

August 5, 2002

**SARBANES-OXLEY ACT OF 2002 USHERS IN SWEEPING CHANGES  
FOR PUBLIC COMPANIES IN THE UNITED STATES**

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002 (the “Act”).<sup>1</sup> The Act was approved by nearly unanimous votes<sup>2</sup> in the Congress in response to recent accounting scandals and corporate governance abuses. The Act was spurred by weak stock markets, voter anger and approaching congressional elections and is the most sweeping legislation affecting public companies since the Depression-era laws that are the backbone of the U.S. securities laws. Some of the Act’s provisions are immediately effective, although most provisions require rulemaking by the Securities and Exchange Commission (the “SEC”), in some cases in areas where the SEC already has pending proposals. In addition, many of the Act’s provisions are unclear, and their meaning may ultimately need to be decided by judicial proceedings. It is therefore difficult to predict the full consequences of the Act.

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<sup>1</sup> Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

<sup>2</sup> The House of Representatives approved the bill 423-3; the Senate 99-0.

## I. SUMMARY OF PRINCIPAL PROVISIONS

The following are the principal provisions of the Act. Because the Act generally applies to all SEC-reporting companies, and thus expands in critical ways the application of the U.S. securities laws to foreign issuers, we have highlighted the implications of the Act for foreign issuers in Section II. Section III provides recommendations for all affected companies that should be considered in light of the Act. Section IV contains an analysis of the Act's principal provisions. A more complete summary of the Act's provisions, which includes the effective date and/or required regulatory action for each provision discussed, is attached as Annex A, and a list of the various studies commissioned by the Act is attached as Annex B.

- **CEO and CFO Certification Requirements.** The Act requires the SEC to adopt rules by August 29, 2002 providing for various CEO and CFO certifications on an annual and quarterly basis.<sup>3</sup> Effective immediately, the Act also imposes criminal liability, including in certain cases imprisonment for up to 20 years, for CEOs and CFOs who knowingly or willfully furnish inaccurate certifications.<sup>4</sup> These two certification requirements are phrased differently and are apparently independent, and each differs from the SEC's previous certification proposal.<sup>5</sup> The certification requirement giving rise to criminal liability applies to annual reports on Forms 10-K, 20-F and 40-F and quarterly reports on Form 10-Q, but does not appear to apply to current reports of domestic issuers on Form 8-K or to foreign issuer submissions on Form 6-K. The first of these certifications therefore must accompany Forms 10-Q due by August 14.
- **Audit Committee for Listed Companies.** The Act will effectively require all listed companies, including (unless the SEC exempts them) foreign issuers and issuers that have only listed debt securities, to have fully independent audit committees.<sup>6</sup> The SEC is required to adopt rules implementing this requirement (directly or by approval of rules proposed by the national securities exchanges and associations) by April 26, 2003.<sup>7</sup> The audit committee is required to hire and supervise the company's auditors. Issuers will be required to disclose whether

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<sup>3</sup> § 302. The SEC issued a release with respect to this certification requirement on August 2, 2002. SEC Rel. No. 34-46300 (Aug. 2, 2002).

<sup>4</sup> § 906.

<sup>5</sup> SEC Rel. No. 34-46079 (June 14, 2002).

<sup>6</sup> § 301.

<sup>7</sup> The New York Stock Exchange ("NYSE") and the Nasdaq Stock Market, Inc. ("Nasdaq") recently announced changes to their corporate governance requirements, including changes relating to director independence and audit committees. These changes, however, do not appear to alter the traditional policy of both the NYSE and the Nasdaq to allow foreign issuers to follow home country practices. The NYSE will now require foreign issuers to provide a brief, general summary of the material differences between the NYSE requirements and home country practices. Nonetheless, these announced changes require SEC approval, which could result in revisions to these changes.

their audit committee includes a “financial expert,” and if not, to explain why not.<sup>8</sup>

- **Disgorgement of CEO and CFO Compensation Following Restatement of Financial Statements.** Effective immediately, an issuer’s CEO and CFO must disgorge all bonuses and incentive-based compensation, as well as profits from sales of the issuer’s securities, if the issuer restates its financial statements due to material noncompliance with any financial reporting requirement as a result of misconduct.<sup>9</sup> This provision covers the foregoing sources of compensation earned in the 12-month period following the first public issuance or filing of the non-compliant report.
- **Prohibition on Insider Trades During Individual Account Plan Blackout Periods.** Effective January 26, 2003, the Act prohibits executive officers and directors from purchasing or selling equity securities of an issuer during certain blackout periods imposed on 50% or more of the participants in an individual account plan, such as a 401(k) plan, maintained by the issuer (or, subject to regulations, its subsidiaries), if the director or officer acquired such securities in connection with his employment with the issuer.<sup>10</sup>
- **Prohibition of Insider Loans.** Effective immediately, an issuer may not make, maintain or arrange for loans to executive officers and directors, subject to limited exceptions for currently outstanding loans, home improvement loans, margin loans by a broker-dealer to its employees, loans by a depository institution subject to insider lending restrictions, and certain other credit transactions.<sup>11</sup>
- **Real Time Disclosure Requirements.** The Act requires issuers to disclose “on a rapid and current basis” in plain English such information as the SEC may require concerning material changes in their financial condition and operations.<sup>12</sup> The Act does not establish a time frame for SEC rulemaking in this regard, and it is unclear whether the rules to be adopted would establish a continuous reporting system (such as the ones that exist in many foreign jurisdictions) or take a more measured approach by expanding the list of events that give rise to a reporting obligation under existing SEC requirements (perhaps along the lines of an

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<sup>8</sup> § 407.

<sup>9</sup> § 304.

<sup>10</sup> § 306.

<sup>11</sup> § 402.

<sup>12</sup> § 409.

outstanding SEC proposed amendment to Form 8-K). It also is unclear whether this will be applied to foreign issuers.<sup>13</sup>

- **Mandated Periodic SEC Review of Public Company Filings.** The Act establishes criteria to be used by the SEC in determining the frequency with which a listed company's filings are reviewed and requires the review of each public company's disclosures at least once every three years.<sup>14</sup>
- **Accelerated Section 16 Reporting.** The Act amends Section 16 of the Securities Exchange Act of 1934 (the "Exchange Act") effective August 29, 2002 to require, among other things, reporting insider transactions on Form 4 within two business days of the relevant transaction.<sup>15</sup> Section 16 is not applicable to most foreign issuers.
- **Newly Created Accounting Oversight Board under SEC Supervision.** The Act establishes the Public Company Accounting Oversight Board, which will be responsible for establishing auditing, quality control, attestation and ethics standards for auditors of public companies.<sup>16</sup> The board will be subject to SEC oversight.
- **Auditor Independence; Auditor Relationship with Audit Committee.** The Act prohibits auditors from providing nine types of non-audit services to their audit clients, and requires an issuer's audit committee to approve in advance any audit or permitted non-audit services provided by the issuer's auditor.<sup>17</sup> Auditors are required to report to the audit committee with respect to critical accounting policies, alternative treatments of financial information under generally accepted accounting principles ("GAAP") that have been discussed with management and any other material written communications with management.<sup>18</sup> In addition, the Act requires that filings include all material adjustments that have been identified

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<sup>13</sup> The SEC's current proposal to expand the events reportable on Form 8-K does not apply to most foreign issuers. SEC Rel. Nos. 33-8106; 34-46084 (June 17, 2002).

<sup>14</sup> § 408.

<sup>15</sup> § 403. The amendment to Section 16 partially supersedes a current SEC proposal to require domestic issuers to disclose certain management transactions on Form 8-K. SEC Rel. Nos. 33-8090; 34-45742 (Apr. 12, 2002).

<sup>16</sup> §§ 101-107.

<sup>17</sup> §§ 201-202. The Act defines audit committee to be the entire board of directors where no audit committee exists. § 2(a)(3).

<sup>18</sup> § 204.

by an accounting firm.<sup>19</sup> The Act requires audit partner rotation every five years.<sup>20</sup>

- **Enhanced Criminal and Civil Provisions.** The Act significantly strengthens existing criminal provisions. Key provisions include: (i) creation of a new crime for destruction or alteration of records in federal investigations or bankruptcy, subject to fines and imprisonment of up to 20 years;<sup>21</sup> (ii) creation of a new crime for destruction of audit records, which must be maintained for five years, subject to fines and imprisonment of up to ten years;<sup>22</sup> (iii) creation of a new securities fraud crime with respect to public companies, subject to fines and imprisonment of up to 25 years;<sup>23</sup> (iv) extension of the statute of limitations for securities fraud claims, which must be brought within two years of discovery and five years of the violation (previously, those periods were one and three years);<sup>24</sup> and (v) increases in the term of imprisonment for mail and wire fraud from five years to 20 years.<sup>25</sup> The effect of these provisions is that the U.S. Sentencing Commission will revise its guidelines range of incarceration periods for these crimes, resulting in stiffer sentences for defendants convicted of these crimes.

## II. APPLICABILITY TO NON-U.S. ISSUERS

With a few exceptions,<sup>26</sup> the Act applies to all “issuers,” which is defined in the Act as an issuer:

- with securities registered under Section 12 of the Exchange Act,
- that is required to file reports under Section 15(d) of the Exchange Act, or
- that has filed a registration statement under the Securities Act of 1933 (the “Securities Act”) that has not yet become effective and that it has not withdrawn.<sup>27</sup>

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<sup>19</sup> § 401.

<sup>20</sup> § 203.

<sup>21</sup> § 802.

<sup>22</sup> § 802.

<sup>23</sup> § 807.

<sup>24</sup> § 804.

<sup>25</sup> § 903.

<sup>26</sup> The most notable exception is that the rules to be issued with respect to audit committees under Section 301 of the Act will apply only to listed companies, as discussed in Section IV.A.2 below. The Act also grants the SEC specific exemptive power, and does not derogate from the SEC’s general exemptive authority under Section 36 of the Exchange Act.

This includes all SEC-reporting companies, domestic or foreign.<sup>28</sup> It does not include a foreign issuer exempt from the reporting requirements of the Exchange Act pursuant to Rule 12g3-2(b).

The coverage of foreign issuers is surprising in light of policies of the SEC, the NYSE and the Nasdaq to accommodate home country practices of foreign issuers.<sup>29</sup> The extent of the Act's applicability to foreign issuers ultimately will depend on whether the rules adopted by the SEC preserve the differential treatment historically accorded to foreign issuers.<sup>30</sup> The Act contemplates general and specific rulemaking by the SEC and grants the SEC specific exemptive power in certain cases, which will enable the SEC to shape the scope of the Act. Under the Administrative Procedure Act,<sup>31</sup> the SEC's rulemaking is subject to a notice and comment period. It will be extremely important for non-U.S. issuers to monitor the rulemaking process and submit comments on the rulemaking proposals either directly or through their U.S. counsel to ensure that appropriate accommodations for foreign issuers are taken into account.

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<sup>27</sup> This last provision makes the Act applicable to an issuer once it has filed its first registration statement with the SEC under the Securities Act. An issuer that cancels a proposed initial public offering would be required to withdraw its registration statement to remove itself from application of the requirements of the Act. The Act highlights the importance of the SEC's policy of reviewing the initial registration statement of a foreign issuer on a confidential basis, rather than requiring that it be publicly filed as would be required for domestic issuers. As a result of this policy, a foreign issuer making its initial U.S. public offering would not be subject to the Act until after the SEC had reviewed and commented on its registration statement and the foreign issuer had made its first public filing of the registration statement.

<sup>28</sup> The definition includes foreign issuers organized in Canada, including those eligible to effect filings pursuant to the U.S.-Canadian multijurisdictional disclosure system. The definition of issuer would also appear inadvertently to include sovereign issuers with reporting obligations under Section 12(b) of the Exchange Act with respect to listed debt securities, although it is not clear how a majority of the Act's provisions could be applied to sovereigns.

<sup>29</sup> The SEC traditionally has recognized a number of accommodations for foreign issuers to avoid imposing undue burdens that might discourage them from accessing the U.S. capital markets. For example, foreign issuers generally are exempt from the proxy rules under Section 14 of the Exchange Act and from the reporting and short swing profit provisions of Section 16 of the Exchange Act. Foreign issuers also generally are not required to file quarterly reports on Form 10-Q or current reports on Form 8-K. Both the NYSE and the Nasdaq have exempted foreign issuers from certain listing requirements in recognition of inconsistencies between home country practices and the standards applicable to U.S. companies.

<sup>30</sup> The following comment by Senator Enzi during the Senate conference debate to approve the final version of the Act suggests that the Act was not intended to apply equally to U.S. and non-U.S. issuers:

In addition, I believe we need to be clear with respect to the area of foreign issuers and their coverage under the bill's broad definitions. While foreign issuers can be listed and traded in the U.S. if they agree to conform to GAAP and [NYSE] rules, the SEC historically has permitted the home country of the issuer to implement corporate governance standards. Foreign issuers are not part of the current problems being seen in the U.S. capital markets, and I do not believe it was the intent of the conferees to export U.S. standards, disregarding the sovereignty of other countries as well as their regulators.

148 Cong. Rec. S7350-7365 (daily ed. July 25, 2002) (Statement of Sen. Enzi).

<sup>31</sup> 5 U.S.C.A. § 553 (2002).

### III. RECOMMENDATIONS

The Act includes various far-reaching provisions that will have a significant impact on the corporate governance and management of all SEC-reporting companies, both domestic and foreign. The final impact of many of the Act's provisions, however, will not be known for several months, when the SEC will have adopted rules under the Act. Nevertheless, there are a number of steps that domestic and foreign issuers should take to comply with those provisions of the Act that take effect immediately and to prepare themselves for those provisions that are to be implemented through SEC rulemaking.

- **Monitor and Participate in Rule Adoption Process.** Issuers should monitor the SEC's rulemaking process carefully so that they can assess the potential impact of new rules and be in a position to comment, either directly or through counsel. This is particularly important for foreign issuers, since the applicability of many of the Act's provisions to foreign issuers will depend on decisions made by the SEC during the rulemaking process.
- **Establish Procedures that Permit the CEO and CFO to Provide Required Certifications.** Issuers should evaluate the steps involved in the preparation of their annual and, for domestic issuers, quarterly SEC reports and their internal controls to determine if they are sufficient to allow their CEO and CFO to provide the required certifications. A core element of these procedures is the internal audit and control function, but the procedures should address matters considerably beyond this function.<sup>32</sup> The new certification requirement under Section 906 (which is effective immediately) may result in significant criminal penalties.
- **Prepare for New Audit Committee Requirements.** Issuers should make an inventory of existing procedures, including a review of their audit committee charter and bylaw provisions pertaining to the composition and duties of their audit committees, to determine the changes that are likely to be required to comply with the Act. Among other things, issuers should consider whether their existing audit committee members are likely to be considered independent under the Act and whether any member of their audit committee would likely qualify as a financial expert under the Act. Issuers should also begin to plan the specific tasks to be assigned to their audit committees in light of the requirement in the Act that the committee hire and oversee their external auditors. Foreign issuers listed on a U.S. exchange or Nasdaq that do not have audit committees should prepare to establish them, in the event the SEC declines to exclude foreign issuers in implementing Section 301 of the Act.
- **Discuss the Act's Requirements with External Auditors.** Issuers should meet with their auditors to discuss the requirements of the Act that affect them and

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<sup>32</sup> For a discussion of suggested procedures to be implemented, please refer to our memorandum to clients of July 15, 2002 entitled "Concrete Steps Every CEO and CFO Should Consider in Responding to the SEC's Order Regarding Sworn Statements."

address issues raised by the Act. For example, issuers should review the non-audit services historically provided by their auditors to determine which, if any, should continue to be provided by the audit firm and which should be contracted out to other parties. Issuers should consider asking their external auditors to describe the changes they anticipate implementing in response to the Act (for instance, audit partner rotation). Issuers and auditors should also formalize arrangements for typical, additional audit services, such as the furnishing of comfort letters, because of the Act's requirement for prior audit committee approval of those services, as well as existing communication channels with auditors in light of the new record keeping requirements in the Act and the Act's requirement that auditors report to the audit committee on various matters.

- **Evaluate Compensation Arrangements to Ensure Compliance with the Act's Prohibitions on Loans to Executive Officers and Directors.** Because the Act's prohibition on loans to executive officers and directors is already effective, issuers should carefully review their compensation arrangements to verify compliance with the Act's broad prohibitions on loans to, and the arranging of financing for the benefit of, executive officers and directors. Certain cashless exercise stock option plans could, for example, run afoul of the Act's restrictions on the extension of credit.
- **Review Restrictions on Insider Transactions.** Issuers should review their policies covering stock sales by insiders and be prepared to make the necessary modifications to comply with the Act's prohibition on insider transactions during blackout periods under 401(k) and other individual account plans, which takes effect January 26, 2003. Foreign issuers should be mindful that this restriction could apply to them if they or any of their subsidiaries have plans covered by the Act.
- **IPO Participants Should Implement Many of the Act's Corporate Governance Provisions Prior to First IPO Filing.** Issuers contemplating an initial public offering and their financial and legal advisors should revise their pre-IPO procedures to take account of corporate governance changes required to be implemented prior to an issuer's initial filing of its IPO registration statement with the SEC. Because the Act becomes applicable to an issuer upon that initial filing, issuers should have a properly functioning audit committee in place at that time. Private companies that extend credit or arrange financing for a director or executive officer after July 30, 2002 must ensure that the financing is repaid prior to that filing.
- **Review Document Retention Policies.** In view of the new criminal provisions concerning document destruction, and particularly new Section 1519's reference to merely contemplated proceedings, issuers should review their existing document retention policies and programs to determine if they will assure compliance with the new provisions.
- **Anticipate Heightened SEC Review.** Issuers should expect that their registration statements and Exchange Act reports will be reviewed more

frequently by the SEC. As a result of the SEC's expanded budget, issuers should anticipate that they will receive greater scrutiny in these reviews than they may have experienced in the past.

#### IV. ANALYSIS OF PRINCIPAL PROVISIONS

##### A. Corporate Governance and Management

**1. CEO and CFO Certification Requirements.** Section 302 of the Act mandates that the SEC issue rules requiring CEOs and CFOs to make detailed representations in each annual and quarterly report.<sup>33</sup> A CEO and CFO must certify that:

- he or she has reviewed the relevant report,
- to his or her knowledge, the report contains no material misstatements or omissions,
- to his or her knowledge, “the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer” as of the date of, and for the periods presented in, the report, and
- the signing officers are responsible for internal controls, have properly designed and evaluated (within the 90 days prior to the report) the controls and have had discussions with the issuer's auditors and audit committee concerning significant control deficiencies and any fraud (regardless of materiality) by persons having a significant role in the internal controls.<sup>34</sup>

These certifications are noteworthy in that they are broader than those required under the SEC's recent order requiring the CEOs and CFOs of nearly 950 U.S. domestic companies to submit one-time sworn certifications by August 14, 2002, as well as those initially proposed in the SEC's pending proposal for ongoing CEO and CFO certifications.<sup>35</sup>

The Act requires the SEC to adopt rules implementing these certification provisions by August 29, 2002. The SEC issued a release on August 2, 2002 discussing the final

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<sup>33</sup> A prior version of the Act would also have required certification by the chairman of the board.

<sup>34</sup> The Act also requires disclosure in the issuer's annual Exchange Act report about the effectiveness of the internal controls, significant changes in controls, factors that could significantly affect the controls in the future and any corrective action taken. See § 404 of the Act, which is discussed in Section IV.B.1 below.

<sup>35</sup> SEC Rel. No. 34-46079 (June 14, 2002); SEC Order Requiring the Filing of Sworn Statements Pursuant to 21(a)(1) of the Exchange Act, File No. 4-460 (June 27, 2002). For a discussion of the liability and other implications of these types of certifications, please refer to our memorandum to clients of July 9, 2002 entitled “SEC Orders Senior Corporate Officers to Vouch Personally for Exchange Act Reports and Proposes New Certification Rules.” Section 302(b) of the Act states that a reincorporation of an issuer domiciled inside the United States to a foreign jurisdiction shall not lessen the force of the certification. This provision would appear to be a congressional response to the fact that the SEC's certification order excluded issuers domiciled abroad. There is nothing in the Act itself, however, that would result in preferential treatment for such issuers.

rules to be issued pursuant to Section 302.<sup>36</sup> The release confirms that the Section 302 certifications will apply to annual reports on Form 10-K and quarterly reports on Form 10-Q filed by domestic issuers, as well as to annual reports on Forms 20-F and 40-F filed by foreign issuers. The release also states that the SEC does not intend to modify its proposed requirement that issuers maintain sufficient procedures to provide reasonable assurance that they are able to collect, process, and disclose in a timely manner the information required to be disclosed in their periodic and, in the case of domestic issuers, current reports.<sup>37</sup>

In addition to the certification required pursuant to Section 302, Section 906 of the Act, which is effective immediately, separately requires CEOs and CFOs to include in each “periodic report containing financial statements filed by an issuer with the [SEC]” a certification that:

the periodic report containing the financial statements fully complies with the requirements of section 13(a) or 15(d) of the [Exchange Act] and that information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer.

Section 906 imposes criminal liability for inaccurate certifications knowingly or willfully furnished by a CEO or CFO.<sup>38</sup> Although Section 906 purports to be effective as of July 30, 2002, giving immediate effect to the provision would appear to conflict with the requirement for rulemaking by the SEC in connection with the certifications required by Section 302 (a point noted by Senator Enzi in the Act’s legislative history).<sup>39</sup> Although it had been hoped that guidance would emerge from Congress, the SEC or the Department of Justice, which is charged with enforcement of Section 906, to date the issue has not been addressed.<sup>40</sup>

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<sup>36</sup> SEC Rel. No. 34-46300 (Aug. 2, 2002).

<sup>37</sup> See proposed Rules 13a-15(a) and 15d-15(a). SEC Rel. No. 34-46079 (June 14, 2002)

<sup>38</sup> The new penalties enacted include up to 20 years imprisonment for anyone who “willfully” certifies such statements, or up to ten years imprisonment for anyone who otherwise certifies such statements knowing that the report does not comport with all the relevant requirements. One peculiar aspect of the statute is that the penalties apply to non-compliance with the terms of the certification, but the statute does not explicitly provide that a failure to file triggers the potential liability.

<sup>39</sup> During the floor debate in the Senate, Senator Enzi said:

I ... realize inconsistencies appear in sections 302 and 906. The SEC is required to complete rulemaking within 30 days after the date of enactment with regard to CEO certification under section 302. However, section 906 suggests that certification would be required upon enactment, thus the penalties would go into effect before the certification requirement is completed through the rulemaking process. I believe it was the intent of the Conferees that the penalties under section 906 should not become effective until the rulemaking process is finalized.

148 Cong. Rec. S7350-7365 (daily ed. July 25, 2002) (statement of Sen. Enzi).

<sup>40</sup> In its August 2 release addressing Section 302, the SEC did not address Section 906, except to note that by its terms it is effective immediately.

By its terms, Section 906 clearly applies to annual reports on Forms 10-K, 20-F and 40-F and quarterly reports on Form 10-Q, because these are the only Exchange Act reports that require the filing of financial statements on a periodic basis. Forms 8-K and 6-K are event driven and not “periodic.” In addition, the SEC rules require foreign issuers to “make” and “furnish” reports on Form 6-K rather than “file” them as is the case with Forms 10-K, 20-F, 10-Q and 8-K.<sup>41</sup> Accordingly, although there is some inconsistency in the SEC’s rules and other pronouncements in the use of the terms “periodic” and “filed,” we believe the better view is that Section 906 was not intended to apply to reports on Form 8-K or 6-K that contain financial statements filed with (in the case of Form 8-K) or submitted to (in the case of Form 6-K) the SEC.<sup>42</sup>

All SEC-reporting companies (domestic and foreign) should immediately begin developing internal procedures to allow them to comply with certification requirements in their next covered filing. Domestic issuers required to file their Forms 10-Q by August 14, 2002 should consider postponing the filing of their Forms 10-Q until the latest possible date to allow for the possibility of further guidance from the SEC or the Department of Justice regarding Section 906.

A form of certification satisfying Section 906 to accompany the Form 10-Q due by August 14, 2002 is attached as Annex C. The recommended form of certification includes a bracketed qualification relating to the “knowledge” of the certifying officer. While this language is not in the text of the Act, we believe it is appropriate in light of similar qualifications included in the certification under Section 302 of the Act and under the SEC’s order and proposed rules requiring certifications. Knowledge also is a predicate requirement for the criminal penalties under Section 906 itself.<sup>43</sup>

We also advise issuers to furnish Section 906 certifications electronically to the SEC via EDGAR as “correspondence” and not as an exhibit to the Form 10-Q. If an issuer wishes to publicize the certification, it may post the certification or a note to the effect that the certification has been made, together with the quarterly report, on its website or file the

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<sup>41</sup> The rules applicable to Form 10-K, 10-Q and 8-K all refer to “filing”: (a) Rule 13a-1 requires each issuer with securities registered pursuant to Section 12 of the Exchange Act to “file” an annual report on the appropriate form, (b) Rule 13a-13 requires a domestic issuer to “file” a quarterly report on Form 10-Q, and (c) Rule 13a-11 requires a domestic issuer to “file” a current report on Form 8-K. By contrast, Rule 13a-16 requires a foreign private issuer to “make” reports on Form 6-K, which reports are “transmitted” to the SEC. In addition, unlike Forms 10-K, 10-Q and 8-K, which all state they are to be “filed,” Form 6-K provides it is to be “furnish[ed].”

<sup>42</sup> Neither the Exchange Act nor the rules thereunder define “periodic report” and the use of the term in SEC pronouncements (*e.g.*, in rule proposals, administrative proceedings and no-action letters) is not consistent as to the characterization of Form 8-K. In addition, Rule 13a-16(a)(3) under the Exchange Act refers to “periodic reports on Forms 10-K, 10-KSB, 10Q, 10-QSB and 8-K.” Moreover, the application of the Section 906 certifications to “periodic” reports (in contrast to Section 302, which refers to “annual and quarterly” reports) could be inferred to extend the Section 906 certifications to current reports on Form 8-K.

The SEC’s rules under the Exchange Act also are not consistent in their use of the term “file” in relation to Form 6-K. Rule 13a-3 uses “file” in addressing Forms 40-F and 6-K jointly.

<sup>43</sup> For issuers that prefer an unqualified certification as a matter of investor relations, we would be pleased to discuss the consequences of a certification in that form.

certification (or the note) under Item 9 of Form 8-K. Initially, practice is likely to be varied as certifications begin to be made. We suggest that issuers follow this approach until either a common practice emerges or the SEC directly addresses the issue.

**2. Audit Committees for Listed Companies.** The Act amends Section 10A of the Exchange Act by requiring the SEC to adopt rules (directly or through the NYSE and Nasdaq) by April 26, 2003 prohibiting the listing of any security of an issuer not in compliance with the audit committee provisions of the Act. Under the Act, each member of the audit committee must be a member of the board of directors and otherwise be “independent.” An independent director may not, (i) accept any consulting, advisory or other compensatory fee from the issuer other than as a member of the audit committee or the board of directors and (ii) be an “affiliated person” of the issuer or any subsidiary thereof.<sup>44</sup> The audit committee must have the authority to engage independent advisors.

Audit committees must be directly responsible for:

- The appointment, compensation and oversight of the issuer’s accounting firm, which is required to report directly to the audit committee; and
- The establishment of procedures for the (i) receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters and (ii) confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.

As noted above, the term “audit committee” is defined as the board of directors of the issuer if no audit committee exists. Although the Act does not expressly mandate the establishment of an audit committee, as a practical matter it would be virtually impossible for the full board of most companies to satisfy the independence requirement.

Of particular interest is whether foreign issuers will be exempted from any of the audit committee requirements in the SEC’s rulemaking. Historically, the SEC has delegated the adopting of corporate governance standards to the national securities exchanges and national securities associations, which have exempted foreign issuers from many of their corporate governance requirements, including those relating to audit committees.<sup>45</sup> Foreign issuers in

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<sup>44</sup> Section 301 does not contain a definition of “affiliated person.” Under Exchange Act Section 3(a)(19), “affiliated person” is used in the Exchange Act as defined in the Investment Company Act of 1940. Section 2(a)(3) of the Investment Company Act of 1940 contains the following definition of “affiliated person”:

“Affiliated person” of another person means (A) any person directly or indirectly owning, controlling, or holding with power to vote, five per centum or more of the outstanding voting securities of such other person; (B) any person five per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

<sup>45</sup> The NYSE, in its final rule proposals adopted by its Board of Directors on August 1, 2002, does not extend the new governance requirements to foreign issuers, but rather requires them to disclose the differences between their

many countries (*e.g.*, Germany) have dual systems and may find it difficult to satisfy the independence requirement or may find the governance regime imposed by the Act (*e.g.*, granting of authority to supervise the auditors to a committee of the board of directors) inconsistent with local law or practice.

On its face, the provision also applies to issuers, such as wholly-owned subsidiary finance companies and sovereigns, with only listed debt securities. The provision thus (presumably inadvertently) ignores the traditional corporate governance distinctions that are normally drawn between companies with listed debt securities and companies with listed equity securities.<sup>46</sup> As already noted, it also clearly is inapposite to sovereign issuers. We assume the SEC will address the literal overbreadth of Section 301 in its implementing rules.

**3. Auditor Reports to Audit Committees.** An issuer's accounting firm must report to the audit committee in a timely manner: (i) all critical accounting policies and practices to be used, (ii) all alternative treatments of financial information within GAAP that have been discussed with the issuer, and (iii) other material written communications between the accounting firm and the management of the issuer.<sup>47</sup> The SEC is required to promulgate rules to implement these requirements by January 26, 2003.<sup>48</sup>

**4. Prohibition on Personal Loans to Executive Officers and Directors.** The Act prohibits an issuer and its subsidiaries from directly or indirectly extending, maintaining, renewing or arranging for an extension of credit in the form of a personal loan to or for any executive officer<sup>49</sup> or director of the issuer.<sup>50</sup> This prohibition became effective July 30, 2002, but grandfathers loans outstanding on that date so long as no material modification to any term or renewal of those loans occurs.<sup>51</sup> Among the practices that may be prohibited are loans

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governance practices and those applicable to domestic issuers. The NYSE has indicated that this disclosure is intended to be a brief, general summary of material differences. These proposals require SEC approval, which could result in revisions to the proposals.

<sup>46</sup> The NYSE, for example, limits its corporate governance requirements to companies listing common stock. NYSE Listed Company Manual Rule 303.00.

<sup>47</sup> § 204.

<sup>48</sup> § 208. There is some ambiguity as to the date of effectiveness of this provision, as discussed in Section IV.D below.

<sup>49</sup> Executive officer is used as defined in Rule 3b-7 under the Exchange Act and includes the president, any vice president in charge of a principal business unit, division or function and "any other officer who performs a policy making function, or any other person who performs similar policy making functions for the [issuer]."

<sup>50</sup> § 402.

<sup>51</sup> The provision applies to any "issuer" within the meaning of the Act, which as noted above generally includes companies subject to the reporting requirements of the Exchange Act, but also includes any company that has filed a registration statement under the Securities Act, even prior to that registration statement becoming effective. Although Section 402 grandfathers outstanding loans, it does not provide a similar exception for loans made after that date but before a company seeks to go public by filing a registration statement under the Securities Act.

pursuant to split-dollar life insurance arrangements, after-tax leveraged co-investment programs, and certain cashless exercises of options.

The Act provides limited exceptions for extensions of credit for home improvement, manufactured housing, consumer credit, open end credit, charge cards and margin loans by a broker or dealer to an employee of that broker or dealer (other than to acquire stock of the broker or dealer).<sup>52</sup> Extensions of credit pursuant to any of these exceptions must be (i) provided in the ordinary course of a “consumer credit” business, (ii) of a type generally made available by such issuer to the public, and (iii) made on market terms that are no more favorable than those offered by the issuer to the general public. There is no materiality exception in the Act. These exceptions may not be available to most issuers, because, among other reasons, most issuers that are not financial institutions cannot meet the ordinary course requirement. The Act also exempts loans made by U.S. Federal Deposit Insurance Corporation (“FDIC”) insured banks subject to certain existing U.S. insider lending restrictions.<sup>53</sup> This exemption does not extend to loans made by foreign banks, which are not permitted to be FDIC insured.

**5. Disgorgement of Incentive Compensation Received and Profits Realized by CEOs and CFOs Following Restatements.** The Act requires the CEO and CFO of an issuer (presumably the CEO and CFO at the time of the noncompliance) to reimburse it for all bonuses and other incentive-based or equity-based compensation received, as well as all profits realized from sales of issuer securities, in the 12-month period following the first public issuance or filing of reported financial statements that are later restated due to material noncompliance with any financial reporting requirement as a result of misconduct.<sup>54</sup> This provision of the Act became effective July 30, 2002, although it is unclear whether it applies to noncompliance on or after July 30, 2002, or to any restatement on or after July 30, 2002, regardless of when the noncompliance occurred.

The term “misconduct” is not defined in the Act, and reimbursement is not limited to situations in which the CEO or the CFO engaged in the misconduct. The phrase “profits realized” is also not defined, so it is unclear how the cost basis of securities sold during the 12-month period will be determined (*e.g.*, using some artificial matching concept similar to Section 16(b) of the Exchange Act or otherwise).<sup>55</sup> Similarly, the reference to compensation “received” during the 12-month period leaves unanswered questions regarding whether it is the grant of the compensation, its vesting or its payment that will control.

The Act also does not specify the means of enforcement for the provision. The provision provides that the CEO and CFO “shall reimburse” the issuer, suggesting that the issuer itself is entitled to sue for reimbursement. It would appear that shareholders would not be

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<sup>52</sup> Read literally, the exception does not apply to margin loans to employees of the parent of the broker or dealer.

<sup>53</sup> § 5 of the Home Owners’ Loan Act, 12 U.S.C.A. § 1464 (2002).

<sup>54</sup> § 304.

<sup>55</sup> Section 16(b) refers to “profit realized by him from any purchase and sale, or any sale and purchase . . . .” Under the short swing profit rules of Section 16(b), multiple purchases and sales may be matched to create “profit” even where no net economic gain is realized.

entitled to sue the CEO and CFO directly to enforce this obligation, although they may be able to assert a derivative claim on behalf of the issuer, subject to the various restrictions on such claims provided by applicable state law.

#### **6. Prohibition of Insider Trades During Certain Plan Blackout Periods.**

Effective January 26, 2003, the Act makes it unlawful for any director or executive officer of an issuer of any equity security to purchase,<sup>56</sup> sell or otherwise acquire or transfer any equity security of the issuer during any blackout period with respect to that security if the director or executive officer acquired the equity security in connection with service to or employment by the issuer.<sup>57</sup>

A person's profits realized in violation of this provision, regardless of his or her intent, are subject to disgorgement to the issuer. The Act, however, once again provides no guidance as to how to calculate these profits. Under the Act, the issuer will have independent standing to bring a claim for disgorgement, but if the issuer fails to make a claim within 60 days of a request by a shareholder to do so, or fails to prosecute that claim diligently, the shareholder may bring a derivative claim, in either case no later than two years after the date such profits were realized.

The prohibition precludes transactions by executive officers or directors during blackout periods resulting from events such as a change in record keeper, but does not do so in cases of events such as regularly scheduled periods during which employees are prohibited from trading in order to avoid the appearance of trading on the basis of material, non-public information. The SEC has rulemaking authority to clarify that purchases made pursuant to automatic dividend reinvestment programs, as well as purchases or sales made pursuant to an advance election (such as, for example, elections under many broad-based employee stock purchase plans), will not violate the prohibition. The SEC also has rulemaking authority to clarify the application of the prohibition and to prevent its evasion, including authority to treat entities that are 80% or more affiliates as being a single entity for purposes of the provision.

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<sup>56</sup> A blackout period means, with certain exceptions, a period longer than three consecutive business days during which 50% or more of the participants or beneficiaries under all individual account plans (such as 401(k) plans) maintained by the issuer are temporarily unable to purchase, sell or otherwise transfer their interests in the issuer's equity securities as a result of a suspension of such activities by the issuer or a plan fiduciary. Blackout periods do not include, to the extent provided in rules to be promulgated by the SEC, (i) a regularly scheduled period during which participants and beneficiaries may not transfer interests in equity securities of the issuer if such periods are incorporated into the plan and are timely disclosed to employees before they become participants or as a subsequent amendment to the plan, and (ii) any suspension imposed solely in connection with persons becoming or ceasing to be participants or beneficiaries by reason of a corporate event (*e.g.*, mergers, acquisitions and similar transactions). Blackout periods have been imposed most commonly in connection with a change in 401(k) plan administrators.

<sup>57</sup> § 306. The issuer must timely notify affected directors and executive officers and the SEC of the above-described blackout periods. In addition, under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), the plan administrator generally must notify participants and beneficiaries of "any period for which any ability of participants or beneficiaries under the plan, which is otherwise available under the terms of such plan, to direct or diversify assets credited to their account, to obtain loans from the plan, or to obtain distributions from the plan is temporarily suspended, limited, or restricted, if such suspension, limitation or restriction is for any period of more than three consecutive business days."

**7. Improper Influence on Audits.** The Act delegates to the SEC rulemaking to prohibit directors and officers of an issuer, and any person acting at their direction, from taking action to fraudulently influence, coerce, manipulate or mislead any public accountant in an audit for the purpose of rendering the issuer's financial statements materially misleading.<sup>58</sup> Violations will be exclusively enforceable by the SEC. The SEC is required to propose rules by October 28, 2002 and issue final rules by April 26, 2003.

**8. Modifications to Section 16 Disclosure Requirements for Officers, Directors and 10% Shareholders.** Effective August 29, 2002, the Act modifies disclosure requirements for officers, directors and 10% shareholders who are subject to reporting under Section 16(a) of the Exchange Act.<sup>59</sup> These persons and shareholders will be required to report changes in ownership of the issuer's equity securities within two business days of the transaction, or such other time as the SEC shall determine to be feasible in rules that it may promulgate.<sup>60</sup> They will also be required to report transactions under security-based swap agreements involving such equity securities. These transactions were previously required to be reported, at the earliest, on Form 4 within ten days after the end of the month in which the change in beneficial ownership occurred, and, in some cases, on Form 5 within 45 days after the end of the issuer's fiscal year in which the change in beneficial ownership occurred. It is not clear to what extent the SEC will leave in place the existing delayed reporting structure permitted for certain transactions under Form 5. However, in its April 12, 2002 proposal to expand disclosure obligations of insider transactions on Form 8-K, the SEC asked for public comment regarding whether transactions permitted to be reported on Form 5 should instead be reported on Form 4.<sup>61</sup>

These filings must contain a statement of the amount of all of the issuer's equity securities beneficially owned, as well as any changes in such ownership since the last such filing. The filing must also include transactions under security-based swap agreements that have occurred since the last such filing. Beginning not later than July 30, 2003, these filings must be made electronically, and issuers maintaining corporate websites will be required to post such filings on their websites.

The amendment does not affect most foreign issuers, which generally continue to remain exempt from Section 16.

**9. Director and Officer Bars.** The Act amends Section 21C of the Exchange Act and Section 8A of the Securities Act to authorize the SEC, in connection with a

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<sup>58</sup> § 303.

<sup>59</sup> § 403.

<sup>60</sup> In its pending proposal to require issuers to disclose transactions by directors and executive officers, the SEC had proposed a two business day deadline for filing on Form 8-K for transactions with an aggregate value of at least \$100,000. SEC Rel. Nos. 33-8090; 34-45742 (Apr. 12, 2002). Although many comments were received arguing that this standard would be difficult to meet, it remains to be seen whether the SEC will use its rulemaking flexibility under the Act to extend the period for Form 4 filings beyond two business days.

<sup>61</sup> The Act does not expand the category of events that are reportable, although the SEC has proposed to do so. SEC Rel. Nos. 33-8090; 34-45742 (Apr. 12, 2002).

cease-and-desist proceeding, to issue an order barring any person who has violated Section 10(b) of the Exchange Act or Section 17(a)(1) of the Securities Act, as applicable, from acting as a director or officer of any issuer, “if the conduct of that person demonstrates unfitness to serve as an officer or director.”<sup>62</sup> Previously, the SEC could only seek a bar in court. The Act also amends Section 21(d)(2) of the Exchange Act and Section 20(e) of the Securities Act, which provide that a U.S. federal court may bar any person who violates Section 10(b) of the Exchange Act or Section 17(a)(1) of the Securities Act, respectively, from acting as an officer or director of any issuer in a proceeding initiated by the SEC.<sup>63</sup> Previously, a court could only bar a person whose “conduct demonstrates substantial unfitness to serve as an officer or director,” and the amendment lowers the standard from “substantial unfitness” to simply “unfitness.”

**10. SEC Authority to Seek Order Freezing Certain Assets of an Issuer During an Investigation Involving Possible Federal Securities Law Violations.** The Act authorizes the SEC to petition a U.S. federal court for a temporary order requiring an issuer of publicly traded securities to escrow any “extraordinary payments (whether compensation or otherwise)” that appear likely to the SEC to be made to any director, officer, partner, controlling person, agent or employee of the issuer, during an investigation of such issuer or individual involving possible violations of the federal securities laws.<sup>64</sup> A court may issue such an order after notice and an opportunity for a hearing, unless the court determines this requirement to be impracticable or contrary to the public interest.

A court order would take effect immediately and remain in effect for 45 days, unless set aside or modified by a court. The initial order may be extended by up to 45 additional days for “good cause shown.” If, prior to the expiration of the order, the issuer or individual is “charged” with a federal securities law violation, the order will remain in effect until the conclusion of any related legal proceedings, subject to court approval and the right of the issuer or individual to petition the court. If no charges are brought prior to the order’s expiration, the disputed payments (plus accrued interest) must be returned to the issuer or individual.

## **B. New Disclosure Requirements**

**1. Additional Disclosure Requirements.** The Act requires SEC rulemaking for:

- increased disclosures regarding off-balance sheet transactions,
- mandated GAAP reconciliation of *pro forma* financial information,
- internal control reports to be included in annual reports,
- disclosure of an issuer’s code of ethics for senior financial officers, and

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<sup>62</sup> § 1105.

<sup>63</sup> § 305.

<sup>64</sup> § 1103.

- disclosure as to whether an issuer’s audit committee includes at least one person who is a “financial expert.”

These provisions apply to domestic and foreign issuers, although the SEC may adopt exemptions for foreign issuers in the rulemaking process.

The Act also establishes criteria to be used by the SEC in determining the frequency with which a listed company’s SEC filings are reviewed and provides for mandatory review of the SEC filings of all companies every three years.<sup>65</sup>

**Additional Financial Disclosure.** The Act amends Section 13 of the Exchange Act in three ways.<sup>66</sup> First, it adds new Section 13(i) to the Exchange Act mandating that all financial statements required to be prepared in accordance with, or reconciled to, U.S. GAAP and filed with the SEC reflect all material correcting adjustments that have been identified by a registered public accounting firm. Because new Section 13(i) applies to “[e]ach financial report that contains financial statements” and not (as Section 906) only to periodic reports that contain financial statements, it may well apply to a Form 8-K that contains financial statements (*i.e.*, of acquired companies). This provision should not apply to submissions on Form 6-K because, as discussed above, these reports are not “filed.” Second, the SEC must issue rules by January 26, 2003 requiring each annual and quarterly report filed with the SEC to disclose all material off-balance sheet transactions and other relationships of the issuer with unconsolidated entities that may have a material effect on the issuer’s financial condition. By its terms this would apply to annual reports on Forms 10-K, 20-F and 40-F and quarterly reports on Form 10-Q, but should not apply to reports on Form 8-K (which are event driven) or Form 6-K (which are event driven and not filed). Third, by the same date, the SEC must issue rules requiring that any *pro forma* financial information contained in any periodic or other report filed with the SEC or any public disclosure or press release not contain any material misstatement or omissions and be reconciled to GAAP.<sup>67</sup> This third provision has the broadest applicability, since it extends to any public disclosure.

**Internal Control Reports.** The Act provides for the SEC to adopt new rules requiring each annual report on Form 10-K, 20-F and 40-F filed with the SEC to include an internal control report containing a responsibility statement and management’s assessment of the issuer’s financial reporting controls and procedures.<sup>68</sup> The issuer’s auditor also must issue an

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<sup>65</sup> Increased review of foreign issuer filings would be a departure from recent SEC efforts to increase frequency of review exclusively for domestic issuers.

<sup>66</sup> § 401.

<sup>67</sup> The provision expands upon the SEC’s cautionary advice regarding the use of *pro forma* financial information in earnings releases. SEC Rel. Nos. 33-8039; 34-45124 (Dec. 4, 2001). By its terms, the provision applies to all *pro forma* financial information, although it would appear that the provision was intended to address financial statement presentations that differ from GAAP — *e.g.*, those that focus on EBITDA or that eliminate the effect of non-recurring or unusual transactions. It does not appear that Congress intended to modify the *pro forma* financial statement requirements in Article 11 of Regulation S-X, and we expect this matter to be clarified by SEC rulemaking.

<sup>68</sup> § 404.

attestation regarding the internal control report. The time frame for SEC rulemaking is not specified in the Act.

**Code of Ethics and Audit Committee Financial Expert.** The Act delegates to the SEC the adoption of rules requiring disclosure as to (i) whether or not each issuer has a code of ethics applicable to its senior financial officers (and if not, why not) and (ii) any changes to the code or waivers of its requirements.<sup>69</sup> The SEC is also authorized to adopt rules requiring issuers to disclose whether their audit committees have at least one member who is a “financial expert,” as defined by the SEC.<sup>70</sup> By its terms, this requirement would apply to both domestic and foreign issuers, subject to any exemptions or accommodations for foreign issuers in the final rules. The SEC is required to propose rules for both requirements by October 28, 2002 and to adopt final rules by January 26, 2003.

**Mandated Periodic Review.** The Act sets out criteria for the SEC to use in determining the frequency of review of SEC filings by listed issuers and requires review of SEC filings by each reporting company at least once every three years.<sup>71</sup>

**2. Current Reporting Requirement.** The Act adds Section 13(1) to the Exchange Act, which requires issuers to disclose publicly in plain English “on a rapid and current basis” such information as the SEC may require concerning material changes in their financial condition or operations, including “trend and qualitative information and graphic presentations.”<sup>72</sup>

The Act appears to be consistent with the SEC’s approach in its pending proposal to expand the information that domestic issuers report on a “current” basis.<sup>73</sup> That proposal, for

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<sup>69</sup> § 406. Given that the part of the provision referring to changes to the code or waivers requires “prompt disclosures” on Form 8-K, it is unclear whether this provision is intended to be applied to foreign issuers, which are not required to report on Form 8-K.

<sup>70</sup> The requirement of a “financial expert” reflects one of the recommendations of the 1999 report of the Blue Ribbon Panel on Audit Committee Experts and is consistent with existing proposals of the NYSE. It would appear, however, to go beyond the proposals of the Nasdaq, which would require only that members be able to read and understand financial statements at the time of their appointment. In defining “financial expert”, the SEC must consider whether the person has (through education or experience as a public accountant or auditor, a principal financial officer, comptroller or principal accounting officer): (i) an understanding of GAAP and financial statements; (ii) experience in the preparation and/or the auditing of financial statements of comparable issuers and in the use of estimates, accruals and reserves; (iii) experience in internal controls; and (iv) an understanding of audit committee functions. These considerations are substantially those advanced by Financial Executives International in its written testimony in connection with the NYSE proposed rules. See FEI Observations and Recommendations, Improving Financial Management, Financial Reporting and Corporate Governance (Mar. 2002).

<sup>71</sup> § 408. The criteria include: whether an issuer has issued material restatements of its financial statements, the volatility of an issuer’s stock price, an issuer’s market capitalization, whether an issuer is an emerging company with a disparity in its price to earnings ratio and whether the issuer’s operations significantly affect any material sector of the economy.

<sup>72</sup> § 409.

<sup>73</sup> Under the pending proposal, U.S. domestic issuers would be required to file a current report on Form 8-K within two business days of the occurrence of events falling within 19 categories (11 of which are proposed to be added): (i) entry into a material agreement not made in the ordinary course of business; (ii) termination of a material

which the comment period expires on August 26, 2002, stops short of proposing a principles-based rule of continuous disclosure. The pending proposal mandates disclosure of specific categories of information that the SEC considers “unquestionably material.” This approach is designed to make the proposed rules more definite and easier to apply, while still enhancing in a significant way the quality and quantity of information that is provided to the market on a prompt basis.<sup>74</sup>

Although the current reporting requirement called for by the Act appears to endorse the SEC’s pending proposal, and apparently to extend the proposal to foreign issuers, the language in the Act is sufficiently broad that it could be interpreted to authorize a more sweeping change to a principles-based continuous reporting regime that would generally require the disclosure of all material events and developments relating to an issuer. While the Act could be understood to authorize varying degrees of change to the existing Exchange Act reporting system, we believe the Act’s use of the terms “rapid and current,” rather than continuous, suggests that Congress did not intend to authorize a continuous reporting regime.

It is also unclear how the SEC will address the Act’s apparent mandate to extend current reporting to foreign issuers. The SEC has already requested comment on whether it should extend its pending proposal to foreign private issuers. The Act may place additional pressure on the SEC to do so. This would be a significant departure from the SEC’s traditional deference to the home country requirements of foreign private issuers, and could raise difficult issues. Although many foreign private issuers, particularly in Europe, are subject to stringent continuous reporting regimes imposed by listing requirements, harmonizing these requirements with any new SEC rules may prove difficult, and could expose foreign private issuers to greater liability for information reported under those rules.

Whatever form it takes, SEC action to implement this provision of the Act is likely to strain the existing internal reporting systems of many companies. Moving towards a system of more current disclosure will require companies to analyze, evaluate and report information much more quickly than under the existing system. At many companies, internal

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agreement not made in the ordinary course of business; (iii) termination or reduction of a business relationship with a customer that constitutes 10% or more of the company’s revenues; (iv) completion of an acquisition or disposition of material assets; (v) bankruptcy or receivership; (vi) creation of a material direct or contingent financial obligation; (vii) events triggering a material direct or contingent financial obligation; (viii) “exit activities”, including any material write-off or restructuring; (ix) any material impairment; (x) a change in a rating agency decision, issuance of a credit watch or change in company outlook; (xi) delisting, movement to a new exchange, or receipt of notice of failure to comply with listing standards; (xii) unregistered sales of equity securities; (xiii) material modifications of rights of security holders; (xiv) changes in certifying accountant; (xv) conclusion or notice that a previous audit report should no longer be relied upon; (xvi) changes in control; (xvii) election or departure of directors and appointment or departure of principal officers; (xviii) amendments to articles of incorporation or bylaws or change in fiscal year; and (xix) material limitations, restrictions or prohibitions regarding employee benefit, retirement and stock ownership plans. SEC Rel. Nos. 33-8106; 34-46084 (June 17, 2002).

<sup>74</sup> The current SEC proposal nonetheless raises a number of significant issues. Among other examples, the current SEC proposal would require companies to file a current report on Form 8-K whenever they enter into a “letter of intent or other non-binding agreement,” a requirement that could significantly complicate merger negotiations and other types of negotiations where parties have traditionally awaited the signing of a definitive agreement before announcing a transaction.

reporting systems currently may not be set up to permit reporting on the accelerated time frames that may be imposed under the Act and the SEC rules implementing it.<sup>75</sup>

Moving towards a current reporting regime may also increase the litigation exposure of reporting companies. First, requiring companies to report more information more quickly will decrease the time available for verification prior to filing, and will require often difficult materiality decisions to be made much more quickly. This may lead to inaccurate or misleading disclosure, which may in turn provide the basis for increased litigation by private plaintiffs under Rule 10b-5 and, in the case of domestic companies, under Section 18.<sup>76</sup> New current reporting requirements may also lead to increased litigation from both the SEC and private plaintiffs over the timing of disclosure.<sup>77</sup> Failure to file reports on a timely basis may also cause companies to suffer other penalties such as the loss of the ability to use short form registration.<sup>78</sup>

### C. Oversight of Accounting Profession

**1. Public Company Accounting Oversight Board.** The Act creates the Public Company Accounting Oversight Board (the “Board”), a private non-profit corporation, to supervise public accounting firms that provide audit services.<sup>79</sup> The mandate of the Board is to:

- register public accounting firms that prepare audit reports for issuers,
- establish “auditing, quality control, ethics, independence and other standards relating to the preparation of audit reports,”<sup>80</sup> and

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<sup>75</sup> This may particularly be the case for foreign issuers, which have not previously been subject to U.S. current reporting rules.

<sup>76</sup> Reports by foreign private issuers under Form 6-K currently are not deemed to be “filed” for purposes of Section 18 under the Exchange Act. Rule 13a-16(c). If the SEC were to use its authority under the Act to impose an affirmative current reporting obligation on foreign private issuers, it might also decide to treat those disclosures as “filed” for purposes of Exchange Act Section 18. This would subject foreign private issuers to litigation by private plaintiffs under Section 18. Section 18 provides an express private right of action to any person who buys or sells securities in reliance on false or misleading statements in any application, report or document filed under the Exchange Act against any person responsible for such statements. Unlike actions under Rule 10b-5, plaintiffs proceeding under Section 18 do not have the burden of proving *scienter*, but defendants may avoid liability if they can establish that they acted in good faith and had no knowledge of the false or misleading statement.

<sup>77</sup> Under current law, companies generally have a significant amount of discretion over the timing of disclosure of material information when they are not offering securities or filing a required report with the SEC. “Silence, absent a duty to disclose, is not misleading under Rule 10b-5.” Basic, Inc v. Levinson, 485 U.S. 224, 239 n.17 (1988). For this reason, most companies adopt a consistent “no comment” policy about certain matters, such as pending merger negotiations, to avoid triggering a duty to disclose. To the extent the Act or the rules implementing it create a duty to disclose additional information as and when it arises, companies will no longer be able to adopt a “no comment” policy with respect to such matters, and failures to disclose such information on a timely basis when required may give rise to litigation.

<sup>78</sup> Under the SEC’s current rule proposal, a company that fails to file a current report on Form 8-K when required will lose its eligibility for short-form registration, Form S-8 and Rule 144 resales for 12 months after the late filing.

<sup>79</sup> §§ 101-107.

- conduct inspections, investigations and disciplinary proceedings of and take enforcement action against public accounting firms.

The SEC is charged with the organization and oversight of the Board, which must be fully organized by April 26, 2003.<sup>81</sup> Beginning 180 days from the date the Board is fully organized, the Act requires all public accounting firms to register with the Board. It will be illegal to issue an audit report or participate in the preparation of an audit report with respect to any issuer without prior registration with the Board.

Any foreign public accounting firm “that prepares or furnishes an audit report with respect to any issuer” is explicitly subject to the Act. In addition, even foreign public accounting firms that do not furnish audit reports may be required to register if the public accounting firm “plays a substantial role” in the preparation of audit reports.<sup>82</sup> Furthermore, any foreign public accounting firm that “issues an opinion or otherwise performs material services” relied on by a registered public accounting firm is deemed to have consented to produce its workpapers to the Board.<sup>83</sup>

The Act largely delegates the adoption of auditing, quality control and ethics standards to the Board, although the Act requires the Board to adopt rules providing for the following:

- Auditors must maintain workpapers for seven years.<sup>84</sup>
- Audit reports must include additional disclosure about the auditor’s testing of internal control procedures of the issuer and an evaluation of those procedures.
- The Board may require testimony and production of documents from any public accounting firm. Noncompliance with this provision may result in a professional suspension or bar of the noncomplying person or firm.

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<sup>80</sup> Although the Act itself contains numerous provisions with respect to auditor independence, the Board would be entitled to create additional auditor independence rules.

<sup>81</sup> The Act provides that the Board will be composed of five full-time members who will be prohibited from engaging in any other business or professional activity and will serve staggered, five-year terms up to a maximum of two terms. The members of the Board must be appointed by the SEC by October 28, 2002, after consultation with the Chairman of the Board of Governors of the Federal Reserve System and the Secretary of the Treasury. Two members (and only two members) of the Board must be or have been certified public accountants, and the chairperson may only be a certified public accountant if he or she has not been a practicing certified public accountant in the preceding five years.

<sup>82</sup> The Act specifically states that registration shall not provide a basis for subjecting a foreign public accounting firm to the jurisdiction of the federal or state courts, other than with respect to controversies with the Board.

<sup>83</sup> The Act states that any such foreign firms shall be deemed to have consented to the jurisdiction of the United States courts for purposes of enforcing such production of workpapers.

<sup>84</sup> Section 802 of the Act, which criminalizes the destruction of corporate audit records, discussed below in Section IV.G, only requires maintenance of workpapers for a period of five years.

- The Board may seek the issuance of a subpoena by the SEC to require testimony or document production from any third party, including issuers, to the Board.

Except for the information required to be provided in the initial registration and subsequent annual reports filed with the Board (including information regarding fees paid to the public accounting firms by each issuer client for audit and non-audit services), which will be publicly available,<sup>85</sup> other information received by the Board is required to be maintained confidentially, although information with respect to an inspection or investigation may be shared with the SEC and, if deemed to be necessary by the Board, with the U.S. Attorney General or other specified federal and state regulators.

**2. Accounting Standard Setting.** The Act adds Section 19(b) to the Securities Act authorizing the SEC to recognize as GAAP any accounting principles established by a standard setting body meeting the requirements set forth in the Act.<sup>86</sup> The SEC is given rulemaking authority to implement the provision and is charged with the responsibility of overseeing the standard setting board.<sup>87</sup> The Act requires the standard setting board to be organized as a private entity and to have a board of trustees, the majority of whom are not and have not been associated persons at a registered public accounting firm during the prior two years.<sup>88</sup> The Act also requires the standard setting board to adopt procedures to ensure prompt consideration of necessary changes to accounting principles by a majority vote and to consider the need to keep standards current.<sup>89</sup>

**3. Funding for Boards.** The Act provides for the funding of the Public Company Accounting Oversight Board and the standard setting board from a fee to be assessed upon issuers calculated based on their market capitalization.<sup>90</sup>

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<sup>85</sup> The public availability of the registration application and subsequent annual reports is subject to the rules of the Board or the SEC and applicable legal restrictions.

<sup>86</sup> § 108.

<sup>87</sup> Although the text of the Act itself does not mention the Financial Accounting Standards Board (“FASB”), the apparent intent of this provision is to formalize the SEC’s reliance on FASB for the setting of accounting standards. S. Rep. No. 107-205 at 13 (2002).

<sup>88</sup> Changes will be required for FASB to comply with this requirement, because although FASB trustees currently are required to sever any other professional ties when they join the board, no two-year requirement applies. Financial Accounting Foundation, 2001 Annual Report: High Quality Financial Reporting (2002).

<sup>89</sup> Although historically the vote of five out of FASB’s seven trustees was required to set a new accounting standard, on April 24, 2002, FASB announced that, effective immediately, it had decided to change its voting process from a supermajority to a simple majority vote, which is consistent with the requirements of the Act. Press Release, Financial Accounting Standards Board, “Financial Accounting Foundation Changes Financial Accounting Standards Board’s Voting to Increase Efficiency” (April 24, 2002).

<sup>90</sup> § 109. FASB is currently funded from sales of publications, licensing agreements, and voluntary contributions by accounting firms. Financial Accounting Foundation, 2001 Annual Report: High Quality Financial Reporting (2002).

## D. Auditor Independence

The Act amends Section 10A of the Exchange Act to:

- ban specified non-audit services and require prior approval of audit and non-audit services,
- require rotation of audit partners every five years, and
- seek to eliminate auditor conflicts of interest.

A violation of any of these provisions would have significant consequences for a public accounting firm, which would be prohibited from preparing or issuing any audit report to any issuer.<sup>91</sup> The SEC is required to promulgate regulations to implement these provisions by January 26, 2003.<sup>92</sup>

**1. Ban on Specified Non-Audit Services.** Effective 180 days from the date of operation of the Board, the Act prohibits a public accounting firm from providing to any audit client “contemporaneously with the audit” any of the following non-audit services:<sup>93</sup>

- bookkeeping or other services related to accounting records or financial statements;
- financial information systems design and implementation;
- appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- actuarial services;
- internal audit outsourcing services;
- management functions or human resources;
- broker-dealer, investment adviser or investment banking services;

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<sup>91</sup> The text of the Act does not state the maximum duration of any such prohibition, which presumably will be the subject of SEC rulemaking.

<sup>92</sup> § 208. As discussed below, the provision banning certain non-audit services and requiring prior approval for audit and non-audit services states that it is effective 180 days from the date of operation of the Public Company Accounting Oversight Board. § 201(a). No date is specified for the other amendments to Section 10A regarding audit partner rotation and auditor conflicts of interest (discussed below) and mandatory auditor reports to audit committees (discussed in Section IV.A.3 above). These provisions would appear to be effective upon the issuance of final rules by the SEC by January 26, 2003. §§ 203, 204, 206, 208. Nonetheless, this may have been an oversight because these provisions assume the existence of the Public Company Accounting Oversight Board, which is not required to be fully organized until April 26, 2003. The effectiveness of these provisions should be clarified by the SEC’s rules.

<sup>93</sup> §§ 201, 202.

- legal services or expert services unrelated to the audit; and
- any other service that the Public Company Accounting Oversight Board determines to be impermissible.

All auditing services and any permitted non-auditing services may be provided only with the prior approval of an issuer’s audit committee. Although there is a *de minimis* exception from prior approval, it provides minimal relief to issuers.<sup>94</sup> Any approval of non-audit services (including pursuant to the *de minimis* exception) must be disclosed in the issuer’s periodic reports. The probable effect of this provision is that issuers will not hire their auditors to provide any non-audit services.

The prohibited non-audit services are substantially similar to those items prohibited by Rule 2-01(c)(4) under Regulation S-X. Although the additional detail in Regulation S-X (including various exceptions to impermissible services) may aid in the interpretation of the Act, there is no basis in the Act to conclude that the exceptions contained in Regulation S-X are intended to continue to apply. In addition, the prohibition in Rule 2-01(c)(4) applies “at any point during the audit and professional engagement period,” which includes both the audit itself and any time at which the auditor is engaged.<sup>95</sup> The prohibition in the Act only applies to services provided “contemporaneously” with the audit.

As above, the provision applies to all “issuers” and therefore includes both domestic and foreign SEC-reporting companies, including companies with only listed debt securities.<sup>96</sup> Nonetheless, this provision of the Act does not explicitly require an issuer to have an audit committee. As already noted, the Act provides that where no audit committee exists, the audit committee shall be the entire board of directors of the issuer.<sup>97</sup> Because of the scope of the prior approval requirement (for example, the provision of a comfort letter is specifically listed as an auditing service), the new provision adds a significant procedural step to many ordinary course transactions, and these procedures may be substantially more difficult to observe for issuers that do not have an audit committee.<sup>98</sup>

**2. Requirement of Auditor Rotation.** The Act prohibits a public accounting firm from providing audit services to an issuer if the audit partner having primary

<sup>94</sup> The *de minimis* exception, which applies only to permitted non-auditing services, requires that (1) the aggregate amount paid for such services be less than 5% of the total amount paid to the auditor during the year in question, (2) the issuer not have recognized that the services were non-audit services, and (3) the services be promptly brought to the attention of the audit committee.

<sup>95</sup> Rule 2-01(f)(5) under Regulation S-X.

<sup>96</sup> The Board is given explicit authority to exempt any issuer from the requirements of this provision, subject to SEC review. § 201(b).

<sup>97</sup> § 205(a). This adds a new definition of “audit committee” to the Exchange Act that is the same as the previously mentioned definition in Section 2(a)(3) of the Act.

<sup>98</sup> Nonetheless, the potential burdens to an issuer without an audit committee under this provision are much less than those contemplated by the audit committee rules described in Section IV.A.2 that are to be established for listed companies by SEC rulemaking.

responsibility for the audit, or the partner responsible for reviewing the audit, has performed audit services for that issuer in each of the five previous years.<sup>99</sup> As drafted, the provision would appear to require only that the lead audit and reviewing partners recuse themselves one out of every five years.

**3. Auditor Conflicts of Interest.** The Act also addresses conflicts of interest between auditors and issuers by prohibiting a public accounting firm from providing audit services to a client if a CEO, controller, CFO or chief accounting officer of the client was employed by the accounting firm and participated in the client's audit during the one-year period prior to the initiation of the current audit.

## **E. Analyst Conflicts of Interest**

The Act adds new Section 15D of the Exchange Act, which directs the SEC (or, as designated by the SEC, appropriate self-regulatory organizations) to adopt, within one year of the Act's enactment, rules designed to address equity research analyst conflicts of interest. Such rules, the stated objective of which is to "improve the objectivity of research and provide investors with more useful and reliable information," must include provisions that restrict investment banking department influence over research analysts and require disclosure by the analyst in research reports and public appearances of the existence of potential conflicts of interest.

The specific provisions cited in new Section 15D appear by and large to track the rules regarding equity research analyst conflicts of interest recently adopted by the NYSE and the National Association of Securities Dealers ("NASD"), which were approved by the SEC on May 8, 2002.<sup>100</sup> This overlap between the previously approved rules and the scope of the rulemaking required by the Act suggests that the Act is intended to encourage further rulemaking to ensure that the cited concerns are adequately addressed. This is not surprising, since the previously approved rules were widely understood to be only a first step in addressing analyst conflicts of interest. The one area specifically identified in the Act for new rulemaking that was not addressed in the previously approved equity research analyst conflict of interest rules concerns protections against retaliation by a broker-dealer against any analyst who issues a research report that may adversely affect the firm's current or potential investment banking relationship with the issuer covered by the report.<sup>101</sup>

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<sup>99</sup> § 203.

<sup>100</sup> SEC Rel. No. 34-45908 (May 10, 2002). The new NYSE and NASD analyst conflicts of interest rules are discussed in our memorandum to clients of June 12, 2002 entitled, "SEC Approves Research Analyst Conflicts of Interest Rules; Merrill Settlement Agreement Reached."

<sup>101</sup> As part of its continuing efforts to address analyst conflicts of interest, and perhaps in anticipation of the Act's enactment, the SEC proposed Regulation Analyst Certification ("Regulation AC") on July 24, 2002, which was released on August 2, 2002. SEC Rel. Nos. 33-8119; 34-46301 (Aug. 2, 2002). Proposed Regulation AC would require "clear and prominent" disclosures addressed to analyst conflicts of interest in both debt and equity research reports, as well as in connection with public appearances by research analysts. It also requires analysts to certify in research reports that the views expressed "accurately reflect" the analyst's "personal views" about "any and all" of the subject securities or issuers and that no part of the analyst's compensation was, is or will be, directly or

## F. Enhanced Civil Liability and Remedies

The Act contains the following provisions relating to civil litigation under the U.S. securities laws, each of which is applicable to all proceedings commenced on or after the date of the Act:

- **Statute of Limitations for Securities Fraud.** The Act creates a new statute of limitations for any private right of action involving a claim for fraud “in contravention of a regulatory requirement” under the securities laws of the earlier of two years from the date of discovery or five years from the date of the violation.<sup>102</sup> Although the Act is not explicit about the claims that it intends to cover, the likely interpretation of the provision is that it will supply the limitations period for securities claims only where the securities laws themselves do not expressly set out the limitations period. The new statute of limitations thus will not apply to causes of action pursuant to Sections 9 and 18 of the Exchange Act or Sections 11 and 12 of the Securities Act, but will likely apply to causes of action pursuant to Sections 10(b) and 14 of the Exchange Act. The statute of limitations for claims under Sections 10(b) and 14 had been the earlier of one year from the date of disclosure or three years from the date of violation.
- **Debts Nondischargeable if Incurred in Violation of Securities Fraud Laws.** The Act creates an additional exception to the discharge of any individual debtor from any debt relating to any judgment, settlement or order from the violation of the federal or state securities laws or regulations or common law fraud in connection with the purchase or sale of a security.<sup>103</sup>

## G. Enhanced Criminal Provisions

The Act contains the following new crimes and criminal penalties:

- **Destruction, Alteration or Falsification of Records.** The Act creates a new Section 1519 to Title 18, which makes it a crime to knowingly destroy, alter or falsify records with the intent to impede, obstruct or influence a federal investigation or bankruptcy or “in relation to or contemplation of any such matter,” and amends existing Section 1512 of Title 18 to apply to document destruction or alteration in any federal court or similar proceeding.<sup>104</sup> The maximum sentence is 20 years.

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indirectly, related to the “specific” recommendations or views expressed or, if not, identifying the source, amount and purpose of the compensation and disclosing that it could influence the views expressed.

<sup>102</sup> § 804.

<sup>103</sup> § 803.

<sup>104</sup> §§ 802, 1102.

- **Destruction of Corporate Audit Records.** The Act creates new Section 1520 to Title 18, which requires (i) any accountant conducting an audit of an issuer to maintain workpapers for a period of five years, and (ii) the SEC to promulgate rules regarding the retention of workpapers and other documents within 180 days of the Act.<sup>105</sup> The maximum sentence for violation of the Act’s requirement or the SEC’s rules is ten years.
- **Securities Fraud.** The Act creates a new Section 1348 to Title 18 making it a crime to defraud any person in connection with any security of an issuer.<sup>106</sup> This section does not contain the purchase or sale requirement in Section 10(b) of the Exchange Act. The maximum sentence is 25 years.
- **Retaliation Against Informants.** The Act creates new Section 1513 to Title 18 making it a crime to retaliate against any person for providing information to a law enforcement officer.<sup>107</sup> The maximum sentence is ten years.
- **Increased Maximum Penalties.** The Act increases the maximum sentence for mail and wire fraud from five to 20 years.<sup>108</sup> The Act also increases the maximum criminal penalties under the Exchange Act from \$1 million to \$5 million for individuals and from \$2.5 million to \$25 million for entities, and the maximum sentence from ten years to 20 years.<sup>109</sup> The Act increases the penalties for a willful violation of ERISA’s reporting and disclosure provisions to a fine of not more than \$100,000 and imprisonment for not more than ten years.<sup>110</sup>
- **Review by U.S. Sentencing Commission.** The Act instructs the U.S. Sentencing Commission, which sets the sentencing guidelines used by U.S. federal courts, to review the guidelines for obstruction of justice, criminal fraud and securities and accounting fraud related offenses, and to ensure that the sentencing guidelines reflect the nature of the offenses and penalties set forth in the Act.<sup>111</sup>

## H. Other Provisions

- **Lawyers’ Professional Responsibility Rules.** The Act requires the SEC to promulgate rules “setting forth minimum standards of professional conduct” for

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<sup>105</sup> § 802. In contrast, Section 103 of the Act requires maintenance of workpapers for a period of seven years.

<sup>106</sup> § 807.

<sup>107</sup> §1107.

<sup>108</sup> § 903.

<sup>109</sup> § 1106.

<sup>110</sup> § 904.

<sup>111</sup> §§ 805, 905 and 1104.

lawyers practicing before it.<sup>112</sup> In recent years, the SEC generally has interpreted its Rules of Practice as housekeeping rules rather than a means to sanction lawyer misconduct. Rules adopted in response to the mandate in Section 307 could result in more frequent enforcement proceedings against lawyers. In addition, there is a possibility of more severe sanctions, if the SEC interprets the Act to authorize the imposition of a broader array of remedies than a suspension or prohibition on practicing before the SEC. Section 307 also represents a departure from the traditional method of regulating attorney professional responsibility through state authorities, which in some jurisdictions already impose similar, though narrower, requirements (for example, DR 5-109 of New York's Code of Professional Responsibility).

The rules to be adopted under the Act, at a minimum, would require a lawyer (whether in-house or external) to "report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent" of the company to the general counsel or CEO and, if those persons do not take appropriate action, to the audit committee or another committee of independent directors of the company. Unfortunately, Section 307 includes various vague terms whose meaning is left to SEC rulemaking and the courts. For example, it is unclear what would constitute "evidence" of a "breach of fiduciary duty or similar violation" giving rise to a lawyer's reporting obligation. The Act also does not elaborate as to what actions would be sufficiently "appropriate" to avoid elevation of a lawyer's report to the audit committee or another committee of independent directors.

- **SEC Resources.** The Act authorizes additional funding of \$776 million to the SEC for 2003.<sup>113</sup>
- **Whistleblower Protection.** The Act prohibits retaliation by issuers or any representative thereof against employees assisting certain investigations and proceedings by federal agencies, Congress or persons with supervisory authority over the employee.<sup>114</sup>

\* \* \*

Please feel free to contact any of the individuals named on the attached schedule with questions or for copies of the Act.

CLEARY, GOTTlieb, STEEN & HAMILTON

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<sup>112</sup> § 307. Practicing before the SEC is broadly defined in Rule 103(f) of its Rules of Practice and could extend to the conduct of foreign counsel.

<sup>113</sup> § 601.

<sup>114</sup> § 806. President Bush has issued a statement that this provision protects whistleblowers that speak to a congressional committee in the course of an investigation, but not when evidence is provided to individual lawmakers or aides. This statement was criticized by Senators Leahy and Grassley as suggesting too narrow an application of this provision. "Bush Criticized on Whistle-Blowers," The Wall Street Journal, Aug. 1, 2002 at A4.

## SCHEDULE

### Questions And Assistance

### Copies of the Act And Other Materials

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ANNEX A

Provision of the Act	Section	Effectiveness / Required Regulatory Action
<b>Public Company Accounting Oversight Board</b>		
<ul style="list-style-type: none"> <li>Public Company Accounting Oversight Board created to establish auditing standards and to oversee auditors.</li> <li>Recognition of accounting standard setting board.</li> </ul>	<p>§§ 101-107, 109</p> <p>§§ 108, 109</p>	<p>Board members appointed by October 28, 2002. Board to be fully organized by April 26, 2003. Registration of accounting firms required within 180 days of organization.</p> <p>No time period for SEC recognition of board.</p>
<b>Auditor Independence</b>		
<ul style="list-style-type: none"> <li>Prohibition on certain non-audit services and pre-approval requirement for audit and non-audit services.</li> <li>Audit partner rotation every five years.</li> <li>Auditors required to report to audit committees.</li> <li>Prohibition on officer's employment with auditors.</li> </ul>	<p>§§ 201-202</p> <p>§ 203</p> <p>§ 204</p> <p>§ 206</p>	<p>Effective 180 days from operation of Public Company Accounting Standards Board. SEC to adopt final rules by January 26, 2003.</p> <p>SEC to adopt final rules by January 26, 2003.</p> <p>SEC to adopt final rules by January 26, 2003.</p> <p>SEC to adopt final rules by January 26, 2003.</p>
<b>Corporate Responsibility</b>		
<ul style="list-style-type: none"> <li>Listed companies required to have fully independent audit committees to hire and supervise the company's auditors.</li> <li>Certification by CEOs and CFOs of financial reports.</li> <li>Directors and officers prohibited from fraudulently influencing any audit.</li> </ul>	<p>§ 301</p> <p>§ 302</p> <p>§ 303</p>	<p>SEC to adopt final rules by April 26, 2003.</p> <p>SEC to adopt final rules by August 29, 2002 for § 302. (§ 906 criminal liability immediately effective.)</p> <p>SEC to propose rules by October 28, 2002 and to adopt final rules by April 26, 2003.</p>

Provision of the Act	Section	Effectiveness / Required Regulatory Action
<ul style="list-style-type: none"> <li>• Disgorgement of CEO and CFO compensation following restatement of financial statements.</li> <li>• Lower standard for court officer and director bars.</li> <li>• Prohibition on certain insider transactions during blackout periods under individual account plans.</li> <li>• Attorney professional responsibility rulemaking that requires lawyer to report evidence of violations of laws and breaches of fiduciary duty to issuers.</li> <li>• Restitution funds for victim of violations of securities laws.</li> </ul>	<p>§ 304</p> <p>§ 305</p> <p>§ 306</p> <p>§ 307</p> <p>§ 308</p>	<p>Effective immediately.</p> <p>Effective immediately.</p> <p>Effective by January 26, 2003.</p> <p>SEC to issue rules by January 26, 2003.</p> <p>Effective immediately.</p>
<b>Enhanced Financial Disclosures</b>		
<ul style="list-style-type: none"> <li>• Disclosure of material correcting adjustments.</li> <li>• Enhanced <i>pro forma</i> and off-balance sheet disclosure.</li> <li>• Prohibition of loans to executive officers and directors, subject to limited exceptions.</li> <li>• Accelerated reporting of insider transactions on Form 4 under Section 16 of the Exchange Act (not applicable to foreign private issuers).</li> <li>• Annual reports required to contain an internal control report.</li> </ul>	<p>§ 401</p> <p>§ 401</p> <p>§ 402</p> <p>§ 403</p> <p>§ 404</p>	<p>SEC rulemaking required but no time period specified.</p> <p>SEC to issue final rules by January 26, 2003.</p> <p>Effective immediately.</p> <p>Effective August 29, 2002. Electronic filing by July 30, 2003.</p> <p>SEC rulemaking required but no time period specified.</p>

Provision of the Act	Section	Effectiveness / Required Regulatory Action
<ul style="list-style-type: none"> <li>Required disclosure as to adoption of a code of ethics and whether the audit committee includes at least one “financial expert.”</li> <li>Mandated SEC review of public filings at least once every three years.</li> <li>Issuers are required to disclose “on a rapid and current basis” information concerning material changes in their financial condition and operations.</li> </ul>	<p>§§ 406, 407</p> <p>§ 408</p> <p>§ 409</p>	<p>SEC to propose rules by October 28, 2002 and to issue final rules by January 26, 2003.</p> <p>Effective immediately.</p> <p>SEC rulemaking required but no time period specified.</p>
<b>Analyst Conflict of Interest</b>		
<ul style="list-style-type: none"> <li>Directs adoption of rules to address analyst conflicts of interest.</li> </ul>	§ 501	SEC or self-regulatory organization to adopt rules by July 30, 2003.
<b>Commission Resources and Authority</b>		
<ul style="list-style-type: none"> <li>Additional funding for the SEC.</li> </ul>	§ 601	Effective immediately.
<b>Enhanced Criminal and Civil Provisions</b>		
<ul style="list-style-type: none"> <li>New crimes for destruction or alteration of records in federal investigations, court proceedings or bankruptcy.</li> <li>New crime for destruction of audit records.</li> <li>Debts from violation of securities laws nondischargeable.</li> <li>Extension of the statute of limitations for securities fraud claims.</li> <li>Whistleblower protection.</li> </ul>	<p>§§ 802, 1102</p> <p>§ 802</p> <p>§ 803</p> <p>§ 804</p> <p>§ 806</p>	<p>Effective immediately.</p> <p>Effective immediately, except that SEC is to issue final rules for new 18 U.S.C. § 1520(a)(2) by January 26, 2003.</p> <p>Effective immediately.</p> <p>Effective immediately.</p> <p>Effective immediately.</p>

Provision of the Act	Section	Effectiveness / Required Regulatory Action
<ul style="list-style-type: none"> <li>• New securities fraud crime.</li> <li>• Increase in the term of imprisonment possible in the case of mail and wire fraud from five years to 20 years.</li> <li>• Increased penalties for violation of ERISA.</li> <li>• Certification by CEOs and CFOs</li> </ul>	<p>§ 807</p> <p>§ 903</p> <p>§ 904</p> <p>§ 906</p>	<p>Effective immediately.</p> <p>Effective immediately.</p> <p>Effective immediately.</p> <p>Effective immediately. (§ 302 requires SEC to issue final rules by August 29, 2002.)</p>
<b>Corporate Fraud Accountability</b>		
<ul style="list-style-type: none"> <li>• SEC temporary freeze authority.</li> <li>• SEC officer and director bars.</li> <li>• Increased penalties under Exchange Act.</li> <li>• New crime for retaliation against informants.</li> </ul>	<p>§ 1103</p> <p>§ 1105</p> <p>§ 1106</p> <p>§ 1107</p>	<p>Effective immediately.</p> <p>Effective immediately.</p> <p>Effective immediately.</p> <p>Effective immediately.</p>

ANNEX B

Study	Responsible Agency	Date
Adoption of a Principles-Based Accounting System by the United States Financial Reporting System	SEC	July 30, 2003
Potential Effects of Requiring Mandatory Rotation of Registered Public Accounting Firms as Auditors	GAO	July 30, 2003
Historical Consolidation of Public Accounting Firms Since 1989	GAO	July 30, 2003
Role and Function of Credit Rating Agencies in the Operation of the Securities Market	SEC	January 26, 2003
Violators of the Federal Securities Laws from January 1, 1998 to December 31, 2001	SEC	January 30, 2003
Review of All SEC Enforcement Actions Involving Reporting Requirement Violations for Preceding Five Years	SEC	January 26, 2003
Whether Investment Banks Assisted Public Companies in Manipulating their Earnings and Obfuscating their True Financial Condition	GAO	January 26, 2003

ANNEX C

**Certification**

**Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  
(Subsections (a) and (b) of Section 1350, Chapter 63 of Title 18, United States Code)**

Pursuant to section 906 of the Sarbanes-Oxley Act of 2002 (subsections (a) and (b) of section 1350, chapter 63 of title 18, United States Code), each of the undersigned officers of [Company], a [State] corporation (the "Company"), does hereby certify[, to such officer's knowledge,] that:

The Quarterly Report on Form 10-Q for the quarter ended June 30, 2002 (the "Form 10-Q") of the Company fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 and information contained in the Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated:

\_\_\_\_\_  
[Name]  
Chief Executive Officer

Dated:

\_\_\_\_\_  
[Name]  
Chief Financial Officer

The foregoing certification is being furnished solely pursuant to section 906 of the Sarbanes-Oxley Act of 2002 (subsections (a) and (b) of section 1350, chapter 63 of title 18, United States Code) and is not being filed as part of the Form 10-Q or as a separate disclosure document.