary of the Company is or has been required to file any form, report, registration statement or other document with the SEC. **The Company maintains disclosure controls and procedures required by Rule 13a-15 or 15d-15 under the 1934 Act; such controls and procedures are effective to ensure that all material information concerning the Company and its subsidiaries is made known on a timely basis to the individuals responsible for the preparation of the Company's filings with the SEC and other public disclosure documents. Part ____ of the Company Disclosure Schedule lists, and the Company has delivered to Parent copies of, all written descriptions of, and all policies, manuals and**

other documents promulgating, such disclosure controls and procedures. To the Company's knowledge, each director and executive officer of the Company has filed with the SEC on a timely basis all statements required by Section 16(a) of the 1934 Act and the rules and regulations thereunder since _____. As used in this Section ____, the term "file" shall be broadly construed to include any manner in which a document or information is furnished, supplied otherwise made available to the SEC.

Reports and Financial Statements – Certifications. **The Chief Executive Officer and the Chief Financial Officer of the Company have signed, and the Company has furnished to the SEC, all certifications required by SOX Section 906**; such certifications contain no qualifications or exceptions to the matters certified therein and have not been modified or withdrawn; and neither the Company nor any of its officers has received notice from any Governmental Entity questioning or challenging the accuracy, completeness, form or manner of filing or submission of such certifications.

Loans to Executives and Directors. The Company has not, since July 30, 2002, extended or maintained credit, arranged for the extension of credit, or renewed an extension of credit, in the form of a **personal loan to or for any director or executive officer** (or equivalent thereof) of the Company. Part ____ of the Company **Disclosure Schedule identifies any loan or extension of credit maintained by the Company to which the second sentence of Section 13(k)(1) of the 1934 Act applies**.

Legal Proceedings and Compliance with Laws. The Company is, or will timely be in all material respects, in compliance with all current and proposed listing and corporate governance requirements of the [New York] Stock Exchange, and is in compliance in all material respects, and will continue to remain in compliance following the Effective Time, with all rules, regulations and **requirements of SOX or the SEC**.

Each of the Company, its directors and its senior financial officers has consulted with the Company's independent auditors and with the Company's outside counsel with respect to, and (to the extent applicable to the Company) is familiar in all material respects with all of the requirements of, SOX. The Company is in compliance with the provisions of SOX applicable to it as of the date hereof and has implemented such programs and has taken reasonable steps, upon the advice of the Company's independent auditors and outside counsel, respectively, to ensure the Company's future compliance (not later than the relevant statutory and regulatory deadlines therefore) with all provisions of SOX which shall become applicable to the Company after the date hereof.

Covenant Regarding Scope of Due Diligence. Between the date of this Agreement and the Closing Date, the Company shall permit Buyer's senior officers to meet with

the officers of the Company responsible for the Financial Statements, the internal controls of the Company and the disclosure controls and procedures of the Company to discuss such matters as Buyer may deem reasonably necessary or appropriate for Buyer to **satisfy its obligations under Sections 302 and 906 of SOX** and any rules and regulations relating thereto.

XV.
CONCLUSION

SOX and the SEC's rules thereunder are already having a significant impact on how issuers, both public and private, are governed and manage their disclosure processes. They are also having profound effects on the accountants, attorneys, and others who deal with issuers. SOX, as a response to the abuses which led to its enactment, will also influence courts in dealing with common law fiduciary duty claims.[646]

[646] *See* Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporation Law Impacts of the Enron Debacle*, 57 BUS. LAWYER 1371 (2002).