

# Corporate and Securities Law Developments **NEWSLETTER**

JULY 31, 2002

## THE SARBANES-OXLEY ACT OF 2002

**T**he Sarbanes-Oxley Act of 2002, which was signed by the President and became law yesterday, makes sweeping changes to the law in response to recent corporate scandals and stock market declines. This memorandum is a brief overview of the Act's principal requirements applicable to boards and management of publicly-traded corporations, including foreign issuers who have securities listed in the United States. It also notes when the various provisions become effective. The Act contains many other provisions regarding, among other things, regulation of public accounting firms and operations of the Securities & Exchange Commission, which we have not attempted to cover in detail here. This memorandum is not intended to address specific compliance or interpretation issues that will inevitably arise; nor does it constitute legal advice as to the application of the law to any specific situation.

### I. Public Disclosure

The Act mandates enhanced financial and other disclosures as outlined below.

- **Accuracy of Financial Reports:** Financial statements filed with the SEC must reflect all material correcting adjustments that have been identified by the company's accounting firm in accordance with GAAP. [*Effective immediately.*]
- **New Disclosure Rules:** The SEC is directed to issue new rules with respect to the following:
  - Disclosure of off-balance sheet transactions. [*Final rules to be issued within 180 days.*]
  - Presentation of pro forma financial information. [*Same.*]

- Inclusion in the company's annual report of a report on internal controls, attested by the company's outside audit firm. [*No deadline for rules specified.*]
- Disclosure of whether or not (and if not, why not) the company has adopted a code of ethics for senior financial officers, and reporting any changes in this code. [*Proposed rules within 90 days; final rules within 180 days.*]
- Disclosure of whether or not (and if not, why not) its audit committee has at least one member who is a "financial expert" (to be defined by the SEC). [*Same.*]
- **"Real Time" Disclosure of Material Changes:** The Act requires public companies to disclose, "in plain English," on a "rapid and current basis" any additional information concerning material changes in its financial condition or operations, which may include trend and qualitative information and graphic presentations, as the SEC may require. [*No deadline for rules specified.*]
- **CEO/CFO Certifications:** There are two sections of the Act that call for CEO/CFO certification. Under Section 302 of the Act, the SEC is required to prescribe rules under which CEOs and CFOs will be required to certify each annual and quarterly report filed with the SEC. [*Rules to be effective within 30 days.*] Specifically, the CEOs and CFOs must certify in writing that:
  - they have reviewed the report;

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- based on their knowledge, the report meets anti-fraud standards and fairly presents the financial condition and results of the company's operations;
- they are responsible for reviewing and designing internal controls to ensure that material information relating to the company is made known to them and for evaluating the effectiveness of the internal controls, and that they have evaluated the effectiveness of the internal controls within 90 days prior to the report and have presented in the report their conclusions about the effectiveness of the internal reports;
- they have disclosed to the company's auditors and audit committee all significant deficiencies in the internal controls and any fraud, whether or not material, involving employees who have a significant role in the company's internal controls; and
- they have indicated in the report any changes or other factors that could significantly affect internal controls subsequent to the date of the officers' evaluation.

Section 906 is a new criminal law that requires that both the CEO and the CFO certify that each periodic report containing financial statements filed with the SEC "fully complies" with the requirements of section 13(a) or section 15(d) of the Securities Exchange Act of 1934 and that the information contained in the periodic report fairly presents, in all material respects, the financial condition and results of the operations of the company. *[Effective immediately.]* As noted in Section V below, a CEO or CFO who knowingly or willfully certifies a noncomplying or false report can be subject to criminal fines and imprisonment. It is not clear how these two sections are to be reconciled.

- **Other Disclosures:** As discussed below, the company will also be required to disclose (a) audit committee approval of the performance of a non-audit service by the company's audit firm in its periodic reports; and (b) reports of insider transactions in company stock on the corporate website.
- **Enhanced SEC Review of Periodic Disclosures:** The SEC will now be required to review companies' disclosures "on a regular and systematic basis," at least once every three years. The Act specifies factors the SEC should consider in scheduling reviews. *[Effective immediately.]*

## II. Regulation of Trading and Other Activities by Officers and Directors

- **Reports of Changes in Beneficial Ownership:** Insiders will now be required to disclose changes in

beneficial ownership of their company's shares within *two business days* after the trade. Beginning no later than one year after enactment of the Act, these forms will have to be filed electronically. In addition to being posted on the SEC's website, these forms must be posted on the company's website by the end of the next business day after the filing. *[Effective 30 days after enactment.]*

- **Prohibition on Personal Loans to Executives:** Public companies are prohibited, subject to limited exceptions, from, directly or indirectly, extending or maintaining credit, or arranging for a personal loan to, any of their directors or executive officers. *[Effective immediately.]*
- **Bonus and Compensation Forfeiture:** CEOs and CFOs are required to reimburse the company for incentive compensation and profits from the sale of company stock received during the 12 months following the issuance or filing of a financial report that is subsequently restated "as a result of misconduct." *[Same.]*
- **Insider Trades during Pension Fund Blackout Periods:** Directors and executive officers will be prohibited from purchasing or selling equity securities of the company during certain pension fund blackout periods. *[Effective 180 days after enactment.]*
- **Improper Influence on Audits:** It will be unlawful for any director or officer to fraudulently influence, coerce, manipulate, or mislead any accountant performing an audit of the company's financial statements for the purpose of rendering such financial statements materially misleading, as prescribed in rules to be adopted by the SEC. *[Proposed rules to be issued within 90 days; final rules within 270 days.]*

## III. Audit Committees

- **Role of Audit Committees:** The Act requires that audit committees of public companies: (a) have direct responsibility for the appointment, compensation and overseeing of the auditors; (b) receive reports directly from the auditors; (c) establish procedures for the receipt, retention and treatment of complaints, including anonymous submissions from employees, related to accounting, internal accounting controls or auditing matters; and (d) have authority to hire independent counsel and other advisors to carry out its duties. *[SEC to adopt rule requiring delisting of non-compliant companies within 270 days after enactment.]*
- **Independence of Audit Committees:** The audit committee must be made up solely of independent members of the board. To be considered independent, the board members may not accept any consulting,

advisory or other compensatory fees from the company (other than directors' fees) or be affiliated persons of the company or any subsidiary thereof. [Same.]

- **Financial Experts:** As noted above, disclosure will be required about whether or not the Audit Committee has one or more "financial experts."

#### IV. Auditor Independence and Obligations

Auditing firms must comply with the following obligations in order to be able to certify a company's financial statements.

- **Prohibited Non-Audit Services:** A public accounting firm that performs an audit for a company cannot also provide certain non-audit services: (a) bookkeeping; (b) financial information systems design and implementation; (c) appraisal services, fairness opinions or contribution-in-kind reports; (d) actuarial services; (e) internal audit outsourcing services; (f) management functions or human resources; (g) broker or dealer, investment adviser or investment banking services; and (h) legal services and expert services unrelated to the audit. The new Public Company Accounting Oversight Board may designate other impermissible activities. The accounting firm may provide all other non-audit services, including tax services, so long as the audit committee of the company approves the other non-audit services as provided in the next bullet below. [SEC to issue implementing regulations within 180 days after enactment.]
- **Preapproval by the Audit Committee:** The audit committee must preapprove all audit services and permitted non-audit services, with an exception for de minimus non-audit services. The company must disclose in its periodic reports approval by the audit committee of non-audit services. [Same.]
- **Bar Against Audits by Former Employers of Key Officers:** An accounting firm cannot perform any audit service for a company if that company's CEO, CFO, controller, chief accounting officer, or any equivalent person was employed by that accounting firm and participated in the audit of the company during the year before the date of the initiation of the audit. [Same.]
- **Audit Partner Rotation:** The lead audit partner and lead review partner cannot perform audit services for one company for more than five consecutive fiscal years of that company. [Same.]
- **Audit Reports:** The accounting firm must timely report to the audit committee all critical accounting policies and practices, all alternative treatments of financial

information discussed with management, and other material written communications with management. [Same.]

#### V. New and Increased Criminal Penalties and Other Sanctions

- **New Crimes:** The Act creates new criminal offenses, including:
  - Knowing or willful certification of noncomplying or inaccurate financial statements by CEO and CFO (maximum penalties include \$1 million fine and/or 10 years imprisonment, \$5 million fine and/or 20 years, respectively);
  - Fraud "in connection with any security" of a public company (25 years imprisonment);
  - Destruction, alteration or falsification of records with intent to impede any investigation by a federal agency or in a bankruptcy case (20 years);
  - Destruction of audit records by an accountant (10 years);
  - Tampering with a record "with intent to impair the object's integrity or availability for use in an official proceeding" or obstruction of an official proceeding (20 years); and
  - Retaliation against informants who provide truthful information regarding any federal offense (10 years).
- **Increased Penalties:** The Act increases the maximum penalties for existing crimes, including:
  - Mail and wire fraud – imprisonment increased from 5 years to 20 years;
  - ERISA – imprisonment increased from one to 10 years, and fines increased from \$100,000 to \$500,000; and
  - Securities Exchange Act – imprisonment for individuals increased from 10 years to 20 years, and fines increased from \$1 million to \$5 million; fines for corporations increased from \$2.5 million to \$25 million.
- **New SEC Remedial Powers:** The Act gives the SEC new enforcement powers, including authority to:
  - Obtain any equitable relief in enforcement actions "that may be appropriate or necessary for the benefit of investors";

- Petition a federal district court to temporarily freeze any extraordinary payments to directors, officers and employees during an investigation involving a possible securities laws violation; and
- Prohibit individuals found to be unfit (rather than “substantially unfit” under prior law) or to have violated anti-fraud laws from serving as officers or directors of public companies.

- **Statute of Limitations on Private Suits:** The Act extends the statute of limitations for private rights of actions involving securities fraud actions to the earlier of two years after the discovery of facts constituting the violation or five years after such violation. Any such action filed on or after the date of enactment of the Act has the benefit of this extended statute of limitations.
- **Attorneys:** The SEC is directed to prescribe rules of professional responsibility for attorneys appearing or practicing before it. These rules are to include rules requiring attorneys to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company to the chief legal counsel or CEO. If that officer does not respond appropriately, the lawyer must report the matter to the audit committee.
- **Discharge in Bankruptcy:** The Act amends the Bankruptcy Code to provide that debts may not be discharged in a bankruptcy proceeding if they arise from violations of either the federal or state securities laws or other fraud or deceit in connection with the purchase or sale of a security.
- **Whistleblower Protection:** An employee may sue a public company for retaliating, harassing or otherwise

discriminating against such employee for lawfully providing information or assisting in an investigation relating to a violation of the securities laws or securities fraud, subject to first filing a complaint with the Department of Labor.

## VI. Other Provisions

In addition to the foregoing provisions that directly apply to public companies and their officers and directors, the Act includes other important provisions. Among other things, the Act:

- creates a Public Company Accounting Oversight Board with extensive powers to regulate the conduct of audits of public companies by accounting firms, subject to ultimate SEC oversight;
- directs the SEC to address conflicts of interests by security analysts, including barriers between research and investment banking, and disclosure by analysts of interests in securities they cover;
- provides for payment of monetary penalties obtained by the SEC in enforcement actions into a fund for payment to victims of the legal violation leading to the penalty; and
- provides for numerous studies relating to accounting issues, operations of the securities markets, results of implementation under the Act, and sentencing for criminal offenses.

As noted above, the foregoing is a brief synopsis of a complex new statute with widespread implications for public companies, as well as the accounting, investment banking and legal professions. We would welcome the opportunity to address any of these matters in more detail.

### WCP Corporate and Securities Practice Group Partners

Jorge E. Alers	Bruce E. Coolidge	C. Thomas Hicks III	Robert B. McCaw	Roland Steinmeyer
James E. Anderson	Meredith Cross	Michael R. Holter	William McLucas	Peter K. Vigeland
Philip D. Anker	Charles E. Davidow	Robert F. Hoyt	Thomas E. D. Millspaugh	Andrew N. Vollmer
Robert G. Bagnall	Stuart F. Delery	Andrew Kaizer	Duane D. Morse	Paul A. von Hehn
Brandon Becker	Mark A. Dewire	Glynn D. Key	William J. Perlstein	John B. Watkins
Joseph K. Brenner	Colleen Doherty-Minicozzi	R. Scott Kilgore	Mark Pollak	Harry J. Weiss
Russell J. Bruemmer	Stephen P. Doyle	Satish Kini	Erika L. Robinson	Andrew B. Weissman
J. Beckwith Burr	Jennifer M. Drogula	Michael R. Klein	Frank E. Roitzsch	Thomas W. White
Mark D. Cahn	Van W. Ellis	Alexander Kollmorgen	John W. Ryan	William A. Wilson III
Richard W. Cass	Paul Engelmayer	Yoon-Young Lee	Kurt L. Schmoke	Soo J. Yim
Georg Graf Zu Castell-Castell	Gregory J. Ewald	Lewis Liman	Klaus Schubert	
Gregorio B. Catter	Simon Firth	Martin E. Lybecker	Mark S. Shelton	
Louis R. Cohen	Andrew N. Goldman	Eric R. Markus	Marianne K. Smythe	

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2445 M Street, N.W.	399 Park Avenue	100 Light Street	1600 Tysons Boulevard	4 Carlton Gardens	Rue de la Loi 15 Weststraat	Friedrichstrasse 95
Washington, D.C. 20037-1420	New York, NY 10022	Baltimore, MD 21202	Tysons Corner, VA 22102-4826	London SW1Y5AA	B-1040 Brussels	D-10117 Berlin
Telephone: (202) 663-6000	Telephone: (212) 230-8800	Telephone: (410) 986-2800	Telephone: (703) 251-9700	Telephone: 011 (44207) 872-1000	Telephone: 011 (322) 285-4900	Telephone: 011 (49-30) 2022-6400