McKenna Long & Aldridge LLP
Attorneys at Law
Information Advisory

July 31, 2002

Provisions of Sarbanes-Oxley Act of 2002 of Immediate Importance to Public Companies

Part 5 of a Series from the Corporate Group

On July 30, 2002, the President's signature completed enactment of the Sarbanes-Oxley Act of 2002. As we all are aware, this statute had become a focal point of Congress's response to the recent corporate scandals. The statute principally addresses accounting oversight and financial reporting requirements, and also focuses on the specific conduct of corporate officers and directors. The most far reaching impact of the statute will most likely be on the accounting industry itself, with the creation of a new Public Company Accounting Oversight Board ("Board"), which is under the generalized supervision of the Securities and Exchange Commission ("Commission"). The statute also requires the Commission to undertake a number of studies and enhances the criminal penalties for a number of white-collar crimes. In a later advisory we will discuss in greater detail all three of these subjects – the Board, the studies, and the enhanced criminal penalties.

The purpose of this advisory, however, is to discuss the changes imposed by the statute on public companies and their management and to focus on those of most immediate impact. Three in particular require companies to begin AT ONCE preparations to comply: (1) the requirements (there are two) for certification of periodic reports by CEO's and CFO's (See "Certification of Periodic Reports" below); (2) the prohibition on extensions of credit to officers and directors (See "Prohibition of Loans" below); and (3) the reporting by officers, directors and principal stockholders of transactions in a company's securities within two days of the transactions (See "Transaction Reporting" below).

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CHANGES IN RESPONSIBILITY AND DISCLOSURES OF CORPORATE OFFICERS AND DIRECTORS

Certification of Periodic Reports

The statute includes two separate but ultimately overlapping certification requirements for CEOs and CFOs.

The requirement in Section 906 of the statute, which is effective immediately, provides that a written statement by the CEO and CFO must accompany each periodic report containing financial statements. The statement must certify that:

- the periodic report complies with Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- the information contained in the report fairly presents, in all material respects, the financial condition and results of operations of the company.

If the CEO or CFO makes this statement knowing that it is false, he or she may be fined up to $1,000,000 and/or imprisoned up to 10 years, and a willful false certification is punishable by fines of up to $5,000,000 and/or imprisonment of up to 20 years.

Because this requirement is effective immediately, the statement must be included with any quarterly reports (Form 10-Qs) filed on or after July 30, 2002 for the June 30, 2002 fiscal quarter or annual reports (Form 10-Ks) in the case of companies with a June 30 year-end. For those companies whose senior officers are required to certify their recent periodic reports pursuant to the June 27, 2002 Commission Order, they should be aware that this Section 906 certification is in addition to the June 27th certification requirement.

The second certification requirement, located in Section 302 of the statute, requires that the Commission, by **no later than August 29, 2002**, adopt rules requiring certification by a company's principal executive officer and principal financial officer of numerous qualitative items with respect to each annual (Form 10-K) and quarterly (Form 10-Q) report filed thereafter. While the Commission is charged with putting rules into effect by August 29, 2002, the statute specifies the minimum certifications such officers must provide, including:

- Review of the report by such officer;
- Representation regarding material misstatements or omissions;
- Representation regarding fair presentation in all material respects of financial condition and results of operations;
- Status, evaluation and application of internal controls; and
- Disclosure of deficiencies in internal controls and on fraud to auditors and audit committee.

Internal Controls

The statute requires that the Commission prescribe rules requiring each company to include within each annual report its management's assessment of internal controls via an "internal control report". In addition, the company's auditor is required to attest to, and report on, this assessment. Each of the internal control report and the auditor attestation will form part of the annual report. There is no time frame specified in the statute by which the Commission must issue these rules, although we believe companies must assume the requirement will be effective at the same time as the Section 302 certification of such controls is first required - e.g., **by August 29, 2002**.

Transaction Reporting

The statute accelerates the time for the filing of reports by directors, officers and principal stockholders of transactions in the company's securities. **Effective August 29, 2002**, these persons must file the required report by the end of the second business day after the transaction. This significantly changes the current filing requirement — currently these reports must be filed within ten days after the end of the month in which the transaction occurs. While the Commission may change the form or other aspects of this report, until that change we expect reporting persons will use the current Form 4 to make such filings. As is the case now, these persons are still responsible for making the filing, even if a company representative has assist-

ABOUT US

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ed them in the past and companies should communicate these accelerated filing requirements to such persons.

The statute further provides that by **July 29, 2003**, these filings must be made electronically and must be available on a Commission supplied public website and on the company's own website not later than the end of the business day following the filing. McKenna Long & Aldridge will have EDGAR filing capabilities and be able to assist you in making these filings when required.

Other Changes in Responsibilities and Disclosures

Code of Ethics for Senior Financial Officers

Each public company must adopt a code of ethics for senior financial officers (or disclose why a code has not been adopted). The statute specifies that such a code will address standards for honest and ethical conduct, disclosure in periodic reports and compliance with governmental rules and regulations. The Commission is required to propose rules to implement this code by October 28, 2002 and issue final rules **not later than January 26, 2003**.

Specific Financial Statement Disclosures

The statute requires immediately that each financial report filed reflect "material correcting adjustments" that have been identified by a company's auditors. In addition, the statute mandates that the Commission issue rules not later than January 26, 2003 requiring disclosure of material off-balance sheet transactions and arrangements and concerning presentation of pro forma financial information included in reports and public disclosures. Significant changes to internal controls.

Real Time Financial Disclosure

The statute further requires disclosure on a "rapid and current basis" of additional information concerning material changes in the financial condition or operations. Although the provision is **effective immediately**, the statute contemplates Commission rules to interpret this provision. Until such rules appear, we believe compliance with the current rules for dissemination of such changes, including Regulation FD, can be considered "rapid and current".

LIMITS ON CONDUCT OF CORPORATE OFFICERS

Enhanced Review of Periodic Disclosures

Effective immediately, the Commission is required to review periodic reports on a regular basis, with no company to be reviewed less frequently than once every three years.

In addition to the additional responsibilities, the statute provides very specific limitations on conduct of corporate officers:

Prohibition of Loans

Effective immediately, companies are prohibited (with certain narrow exceptions) directly or indirectly from extending credit to corporate officers or directors. Existing loans are grandfathered, provided they are not materially modified or renewed after July 30, 2002. Although the media reports regarding this section have indicated this provision does not prohibit the use of credit cards, the present wording of the statute indicates otherwise. If credit card use is to be permitted, it may need to be one of the subjects of the technical corrections bill, which we understand will be taken up after the Congressional recess.

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Prohibition of Trades During Blackouts

Effective immediately, officers and directors are prohibited from trading during so-called retirement fund "blackout" periods, which under the statute are those blackout periods that are imposed on tax qualified defined contribution plans, such as 401(k) plans. In addition, companies are required to give notice of these blackout periods to directors, officers and the Commission. Profits from transactions in violation of this provision are subject to recapture for the benefit of the company. This section raises many questions - among them, for example, its applicability to Section 10b5-1 plans and the need to modify those plans. This section requires (and will receive) extensive interpretation in the near future so that reliable guidance can be provided. In the meantime, we believe it must be interpreted conservatively.

Forfeitures of Bonuses and Equity Based Compensation

Effective immediately, if a company is required to restate financials due to material non-compliance with any financial reporting requirement that is the result of misconduct, each of the chief executive officer and chief financial officer of the company must reimburse the company for (1) any bonus, other incentive based compensation or equity-based compensation received by that individual from the company during the 12-month period following the first use or filing of the flawed document and (2) any profits realized from the sale of securities of the company during that same 12-month period.

Improper Influence on Audits

The statute prohibits actions by officers or directors to influence improperly its company's auditors in the performance of the audit for the purpose of rendering financial statements materially misleading in violation of the rules that the Commission shall prescribe. The Commission must propose these rules by October 28, 2002 and issue final rules **not later than April 26, 2003**. The Commission has exclusive authority to enforce this provision and rules in civil proceedings.

IMPACT ON AUDITS OF PUBLIC COMPANIES

The time of effectiveness of all of the following provisions is unclear. While the structure of the statute makes such provisions effective immediately, the statute also mandates final rules from the Commission not later than January 26, 2003.

Prohibition of Non-Audit Services

The statute sets forth a distinction between audit services and non-audit services. It expressly prohibits some non-audit services and places limits on others. Audit services, although not defined, appear to include those services with respect to the preparation, review and certification of financial reports that we would commonly consider audit services. Audit services also expressly include providing comfort letters in connection with securities underwritings or statutory audits required for insurance companies.

The statute expressly prohibits an independent auditor from providing the following non-audit services to an audit client:

- 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.
- Legal services or expert services unrelated to audit.
- Any other services determined to be non-audit services by regulation by the board.

Pre-Approval of Audit and Non-Audit Services

A company may engage its audit firm to provide permitted non-audit services (i.e., those not listed above), including tax services, but only with prior approval by the audit committee. Audit services themselves also require pre-approval. The audit committee has the authority to delegate pre-approval to one member of the committee and the decisions of that delegated member must be presented to (and presumably ratified by) the full audit committee at each of its scheduled meetings. Approval of non-audit services must be disclosed in periodic reports. (The statute provides a de minimis exception for pre-approval of non-audit services under very limited circumstances and with a requirement that the audit committee approve such services prior to the completion of the audit.)

Standards Applicable to Audit Relationship

- The audit committee must select the company's auditors.
- The auditors must report to the audit committee and must particularly report with respect to:
    - All critical accounting policies and practices used;

- All alternative treatments of financial information within generally accepted accounting principles (GAAP) that have been discussed with management as well as the ramifications of these alternatives and the treatment preferred by the audit firm; and
    - Any other material written communications between the audit firm and management (including the management letter and schedule of unadjusted differences).
- The audit firm's partner in charge of the client relationship must be rotated after five years.
- The audit firm may not perform an audit for any company whose CEO, Controller, CFO, Chief Accounting Officer or any person serving in an equivalent position, was employed by the audit firm during the one-year period preceding the initiation of the audit and participated in any capacity in the prior audit of that company during the preceding year.
- In addition, it is unlawful for the audit firm to undertake the audit if any of the qualification provisions above (including the provision requiring pre-approval of non-audit services) has not been satisfied. There is no apparent time limit in the statute on this provision.

ROLE OF THE AUDIT COMMITTEE

Present listing standards require companies have an audit committee. The statute requires that the Commission, **not later than April 26, 2003**, direct the national securities exchanges and associations to prohibit the listing of any security of a company not in compliance with the statute's provisions related to Audit Committee Authority and Responsibility and Composition, each discussed below.

Audit Committee Authority and Responsibility

- To engage (including negotiation of compensation) and to oversee the audit firm (the audit firm reports directly to the audit committee).
- To engage independent counsel and other advisers as determined necessary.
- To determine funding for each of the auditors and the advisers; the statute mandates that companies provide such funding.
- To establish procedures
    - for dealing with complaints received by the company regarding accounting, internal accounting controls or audit matters; and
    - for the confidential anonymous submission by employees of concerns regarding accounting or auditing matters.

Audit Committee Composition

While the statute does not mandate a minimum number of directors for an audit committee, all committee members must be independent. Independence requires that the audit committee member receive no compensation from the company other than in his or her capacity as a member of the board of directors or the audit or other board committees. Further, an audit committee member is not independent if that person is an affiliated person of the company or any subsidiary. The statute does not define "affiliated." (One collateral result of this independence standard is that while the statute contemplates that in the absence of a committee, the entire board of directors is the audit committee, such a position is impossible if the board has any management member.)

We expect that the standard of independence, when superimposed upon the proposed changes to listing requirements by the New York Stock Exchange and Nasdaq, will alter the proposals in one significant respect-the prohibition of **any** compensation other than in the role as director and committee member. The Nasdaq proposal would have expressly permitted such compensation to the level of $60,000. The New York Stock Exchange proposal, while silent on the issue, would not have prohibited it per se. For the present, we are assuming that the affiliation limitations in the proposals of both exchanges, reflected in our advisory of July 17, 2002 (Part 2 of this series) are those that will be imposed on the definition of "independence" for audit committee membership. We are unaware of any action contemplated by the Commission that would further refine the standards of independence.

Disclosure of Audit Committee Financial Expertise

Each company will be required to disclose whether or not its audit committee includes at least one member who is a "financial expert" and if such is not the case to disclose the reasons the committee is lacking such a member. While the statute expressly leaves to the Commission the responsibility of proposing (by October 28, 2002) and implementing (by January 26, 2003) a final rule to implement this "financial expert" provision, the statute generally provides for the Commission's consideration of a number of factors, all of which center around an individual's prior education or experience with financial statements. The provision is also effective upon the Commission's issuance of final rules; unlike the two previous provisions, however, these final rules must be issued **not later than January 26, 2003**.

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