



ALERT!

**IMPACT OF THE SARBANES-OXLEY ACT OF 2002
ON PUBLIC COMPANIES**

On July 30, 2002, the Sarbanes-Oxley Act of 2002 (the “Act”) became law. The Act is in response to the recent events regarding accounting issues at large public companies and the ensuing calls for action to prevent repetition of these abuses. While the Act is most notable for its creation of a regulatory body for accountants who audit public companies, it also seeks to enhance corporate governance and reporting obligations, improve the quality and transparency of financial reporting and auditing, protect the objectivity of research analysts and strengthen penalties for securities law violations. Due to the scope of the Act, we will not attempt to summarize all of its provisions, rather we will focus on the most immediate implications of the Act to public companies.

Applicability

The Act generally applies to all companies that have securities registered under Section 12 of the Securities Exchange Act of 1934 (the “Exchange Act”), or that are required to file periodic reports under Section 15(d) of the Exchange Act, or that have filed a registration statement that has not yet become effective under the Securities Act of 1933.

Effective Date

The Act is effective immediately; however, many provisions require the Securities and Exchange Commission, the stock exchanges or other regulators to adopt relevant rules implementing the Act within specified periods, ranging from 30 days to one year.

CEO and CFO Certifications

The Act contains two separate certification requirements, the first (Section 906) being effective immediately while the second (Section 302) requires action by the SEC to adopt rules. The certifications required by the Act are *in addition* to the June 27, 2002 ruling by the SEC requiring the chief executive officer and chief financial officer of approximately 950 of the largest public companies to certify the financial disclosure in their quarterly and annual reports. This certification is still required.

August 2, 2002

- One certification is Section 906 of the Act which requires chief executive officers and chief financial officers (or their equivalents) to certify, in a written statement accompanying each periodic report containing financial statements filed with the SEC, that the report fully complies with the requirements of the Exchange Act and that the information contained in the report fairly presents, in all material respects, the financial condition and results of operations of the company. Anyone making this certification knowing that the report does not comply with the Exchange Act is subject to criminal penalties of up to \$1,000,000 or 10 years in jail for certifying, or up to \$5,000,000 or 20 years in jail for willfully certifying, while knowing that the report does not comport with the requirements. This section is *effective immediately* and applies to annual reports and quarterly reports that contain financial statements. It is unclear whether the certification applies to Form 8-K filings; the SEC should be addressing this issue in the near future. Even though this requirement applies to all reports filed after June 30, 2002, the procedures to follow in making this certification have not been clarified.
- The other certification is required by Section 302 of the Act. It requires the SEC to adopt rules providing for the principal executive officer and principal financial officer of each public company to provide a certification in each annual and quarterly report submitted under the Exchange Act. Section 302 requires the officers to certify (1) that they have reviewed the report; (2) that, based on their knowledge, the report does not contain any untrue statement of material fact or omit any material fact necessary to make the statements, in light of the circumstances in which they were made, not misleading; (3) that, based on their knowledge, the financial statements and information contained in the report fairly present, in all material respects, the financial condition and results of operations of the company; and (4) a variety of matters relating to the establishment, maintenance and significant changes in the company's internal controls. The SEC had proposed a certification requirement in a June 2002 release. On August 2, 2002, the SEC issued a release indicating that it would issue and make effective final rules by **August 29, 2002** to require the certification mandated by Section 302. The SEC also indicated that it would revise the certification proposed in its June proposal to comply with the provisions of Section 302.

Prohibition on Fraudulently Influencing an Audit

The Act makes it unlawful for any officer or director of a public company, or any other person acting under the direction of an officer or director, to take any action to fraudulently influence or mislead any independent public accountant engaged in the performance of an audit of the financial statements of that public company for the purpose of rendering such financial statements materially misleading. This is *effective immediately*.

Prohibition on Personal Loans to Officers and Directors

The Act prohibits public companies from loaning money to their directors or executive officers, except for limited categories of loans issued in the ordinary course of the company's business. This prohibition is *effective immediately* and also applies to renewals and material

modifications of existing loans. Many common compensation arrangements will need to be examined in light of the Act's focus on lending arrangements. For example, it is unclear whether this provision applies to certain "cashless" exercises of options, split dollar life insurance policies and advances of travel expenses.

Forfeiture of Bonuses in Connection with Restatements Resulting from Misconduct

If a public company is required to restate its financials due to the material noncompliance of the company, as a result of misconduct, with its reporting requirements under the securities laws, the CEO and CFO must reimburse the company for (1) any bonus or other incentive-based or equity-based compensation received by them from the Company during the 12 months following the first public disclosure of the document containing the financials which were later restated; and (2) any profits realized from the sale of securities of the Company during those 12 months. This requirement is *effective immediately*.

Insider Trading During Pension Fund Blackout Periods

A company must notify its workers 30 days in advance of "blackout" periods for selling company equity securities held in their 401(k) and other similar retirement funds. Directors and executive officers are prohibited from purchasing or selling any company equity securities during any pension fund blackout if the director or officer acquired the equity security in connection with service or employment as a director or executive officer. Any profits realized from a prohibited transaction may be recovered by the company. This requirement is *effective immediately*.

Acceleration of Insider Reporting

Beginning August 29, 2002, changes in equity ownership by directors, officers and 10% stockholders must be reported on Form 4 by the end of the second business day following the day on which the stock transaction occurred. This is a substantial acceleration from existing law, which requires reports within 10 days after the close of the calendar month during which the transaction took place.

Additionally, *not later than July 30, 2003*, reports on Form 4 are to be filed electronically and, if the company maintains a corporate web site, the Form 4 information must be posted on that web site not later than the end of the business day following the date of filing. This accelerated filing will likely require that public companies adopt policies requiring directors and officers to pre-clear trades and to immediately provide transaction information to a designated official in order to meet the new filing deadlines.

Reports of Violations by Attorneys

The SEC must issue rules *within the next 6 months* requiring attorneys to report evidence of a material violation of securities law or breach of fiduciary duty to the company's chief legal counsel or chief executive officer. If the counsel or CEO does not appropriately

respond to the evidence, the attorney must report the evidence to the audit committee or another committee comprised solely of independent directors, or the board of directors.

Audit Committees

The Act provides that *within 270 days* the SEC must direct each national securities exchange or association to adopt mandatory listing requirements relating to the composition and duties of the audit committee of a public company. Accordingly, each public company should review and, if necessary, amend the charter of its audit committee to comply with the new requirements of the Act, including the following:

- The audit committee shall be directly responsible for the appointment, compensation, and oversight of the company's auditors (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.
- The public accounting firm shall report directly to the audit committee.
- Each member of the audit committee must be a member of the company's board of directors and shall otherwise be independent. To be considered independent, a member of an audit committee may not (other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee), accept any consulting, advisory or other compensatory fee from the company or be an affiliated person of the company or any of its subsidiaries.
- The audit committee shall be responsible for establishing procedures for the receipt, retention, and treatment of complaints received by the company regarding accounting, internal accounting controls, or auditing matters, and the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.
- The audit committee may hire independent counsel and other advisers to carry out its duties.
- The company must provide for appropriate funding, as determined by its audit committee, for payment of compensation to its auditor and any advisers employed by the audit committee.

Enhanced Reporting Requirements

Real Time Disclosure. The Act requires disclosure on a rapid and current basis of additional information concerning material changes in a company's financial condition or operations. The Act does not specify how such disclosure should be made or what needs to be disclosed, but leaves that to SEC rulemaking. As you are aware, the SEC recently proposed revisions to Form 8-K which would require they be filed with respect to many more events and on a much more expedited basis, and we anticipate that this requirement of the Act will be implemented as a part of that rulemaking.

Off-Balance Sheet Transactions. The SEC is to adopt rules requiring companies to disclose in their annual and quarterly financial reports all material off-balance sheet transactions, arrangements, obligations (including contingent obligations) and other relationships with

unconsolidated entities and others that may have a material current or future effect on the financial condition, changes in financial condition, results of operation, liquidity, capital expenditures, capital resources or significant components of revenues or expenses. These rules must be effective *within 180 days* of the Act.

Pro Forma Financial Information. The SEC will *within 180 days* also issue rules requiring that pro forma financial information included in reports filed with the SEC or in press releases be presented so as to not be misleading, and to reconcile the pro forma information with the financial condition and results of operations of the company under GAAP.

Code of Ethics for Senior Financial Officers. *Within 180 days* of the Act, the SEC will establish rules requiring each public company to disclose in periodic filings whether it has adopted a code of ethics for senior financial officers (and if not, why not), and to disclose promptly any change in or waiver of the code.

Audit Committee Financial Expert. *Within 180 days* of the Act, the SEC will also issue rules requiring each public company to disclose whether or not its audit committee includes at least one member who is a "financial expert", as defined by the SEC, and if not, why not.

Securities Analysts and Research Reports

The Act requires the SEC to adopt rules designed to address securities analysts' conflicts of interest. The SEC recently proposed a new Regulation AC to govern analysts' research reports and public appearances. Regulation AC would require analysts to certify the truthfulness of their views in research reports and public appearances and disclose whether they have received any compensation related to the specific recommendation provided in those reports and appearances.

Auditor Independence

A public company may not obtain the following non-audit services from its auditors: (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 expert services unrelated to the audit; and (9) any other service that the newly created Public Company Accounting Oversight Board determines, by regulation, is impermissible. However, a public company may obtain other non-audit services from its auditor, including tax services, with the pre-approval of the company's audit committee and disclosure in its SEC reports. The audit committee may delegate to one or more designated members of the audit committee, who are independent directors of the board, the authority to grant such pre-approvals.

Statute of Limitations

The Act provides a limitations period for private securities fraud claims of the earlier of two years after the discovery of the facts constituting the violation or five years after the violation. Previously there was no explicit limitations period, but the courts generally applied a period of the earlier of one year after discovery or three years after the violation.

Creation of Public Company Accounting Oversight Board

The Act creates a five-member Public Company Accounting Oversight Board (the "Board") to oversee audits of public companies. Public accounting firms must register with the Board, and the Board will establish and enforce auditing, quality control, and independence standards. The Board will be funded by fees on public companies based on their equity market capitalizations, and the Board will also use these fees to fund the Financial Accounting Standards Board, which will continue to establish generally accepted accounting principles.

The Act will certainly result in increased costs and burdens for the vast majority of public companies that have conducted their business properly and in a professional manner. Currently, the Act raises more questions than it answers, and much is yet to be done by the SEC and the securities exchanges. As the SEC (alone or in conjunction with other regulatory organizations) adopts implementing or clarifying regulations, public companies will surely need to review their policies and procedures in light of the new requirements, stricter regulations and harsher penalties imposed by the Act. We will provide additional alerts as major developments occur.

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The information in this Alert is intended for general information purposes only and should not be considered legal advice or opinion on any specific facts or circumstances. You are urged to contact a professional advisor concerning any specific question you may have relating to your own situation.

If you would like to discuss the matters presented in this Alert you may contact:



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