

Client Advisory

August 2002

President Bush Signs Sarbanes-Oxley Act of 2002 into Law to Address Accounting and Corporate Governance Concerns

Several New Corporate Reporting and Governance Provisions Effective Immediately

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002 (the S-O Act). The S-O Act, which had been approved by a unanimous Senate and a nearly unanimous House, attempts to address many of the accounting and corporate governance issues raised by the collapse of Enron, Global Crossing and WorldCom. You can find the text of the S-O Act at the Library of Congress's Web site at <http://thomas.loc.gov>.

A number of critically important provisions of the S-O Act became effective on the date of enactment, with others to become effective over the next several months. One immediately effective provision, Section 906 (described below), will require that *all* periodic reports containing financial statements filed by a company under the Exchange Act (including upcoming Form 10-Q filings) be accompanied by a written statement from the chief executive officer and chief financial officer certifying 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 company. Section 302 of the S-O Act (described below), requires that within 30 days of the enactment of the S-O Act, the SEC adopt even broader certification requirements for CEOs and CFOs.

Much of the S-O Act (and much of the media coverage of the S-O Act) concerns the establishment of an independent board to oversee the accounting industry. Because of the time permitted by the S-O Act to allow that independent board to become functional and begin registering firms that will then be permitted to audit the financial statements of public companies, the effect of the provisions of the S-O Act related to the independent board may not be felt by public companies for more than a year.

Seven provisions of the S-O Act that became effective upon enactment are summarized below in Part I. Two other provisions that will become effective on or before the 30th day following the enactment of the S-O Act are summarized in Part II. Companies may want to focus special attention on the following sections of the S-O Act, which are likely to be of particular importance to most companies:

- Section 202 (audit committee pre-approval of audit and non-audit services);
- Sections 302 and 906 (certification of periodic reports);
- Section 402 (prohibition of loans to executive officers); and
- Section 403 (acceleration of certain filings required by Section 16 of the Exchange Act).

In the near future, Katten Muchin Zavis Rosenman will issue another Client Advisory focusing on provisions of the S-O Act that will become effective six to nine months following its date of enactment.

Part I: Immediately Effective Provisions of the S-O Act

Auditor Independence (Title II)

Audit Committee Pre-approval Requirements (Section 202). The Exchange Act was amended to require that the audit committee of a company must pre-approve all audit and non-audit services to be provided to the company by its auditors, unless the non-audit services fall within certain *de minimus* exceptions. The S-O Act permits the delegation of pre-approval authority to one or more independent members of a company's audit committee. It is not yet clear whether this approval requirement applies to services already in the process of being performed. The new provision also requires that all non-audit services to be performed by the auditor of a company must be disclosed to investors in that company's periodic reports under the Exchange Act. Because the S-O Act directs the Securities and Exchange Commission (SEC) to adopt implementing regulations with respect to these requirements within six months of enactment, there is some uncertainty as to whether they are intended to be currently effective. It is hoped that the SEC will provide prompt guidance on these issues, including as to what, if any, disclosure is required in the Form 10-Qs to be filed by August 14, 2002.

Corporate Responsibility (Title III)

Forfeiture of Certain Bonuses and Profits (Section 304). Effective immediately, if a company is required to restate its accounts due to the material noncompliance of that company, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and the chief financial officer of that company must reimburse the company for (1) any bonus or other incentive-based or equity-based compensation received by that person during the 12-month period following the first public issuance or filing with the SEC (whichever comes first) of the financial document embodying that financial reporting requirement, and (2) any profits realized from the sale of securities of the company during that 12-month period. Unlike Section 16(b) of the Exchange Act, which provides an explicit right of action by companies and stockholders to recover "short-swing profits" realized by officers, directors and certain substantial stockholders, the S-O Act does not specify how the reimbursable bonuses and profits are to be recovered. It also leaves to future interpretations (by the SEC and the courts) what constitutes "material" noncompliance of the company, the nature of the misconduct required to be shown, and how equity-based compensation is to be valued for purposes of reimbursement.

Officer and Director Bars and Penalties (Section 305). The Exchange Act and the Securities Act were amended to provide that a Federal court may determine that a person who has violated certain securities laws may not serve as an officer or director of a company if the person's conduct demonstrates his or her "unfitness" (as opposed to the previous standard of *substantial* unfitness) to serve in that capacity. Additionally, the S-O Act amends the Exchange Act by providing that in any action brought by the SEC under any provision of the Federal securities laws, the SEC may seek, and any Federal court may grant, any equitable relief that may be appropriate and necessary for the benefit of investors.

Enhanced Financial Disclosure (Title IV)

Enhanced Conflict of Interest Provisions (i.e., prohibition of personal loans to executives) (Section 402). The Exchange Act was amended to provide that it shall be unlawful for a company to directly or indirectly extend or maintain credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer of that company. A loan made by the company on or before July 30, 2002, is not subject to these new restrictions, as long as there is no renewal of the loan or material modification to any of its terms. There are limited exceptions to this loan prohibition, including certain home improvement or manufactured home loans, certain consumer credit extensions and certain loans by registered brokers or dealers or FDIC insured institutions, provided that these loans are made in the ordinary course of the company's business and are of the same type and made on the same terms offered by the company to the general public.

Enhanced Review of Periodic Disclosures By Companies (Section 408). The SEC is directed to review periodic reports (including financial statements) filed under the Exchange Act by companies having securities listed on a national securities exchange or traded on an automated quotation facility of a national securities association (Nasdaq), on a regular and systematic basis, *and in no event less frequently than once every 3 years*. Based on the factors that Congress has directed the SEC to consider when scheduling reviews, certain companies will be more likely to be the subject of frequent and thorough reviews, including companies that have made material restatements of financial results, companies with unusually high volatility in their stock prices, companies with the largest market capitalization, emerging companies with disparities in price to earning ratios, and companies whose operations significantly affect any material sector of the economy.

Corporate and Criminal Fraud Accountability (Title VIII)

Protection for Employees of Publicly Traded Companies Who Provide Evidence of Fraud (i.e., whistleblower protection) (Section 806). Effective immediately upon enactment of the S-O Act, no company, nor any officer, employee or agent of any company, may discharge, demote, suspend, threaten, harass or in any other manner discriminate against an employee because of a lawful act done by the employee (1) to provide information or otherwise assist in an investigation conducted by a Federal regulatory or law enforcement agency, any member or committee of Congress, or a person with supervisory authority over the employee regarding any conduct that the employee reasonably believes constitutes a violation of certain Federal statutes, any rule or regulation of the SEC, or any provision of Federal law relating to fraud against shareholders, or (2) to file, testify, participate in or otherwise assist in a proceeding filed or about to be filed related to an alleged violation of certain Federal statutes, any rule or regulation of the SEC, or any provision of Federal law relating to fraud against shareholders. An employee bringing a successful action under these provisions is entitled to “all relief necessary to make the employee whole,” including reinstatement with full seniority, back pay with interest, and recovery of special damages, including litigation costs, expert witness fees and reasonable attorney’s fees.

White-Collar Penalty Enhancements (Title IX)

Certification of Financial Reports by CEOs and CFOs (Section 906). Effective immediately upon enactment of the S-O Act, each periodic report (Forms 10-Q and Form 10-K, for example) containing financial statements filed by a company with the SEC must be accompanied by a written statement of the chief executive officer and chief financial officer of the company certifying that the periodic report fully complies with the requirements of Sections 13(a) or 15(d) of the Exchange Act and that the information contained in the report fairly represents, in all material respects, the financial condition and results of operations of the company. Note that the information to be certified is not limited to that contained in the financial statements and necessarily includes the MD&A and other parts of the report. If a chief executive officer or chief financial officer of a company provides this certification *knowing* that the periodic report accompanying the statement does not comport with all requirements of the provision, he or she is subject to criminal penalties, including a fine of up to \$1 million, and/or imprisonment of not more than 10 years, and if he or she *willfully* provides the certification with such knowledge, the maximum fine is \$5 million, and the executive is subject to imprisonment for up to 20 years. For any company that has not yet filed its Form 10-Q for the period ended June 30, 2002 (due August 14, 2002), these certifications will need to accompany that Form 10-Q. It is hoped that the SEC will shortly provide guidance as to how these certifications should be made (for example, as exhibits to filings or as accompanying correspondence).

Part II: Provisions Effective Within 30 Days of Enactment of S-O Act

Corporate Responsibility (Title III)

Expanded Certification of Financial Reports by CEOs and CFOs (Section 302). Within 30 days of the enactment of the S-O Act, the SEC is required to adopt rules providing that the principal executive officer and the principal financial officer of a company must certify in the company’s periodic reports under the Exchange Act that:

- the signing officer has reviewed the report;
- to the officer’s knowledge, (1) the report is materially accurate and complete and (2) the financial statements contained in the report present fairly in all material respects the financial condition and results of operations of company;
- the signing officers (1) are responsible for establishing and maintaining internal controls of the company to ensure that material information is communicated to those officers, (2) have evaluated the effectiveness of the internal controls and (3) have presented in the filed report their conclusions as to the effectiveness of the internal controls;
- the signing officers have disclosed to the company’s audit committee and auditors (1) any significant deficiencies in the company’s internal controls and (2) any fraud, whether material or not, by management or top employees of the company; and
- the signing officers have described any significant changes in internal controls or other factors that could affect subsequent reporting of the company.

A similar (but not identical) certification scheme was proposed by the SEC on June 14, 2002 (SEC Rel. No. 34-304069). Presumably, the SEC will withdraw or modify its proposal in light of the new Section 302 requirement.

Enhanced Financial Disclosure (Title IV)

Disclosure of Transactions Involving Management and Principal Stockholders (Section 403). Effective 30 days after the enactment of the S-O Act, Section 16(a) of the Exchange Act is amended to provide that each officer, director and owner of more than 10% of any class of registered equity securities of the company must file a statement with the SEC (presumably on a Form 4) if there has been a change in that person's ownership of the company's equity securities, or if that person has purchased or sold a security-based swap agreement involving those equity securities, *before the end of the second business day following the day on which the subject transaction has been executed.* This is a significant departure from the prior reporting requirement, which provided generally that such transactions did not have to be reported until the tenth day of the month following the month in which the transaction occurred. Additionally, effective one year after the enactment of the S-O Act, the Section 16 disclosure statements must be filed with the SEC electronically, and a company must post each statement on its corporate Web site (unless it does not have one) not later than the end of the business day following the filing of the statement.

We Can Help

The S-O Act is notable for its scope and the rapidity with which it moved through Congress. As might be expected when legislation of such complexity is passed so quickly, the S-O Act raises many questions that companies should discuss with legal counsel. Please direct questions regarding the issues discussed in this Client Advisory to the co-chairs of KMZ Rosenman's Securities Practice:

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08/01/2002