FULBRIGHT
FULBRIGHT & JAWORSKI L.L.P.

Legal Update

The Sarbanes-Oxley Act of 2002:
An Ambitious Congressional Attempt at Regulating the Behavior of Corporate America and Its Advisors

August 2002

Introduction. . .

President Bush signed the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley" or the "Act") into law on July 30th. Sentiments expressed about this legislation cover every color of the political spectrum. Some say that it is a prime example of Congressional overreaction to admittedly egregious corporate behavior, and that the wrongdoers (who could be dealt with under existing criminal statutes) are just a few "bad apples." Others say that Congress still has not gone far enough to address the root causes of the problems affecting corporate America.

The Statute's Reach is Extensive. . .

Whatever one's views, a close reading of Sarbanes-Oxley reflects a Congressional desire to administer shock treatment to those with stewardship responsibility for America's publicly traded companies. Congress's reach extended as well to the public accounting profession, stock analysts and securities dealers, and lawyers (outside counsel as well as inhouse counsel) who represent publicly traded clients.

At the same time, as with so much in life and in legislation as well, the "devil is definitely in the details." The long-term effects of Sarbanes-Oxley will likely rest upon the regulatory embellishments which have already begun (given the tight time limitations built into the Act) by the Securities and Exchange Commission.

Some of the most critical features of this legislation take effect on the date of enactment, that is July 30, 2002. Consequently a close reading of Sarbanes-Oxley is clearly in order. The Act is somewhat fragmentary because it is a mixture of many entirely new legislative initiatives, including standalone statutes, with a series of amendments to various existing statutes. The primary focus of this analysis and discussion will be directed to new statutory requirements, except when amendments to existing legislation need to be addressed in order to add clarity to the discussion.

See Inside. . .

- Analysis of the key provisions contained in the Act's 11 Titles.
- Discussion of some of the Act's most potentially challenging features.

SIGNIFICANT SARBANES-OXLEY REQUIREMENTS AND INITIATIVES

1. Regulating the Behavior of Corporate Officials of Issuers:

In Sarbanes-Oxley, Congress turned its full attention to the behavior of corporate officials, enacting a variety of attempted legislative antidotes to the types of corporate behavior that have been a staple of media reporting over the last nine months.

- Standards for public company board audit committees are established through the mechanism of required SEC oversight rulemaking.
- **Pursuant to SEC rules to be adopted by April 26, 2003, companies, to be listed on a national securities exchange, must satisfy the following requirements relative to their board audit committees:**
    - Audit Committee must be responsible for appointment/ compensation/oversight of outside accountants.
    - Audit Committee members must be board members and otherwise independent.
        - No fees or compensation from the company, other than for work as a director.
        - Cannot be affiliated with the company or a company subsidiary.
        - Disclosure required as to which member is a "financial expert;" if there is none, the reasons for the omission.
    - Procedures in place for dealing with complaints about company accounting, internal controls or audit matters, including means whereby employees may make anonymous submissions.
    - Authority to hire counsel and other advisors is to be provided for, along with sufficient funding therefor as well as for the issuer's accounting firm.
- **By August 29, the SEC must require periodic company report certifications by the issuer's principal executive officer and principal financial officer:**
    - **Signing officer affirmation that the report has been reviewed.**
    - **No untrue statements or omissions of material fact contained in such report, to signing officer's knowledge.**
    - **Report fairly presents, in all material respects, the company's financial condition and results of operation for the period covered, to signing officer's knowledge.**
    - **Affirmation re: corporate internal controls covering the reporting period, as well as changes in such controls which could negatively affect their subsequent efficacy.**
    - **Affirmations that all significant internal controls defects, including acts of fraud, have been reported to the company's auditors and board audit committee.**[1]

---

[1] **The SEC, on August 2nd, issued proposed implementing rules. See, however, discussion on page 9 covering new Section 906 CEO/CFO certification requirement which is now in effect.** Also, the Act's provisions are specifically made applicable to an issuer that reincorporates or transfers its corporate domicile outside the U.S.

- **The Act prohibits company officers/directors or their representatives from "fraudulently" influencing, coercing, manipulating or misleading outside auditors for the purpose of rendering company financial statements materially misleading.**[2]

- **CEO'S/CFO's must reimburse the Company for bonuses or similar compensation** received from the company as well as profits from the sale of securities:

  - **If the company is required to submit an accounting restatement** due to the company's material noncompliance, because of misconduct, with financial reporting requirements.
  - The law establishes a 12-month period for affected compensation "recapture."[3]

- **After January 27, 2003, directors or officers of issuers are prohibited from engaging in securities transactions involving an issuer's securities during "blackout periods"[4] involving those securities, if acquired in connection with service for the issuer.**

  - Profit derived inures to the issuer.
  - The issuer or a shareholder has a cause of action to recover.
  - Establishment of covered blackout periods generally determined by reference to ERISA as well as SEC implementing regulations.
  - Requirement takes effect no later than February 5, 2003.
  - "Good faith compliance" with statute in advance of SEC regulations equates to compliance with the statute.

- **An issuer (or its subsidiary) is prohibited from extending personal loans to or for any director or executive officer**, except for specified loans that are made in the ordinary course of the consumer credit business of the issuer. **Credit extensions existing on July 30, 2002 may not be renewed or materially modified after that date.**

- **Insider trading reports**:

  - As of August 29, 2002, Form 4's must be filed with the SEC and any national exchange on which the securities are listed within two business days following a change of ownership or purchase or sale of an issuer's security by an insider.
  - Not later than July 30, 2003, insider trading reports are to be filed electronically and made available on the SEC's and the issuer's web sites by the end of the next business day after the filing.

2. Measures Intended to Insure Independence of Outside Auditors from the Issuers they Audit:

The Act establishes a variety of "bright line" requirements and prohibitions intended to ensure that the outside auditor-issuer relationship is maintained on an "arms length plus" basis and that complete and proper disclosure of audit findings is provided by the auditor to the issuer's responsible authority.

---

[2] This provision is said not to preempt other existing laws, there being considerable preexisting law and regulation on this subject already.

[3] These penalties are separate and apart from other civil or criminal action that could be pursued. The Act also makes it easier to cause individuals to be barred from serving as officers or directors of listed companies.

[4] Generally defined as any period of more than 3 consecutive business days when not less than 50% of plan participants/beneficiaries are precluded from engaging in transactions affecting their plan accounts.

- Beginning 180 days after commencement of the new Public Company Accounting Oversight Board (see Section 4 of this Update), a **registered accounting firm is prohibited from performing audits for an issuer if the firm is also providing one or more of the following non-audit services:**
  - Bookkeeping/accounting.
  - Financial information systems design/implementation.
  - Appraisal/valuation services including fairness opinions or contribution-in-kind reports.
  - Actuarial, internal audit, management or HR functions.
  - Broker/dealer/investment advisor/investment banking services.
  - Legal services and expert services unrelated to the audit.
  - Other impermissible services as determined by the Board.
- **Audit services and permissible non-audit services can only be performed if pre-approved by the issuer's board audit committee:**
  - Committee approval must be disclosed in periodic reports.
  - Approval may be delegated to a member of the Audit Committee.
- **Registered public accounting firms must change the lead/coordinating audit partner or audit review partner for an issuer at least every five years.**
- **Audit reports by a registered public accounting firm to an issuer's audit committee must cover:**
  - Critical accounting policies/practices used.
  - Alternative treatments of financial information, consistent with GAAP, that were discussed with management, including their ramifications and the treatment preferred by the auditor.
  - Other material communications between issuer management and the accounting firm.
- A registered public accounting firm cannot provide audit services to an issuer if the issuer's CEO, controller, CFO, or chief accounting officer (or their equivalents):
  - Was employed by the audit firm; and
  - Participated in any capacity in the audit of the issuer during the one year period preceding audit initiation.

3. <u>Institution of Enhanced Financial Disclosure Measures:</u>

The Act alters the timing and substance of **corporate disclosures and requires a code of ethics for senior financial officers.**

- **Required Disclosures:**
  - **Financial reports filed with the SEC, with GAAP financials, must reflect all material correcting adjustments identified by a registered public accounting firm.**
  - **By January 27, 2003, the SEC must issue rules requiring Form 10-K, Form 10-Q, and Form 20-F disclosure of all material off balance sheet transactions and other relationships with unconsolidated entities having a material current or future effect on the financial condition**

of the issuer; pro forma financial information to be presented in a manner that is neither materially incomplete nor misleading (while being reconciled to GAAP results).

- **The SEC must prescribe issuer internal control rules:**
    - Requiring Form 10-Ks to contain an internal control component delineating the responsibility of management to establish and maintain an adequate internal control system and financial reporting procedures.
    - Assessing the effectiveness of that system and those procedures as of the end of the most recent fiscal year of the issuer.
    - Auditors must attest to, and report on, the assessment made by management.
- **The SEC must issue rules, by January 27, 2003, requiring issuers to disclose in their periodic reports:**
    - **whether the issuer has adopted a code of ethics for senior financial officers;**
    - **whether the audit committee contains a "financial expert," as defined by the SEC.**
    - the reasons for not adopting such an ethics code or including such a financial expert must be reported.
- The SEC must revise its rules regarding matters to be reported on Form 8-K to include any change or waiver of the ethics code.
- **Enhanced Review of Periodic Disclosures and Real Time Disclosures:**
    - The SEC is to review filed reports, including the financial statements of every reporting company listed on a national exchange or automated quotation facility no less frequently than once every three years.[5]
    - **Every reporting company must disclose to the public, in plain English, on a "rapid and current" basis, any additional information concerning material changes in financial condition or operations as the SEC determines is necessary or useful for the protection of investors and the public.**
    - **SEC to promulgate rules on real time disclosure (See Section 409 of Act).**

4. Creation of a Public Company Accounting Oversight Board:

Sarbanes-Oxley creates a wholly new **Public Company Accounting Oversight Board (the "Board").**

The Board is to oversee the audits of public companies, protect investors and further the public interest in the preparation of audit reports for issuers.

- The Board's duties include:
    - Registering public accounting firms.
    - Establishing standards relating to the preparation of public company audit reports.
    - Conducting investigations and disciplinary proceedings of public accounting firms and imposing appropriate sanctions when justified.

[5] The Act contains suggested factors to prioritize those reviews.

    - Promulgating public accounting professional standards.
    - Enforcing Sarbanes-Oxley and other legislation relating to preparation/issuance of audit reports and the obligations of public accounting firms.

- **Board must be "ready for business" no later than April 27, 2003.**

- Board features and makeup:
    - Five members serving no more than two terms of five years.
    - Two members must be CPA's.
    - Full time service with generally no outside compensation or occupation.

- **Mandatory registration by public accounting firms:**
    - Unlawful for non-registered firms to prepare, issue or participate in preparation or issuance of audit reports for pubic companies.
    - Registration application to include fees received from issuers for audit and non-audit services, and records of accounting disagreements between registrant and issuers being audited.

- **Board to establish auditing/quality control/ethics standards to be used by public accounting firms which shall include:**
    - **Retention of audit work papers for no less than 7 years.**[6]
    - Procedures for concurring/second partner approval of audit reports, and concurrence by a "qualified person" other than the person in charge of the audit.
    - Testing of issuer's internal controls structures/procedures (tailored generally to internal controls requirements under the Foreign Corrupt Practices Act).
    - Auditor professional ethics and independence standards.
    - Intra-firm consultation on accounting/audit issues and related quality control matters.

- **Board to inspect registered public accounting firms:**
    - Frequency determined by number of firm audit clients.
    - Inspections to focus on firm audit/review engagement, quality controls and internal documentation system and communications within the firm.
    - Inspection reports provided to the SEC and appropriate state regulatory authority.

- **Board has separate statutory authority to investigate and discipline registered firms:**
    - Board has power to take testimony and require submission of documents, along with subpoena power (to be issued by SEC).
    - Failure of the investigated firm to cooperate may lead to suspension of persons from association with the investigated firm or suspension/revocation of the firm's registration.
    - Board sanctions for violations include: temporary suspension or permanent revocation of registration; temporary suspension or bar of persons from association with a firm; limitation on

---

[6] But see Section 802 of the Act, now in effect, which mandates retention for 5 years from the end of the fiscal period in which the audit was concluded.

the scope of a firm's practice; civil penalties ranging up to $15,000,000; censure; additional education or training; or other appropriate sanctions (penalties vary depending upon whether conduct is "intentional," "knowing," or "reckless" or includes "repeated instances of negligent conduct")

- Separate sanction authority available if a firm fails to supervise its employees if they violate laws, regulations or standards related to audit report preparation/issuance.

- **A foreign public accounting firm[7] may be subject to the Act:**
  - If it prepares or furnishes an audit report with respect to an issuer.
  - If it plays a "substantial role" in the preparation/furnishing of such reports for certain issuers.
  - Foreign firm's issuance of an opinion or performance of material services relied upon by a Board-registered firm in the issuance of the audit report (or opinion contained in an audit report) equates to consent by foreign firm:
    - To produce audit work papers for the Board/SEC in connection with an investigation into a covered audit report; and
    - To jurisdiction of U.S. courts for purposes of enforcement of a request to produce such work papers.
  - Registered domestic firms relying on a foreign accounting firm's opinion are deemed:
    - To have consented to supplying foreign firm audit papers in response to Board/SEC document requests; and
    - To have obtained the agreement of the foreign firm to such production.

- **Sarbanes-Oxley provides for oversight of all Board activities by the SEC, to include the Board's imposition of sanctions on registered firms, as well as oversight of the independent accounting standards-setting body whose GAAP pronouncements are to be recognized by the SEC.**

5. Creation of New Rules Mandating Disclosures by Lawyers:

- The SEC is, by regulation, to establish **"minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers," including a rule:**
  - **Requiring an attorney to report evidence of a "material violation of securities law or breach of fiduciary duty or similar violation by the company" to the company's chief legal counsel or CEO.**
  - **Failing remedial action, requiring the attorney to report the matter to the company's audit committee or the full board.**

6. Creation of Rules to Limit Analyst Conflicts of Interest:

By July 30, 2003, the SEC (or the exchanges as permitted by the SEC) must adopt stock analyst conflict rules which:

[7] Defined as a public accounting firm organized and operating under the laws of a foreign government.

- Address potential conflicts when securities analysts make equity recommendations in print or in personal appearances.

- Require analysts to disclose conflicts of interest including investments in securities of the issuer, compensation received from the issuer in the preceding year and whether the analyst's compensation was determined based upon investment banking revenues received by an analyst's firm from the subject issuer.

7. Denial of SEC Practice Privilege:

- The Act gives the SEC authority to censure any person or deny (temporarily or permanently) any person the privilege of appearing or practicing before the SEC if that person:

  - Does not possess the required qualifications to represent others.
  - Lacks character or integrity or has engaged in unethical or improper professional conduct.
  - Has willfully aided and abetted a violation of any provision of the securities laws.

8. Corporate, White Collar, and Fraud Crimes and Penalties:

- **Financial Statement Certification**

  - **Section 906 of the Act requires any periodic statement containing a financial statement filed with the SEC pursuant to section 13(a) or section 15(d) of the 1934 Act to be accompanied by a written statement signed by the CEO and CFO of the issuer, certifying that the information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer.** A certificate signatory who knows the periodic report does not meet the minimum standard in the certification is subject to a fine of not more than $1 million, imprisonment for not more than 10 years, or both. Willfully signing a false certificate is punishable by a fine of not more than $5 million and imprisonment for not more than 20 years, or both.[8]

- **Document Destruction and Retention: Obstruction of Justice**

  - The Act (new 18 USC §1519) imposes fines and not more than 20 years imprisonment for **knowingly altering, destroying, mutilating, concealing, covering up, falsifying, or making a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States** or any case filed under the Bankruptcy Code, or in relation to or contemplation of any such matter or case.[9]

  - New 18 USC §1820 requires **any accountant** who conducts an audit of an issuer of securities to which section 10A of the 1934 Act applies, **to maintain all audit and review workpapers for 5 years after the end of the fiscal period in which the audit was completed**. By January 27, 2003 the SEC must adopt rules and regulations reasonably necessary to the retention of relevant records which are created, sent, or received in connection with an audit or review and contain conclusions, opinions, analyses, or financial data relating to such an audit or review. Violation of these retention requirements is punishable by fine and not more than 10 years imprisonment.

---

[8] **This certification requirement is different than the requirement in Section 302 of the Act and is effective for reports (including Form 10-Qs) filed after July 30, 2002.**

[9] Note, this provision is not limited to SEC proceedings or securities fraud.

  - New 18 USC § 1512 mandates that **corruptly altering, destroying, mutilating, or concealing a record, document, or other object, or attempts to do so, with the intent to impair the object's integrity or availability for use in an official proceeding**, or otherwise obstructing, influencing, or impeding any official proceeding is punishable by fine and imprisonment for not more than 20 years, or both. [10]
  - Under new 18 USC §1513(e), **retaliation against an informant of** truthful information to a law enforcement official relating to the commission or possible commission of a Federal offense is **punishable by fine or imprisonment for not more than 10 years**, or both.

- **Securities Fraud**
  - 18 USC §1348 defines a new securities fraud offense of **knowingly executing or attempting to execute a scheme or artifice to defraud** any **person in connection with any security of an issuer** to obtain, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale of any security of any such issuer. The offense is punishable by fine, not more than 25 years of imprisonment, or both.
  - Effective for proceedings commenced after July 30, 2002, the statute of limitations on securities fraud actions extended to the later of 2 years from discovery of the facts constituting the violation or 5 years from the date of the offense.
  - The Bankruptcy Code amended to render debts incurred by reason of a violation of securities anti-fraud laws nondischargeable in bankruptcy.
  - There is a new procedure for an **employee of a publicly traded company who has provided information about a securities violation to obtain redress against harassment, threats, or discriminatory or retaliatory treatment by the company**, its officers, directors, subsidiaries, suppliers, and agents.[11]

- **Escrow of Extraordinary Payments During Investigation**
  - If the SEC believes, during the course of an investigation of possible federal securities law violations by an issuer, that the issuer will make extraordinary payments (whether compensation or otherwise) to any of these persons, the SEC may petition a federal district court for a temporary order requiring the issuer to escrow those payments, subject to court supervision, in an interest-bearing account for up to 90 days.
  - If a federal securities law violation is charged before the order expires, the order shall remain in effect, subject to court approval, until the conclusion of all legal proceedings relating to the violation, subject to the issuer's right to petition the court for review of the order. Otherwise, the escrow terminates on expiration of the order, and the disputed payments and interest are returned to the issuer or other affected person.

- **Enhanced Penalties**
  - SEC may, in cease and desist proceedings, prohibit, conditionally or unconditionally and permanently or for any period of time, **any person who has violated section 17(a)(1) of the 1933 Act or section 10(b) of the 1934 Act from acting as an officer or director of a publicly-traded or reporting company if that person's conduct demonstrates unfitness to serve in either of those capacities**.[12]

---

[10] Practices of not retaining drafts, notes, or emails could become very problematic under this new criminal statute.

[11] Relief includes compensatory damages and restoration of employment status.

[12] The "unfitness" standard is a lesser standard than the existing "substantial unfitness" standard.

- Criminal penalties specified in the 1934 Act are increased from $1 million to $2.5 million and imprisonment for not more than 10 years to $5 million to $25 million and imprisonment for not more than 20 years.
- Maximum prison terms for mail fraud and wire fraud are increased from 5 years to 20 years.
- The minimum and maximum fines and maximum imprisonment for a criminal violation of ERISA are increased from $5,000 to $100,000 and 1 year, to $100,000 to $500,000 and 10 years, respectively.

Conclusion:

There is much in Sarbanes-Oxley to be concerned about, particularly for issuers and their senior officials. This concern is not necessarily borne out of fear of violating the law but in trying to understand what the law really requires. The "short fuse" requirements in the Act are particularly significant. SEC rules governing CEO/CFO certification must be effective no later than August 29th. However, Section 906 has a CEO/CFO certification requirement, with penalties for violations, which appear on their face to be effective right now.[13] The prohibitions on new personal loans to issuer directors and senior executives are in effect now but the operative language is not easily understood in all respects. Employee prohibitions for "whistleblowing" directed against issuers also took effect on the date of enactment.

The internal controls components of the reports required by Section 302 may be in conflict with similar reporting requirements set out in Section 404. Additionally, while Section 802 establishes criminal penalties for failure to keep audit papers for five years from the end of the fiscal period in which the audit was concluded, Section 103(a)(2) envisions a minimum seven year retention period.

The lawyer whistleblowing provisions of Section 307, are unclear on their face and will require imagination and perspicacity on the part of the SEC, which has less than six months to issue credible, clear rules that do not undermine the intent of the legislative drafters.[14]

There are other confusing and contradictory elements in the Act, many of which are obvious and others which will become so. SEC rule drafting is underway. Affected parties will have to be alert to the issuance of proposed rules for public comment in the hope that what Congress and the Administration have wrought can be interpreted, in time, by the persons and entities coming within the reach of Sarbanes-Oxley's requirements and prohibitions.

[13] See footnote 8.

[14] In addition to the blizzard of new rules to be drafted, the SEC is also responsible for preparing a number of reports and studies. The Comptroller General is likewise charged with preparing studies on outside auditor rotation and audit firm consolidation and recent investment bank behavior.

Fulbright & Jaworski l.l.p.
Corporate Compliance Practice

This memorandum was prepared by attorneys in Fulbright & Jaworski's corporate compliance practice group. The co-editors of this issue of *Legal Update* are Frank W. Blue (*fblue@fulbright.com*), Of Counsel to the firm, Steven Salch (*ssalch@fulbright.com*), Partner to the firm and Candice Wells (*cwells@fulbright.com*), Associate to the firm.

Notice:

We are providing this *Legal Update* as a commentary on current legal issues, and it should not be considered legal advice, which depends on the facts of each situation. Receipt of this *Legal Update* does not establish an attorney-client relationship. Unless otherwise indicated, the attorneys listed in this *Legal Update* who are licensed to practice in Texas are not certified by the Texas Board of Legal Specialization. New York, California, and the District of Columbia do not board certify attorneys. The listed attorneys and/or other attorneys may provide services in connection with a particular matter.