

Client Update

August 2002

The Sarbanes-Oxley Act of 2002

I. Introduction

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002 ("Act"). The Act has introduced significant corporate governance and reporting changes to over 17,000 public companies that file reports or have registered securities with the Securities and Exchange Commission ("SEC"). These companies must give prompt attention to their efforts to comply with the new laws, many portions of which became effective on July 30, 2002. Please note that some of the provisions of the Act may also apply to non-public companies.

What gave rise to the most sweeping securities law changes in decades? In short, the recent stock market plunge and the ongoing revelations by major U.S. corporations such as

ABOUT THIS UPDATE

New Corporate Reform
Law Ushers In Era Of
Sweeping Changes.

Enron, Tyco, WorldCom, Adelphia and others of substantial accounting and operating irregularities. Although there have been a number of scandals over the past 20 years (e.g., insider trading, junk bond financing and takeover abuses, savings and loan crisis), the present situation is unprecedented in its suddenness and size. The first seven months of 2002 have produced five of the ten largest bankruptcies in U.S. history.

The present scandals share many common elements:

- A failure to timely disclose important developments;
- Inaccurate or incomplete disclosure, particularly financial information;
- Senior management receiving substantial compensation packages and selling company securities when their company had significant, undisclosed problems;
- The failure of the board of directors to either exercise reasonable diligence over management or correct identified problems; and
- Outside auditors' willingness to accept or accommodate management initiatives or practices which ultimately were proven to be improper or illegal.

SHEPPARD, MULLIN, RICHTER & HAMPTON LLP

LOS ANGELES
(213) 620-1780

SAN FRANCISCO
(415) 434-9100

ORANGE COUNTY
(714) 513-5100

SAN DIEGO
(619) 338-6500

SANTA BARBARA
(805) 568-1151

WEST LOS ANGELES
(310) 824-0097

DEL MAR HEIGHTS
(858) 720-8900

II. The Act

The Act represents Congress' initial response to these corporate scandals and abuses. The Act is sweeping in its scope and places new requirements on a number of constituencies, including: directors and officers of public companies that have securities registered under the Securities and Exchange Act of 1934, as amended, ("Exchange Act"), and outside professionals – auditors, financial analysts and attorneys. The Act instructs the SEC to implement various regulations and procedures by certain identified deadlines (ranging from 30 to 360 days in most cases).

Although the Act contains a number of new statutes, it can be categorized into four basic areas:

- Corporate Governance – Director and Officer Responsibilities for Corporate Reporting;
- Expanded and Enhanced Company Disclosure;
- New Crimes and Penalties; and
- Audit Practices and Procedures.

This newsletter will focus primarily on the impact of the Act on public companies rather than its effect on audit practices, the audit profession or financial analysts; and is principally directed to public company directors and officers and those that advise them. This is not intended to diminish the importance of the new auditor independence and practice requirements (which are enormously significant) or other changes such as the rules dealing with financial analysts. Finally, please recognize that, due to substantial public and political pressure, the Act was prepared and adopted in a matter of weeks. The Act has not benefited from the careful analysis and public commentary that are critical to most well-crafted laws. Undoubtedly, during the next several months we will witness a considerable amount of confusion, as the various problems and conflicts lurking in the Act are uncovered.

III. The Act's Impact on Public Company Directors and Officers

The Act changed and provides for new legal requirements in three key areas: (a) corporate governance, (b) enhanced disclosure and (c) increased SEC enforcement powers, civil and criminal penalties, all of which will materially affect the responsibilities of directors and officers.

A. Corporate Governance:

- **Role of the Audit Committee.** The role of the audit committee has been greatly expanded and stricter independence standards for audit committees have

been adopted. Additionally, audit committees will have enhanced responsibility for overseeing independent auditors including pre-approval of all non-audit services by any independent auditor. New requirements regarding the treatment of complaints concerning accounting and compliance with securities laws, and greater disclosure about audit committee activities and responsibilities are also part of the Act.

- **Certification of Annual and Quarterly Reports filed with the SEC.** The Act requires that the principal executive officer or officers and the principal financial officer or officers, or persons performing similar functions, certify in each annual and quarterly report filed under the Exchange Act that:

- The signing officer has reviewed the report;
- Based on the officer's knowledge, the report is true and not misleading;
- Based on the officer's knowledge, the financial statements and information included in the report is accurate;
- The signing officers must:
 - be responsible for establishing and maintaining internal controls;
 - have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within the company; and
 - have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date.
- The signing officers have disclosed to the company's auditors and the audit committee of the board of directors the following:
 - all significant deficiencies in the design or operation of internal controls and have identified those material weaknesses to the auditors; and
 - any fraud that involves management or other employees who have a role in the internal controls.
- The signing officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation.

A significant inconsistency (and controversy) in the Act exists with respect to the effective date of the certification requirements. Section 906 of the Act, which establishes the certification requirement for periodic reports under the Exchange Act, states that it is immediately effective. Section 302 of the Act, however, directs the SEC to adopt such a rule within 30 days. Congressional and SEC sources are advising that Section 906 governs, and that the certification requirement is immediately effective. The effect of this posture will be felt almost immediately because many public companies have a Form 10-Q due on August 14, 2002 for the period ended June 30, 2002. An immediate issue will concern exactly how to submit such a certification to the SEC and what it should provide, if any, in the way of limitations. The SEC has previously told the 947 largest public companies (revenues in excess of \$1.2 billion), who had previously been ordered by the SEC to file such a certification by August 14, 2002, that there can be no qualifications to such certifications. We expect to issue another update very shortly outlining the procedures companies should follow to comply with the new certification requirements.

- **Loans to officers and directors.** The Act prohibits companies from, directly or indirectly, extending or maintaining personal loans to their directors or executive officers, other than certain consumer credit arrangements: (i) made in the ordinary course of business; (ii) similar to those generally made available by the company to the public; and (iii) made on market terms. The Act excludes personal loans already existing on the day of enactment as long as such loans are not extended or modified. *This provision of the Act is effective immediately.*
- **Reimbursement of bonuses and stock sales.** In the event of certain company misconduct or as a result of material noncompliance with the SEC's rules and regulations, the company's chief executive officer and chief financial officer may be required to reimburse the company for (i) any bonus or other incentive-based or equity based compensation such person received from the company during the 12-month period following the first public issuance or filing with the SEC of the financial document that did not comply with such financial reporting requirement; and (ii) any profits realized from the sale of securities of the company during such period. *This provision of the Act is effective immediately.*

- **No stock sales during a "black-out" period.** No director or executive officer may trade in any equity security of a company during a "pension fund black-out period" if such security was acquired in connection with his employment as a director or executive officer. A "pension fund black-out period" is a period during which participants in the company's 401(k) plan or certain similar plans are subject to any of several specified restrictions on trading in company securities held for their account in such plans. Any profit earned by such prohibited trading may be recovered by the company or a shareholder.
- **Adoption of Code of Ethics.** Companies are required to disclose in their SEC reports whether they have adopted a code of ethics for their senior executives and, if not, the reasons why.

B. Expanded and Enhanced Company Disclosure:

- **Accuracy of SEC Reports and Adjustments.** The Act requires that all financial reports filed with the SEC that are to be prepared in accordance with generally accepted accounting principals reflect all material correcting adjustments identified by a company's independent auditors.
- **Restrictions on use of Pro Forma Information.** The Act requires companies to reconcile any pro forma information with their financial condition and results of operations as presented in accordance with generally accepted accounting principles.
- **Off-Balance Sheet Matters.** In their SEC reports, a company must disclose all material, off-balance sheet matters, including any relationships with any unconsolidated subsidiaries or persons that could have a material affect on the company.
- **Disclosure of Insider Transactions.** Company insiders will be required to disclose their purchases or sales of company securities on an accelerated basis. Such disclosure will generally be required within two business days of the trade or other event requiring the filing.
- **Internal Control Report.** Companies will be required to include in their annual reports an internal control report that sets forth management's responsibility for establishing and maintaining adequate internal controls and assessing the effectiveness of such controls on an annual basis.

C. New Crimes and Penalties

1. **New Crimes:** The Act adds five new crimes of which directors and officers should be aware:

- **Destruction or Falsification of Records.** A new felony, with a 20-year maximum sentence, prohibits destruction, concealment or falsification of records with the intent to obstruct or influence the investigation or “proper administration” of any matter within federal jurisdiction or a bankruptcy case. The Act also prohibits such conduct “in relation to or contemplation of any such matter or case,” such as records tampering in contemplation of a bankruptcy. This change addresses an unsuccessful defense by Arthur Andersen in its prosecution for tampering with evidence, that it stopped destroying records when it learned the SEC had begun a formal investigation. This crime applies to employees of non-public companies.
- **Tampering With Evidence.** The Act doubles the penalty for the conduct for which Arthur Andersen was convicted. Previously, it required an attempt to kill a witness or informant to merit 20 years in prison. Now this penalty can be imposed for criminal shredding.
- **Securities Fraud.** The legislation adds a new 25-year felony for securities fraud, committed against public companies. Criminal violations of Rule 10b-5 will now allow 20-year terms and, for corporations, a maximum of a \$25 million fine.
- **Non-Compliance with Certification Rules.** The Act creates a new 10-year felony when a public company’s chief executive officer or chief financial officer certifies a financial statement that he or she knows is not in compliance with the certification rules. The penalty doubles to 20 years if the false certification is willful. Although the legislation is vague, creating two felonies for the same act indicates negligence may lead to 10 years in prison. No scheme to defraud (as in other fraud statutes) is required. Existing crimes require that the signer must know he is signing a financial statement for filing with the SEC that is materially false or contains a material omission. However, it would be difficult to find another crime — federal or state — that exposes a

document signer to 10 years in prison when he or she lacks criminal intent. Particularly here, where so many subordinates are involved in the creation of the document.

- **Retaliation Against Informants.** A 10-year felony for “Retaliation Against Informers” is included in the Act. Anyone with the intent to retaliate, who takes any actions “harmful,” including interference with work, or against a person who provides any truthful information to any law enforcement officer, relating to even the possible commission of a federal offense, may be prosecuted as a felon. An employee, about to be disciplined or terminated, with any information, partially true and arguably related to any federal offense, would qualify for protection by passing it along to any cop or sheriff or agent or inspector-general. The retaliator simply needs to be aware that a tip has been passed by the employee. This crime applies to employees of non-public companies.
2. **New Penalties.** The Act increases criminal penalties, allows investors more time to sue, denies bankruptcy protection to securities violators and gives the SEC more enforcement powers over internal company decisions.
- **White Collar and ERISA Penalties.** A portion of the Act is entitled “White Collar Crime Penalty Enhancement Act of 2002.” To deal with securities fraud, even if it is committed against non-public companies, this portion of Act adds 15 more years to the formerly five-year felonies of mail and wire fraud. One envelope or one phone call has always been enough to support a mail fraud charge with a five year term. Now, a 37¢ stamp could be worth 20 years. Criminal ERISA violations, formerly one-year maximums, now become 10-year felonies.
 - **Statute of Limitations.** Private actions for securities fraud won’t be time-barred now if filed within two years of discovering the facts or within five years of the violation, whichever occurs earliest.
 - This may have a bigger impact on litigation over unregistered securities. SEC announcements and restatements typically produce litigation within days or weeks of “discovery.”

- This applies to both public and non-public companies.
- **Discharging Debts Arising from Securities Violations.** The Act also amends the Bankruptcy Code to make non-dischargeable: judgments, consent orders, settlement agreements, fines, penalties, restitution, disgorgement payments, attorney’s fees, court costs and anything else, if those debts arose from federal or state securities violations.
 - The litigation could have been criminal or civil, governmental or private.
 - This amendment applies whether the company whose securities were the subject of a violation is public or private.
- **Expanded Power of the SEC To Freeze Assets.** The final part of the legislation is titled the “Corporate Fraud Accountability Act of 2002.” Its most unusual feature is a Securities Exchange Act amendment, giving the SEC power to petition a federal court for a freeze order on “extraordinary payments (whether compensation or otherwise)” when it is investigating a company or its personnel and believes such payments are about to be made to directors, officers, partners, controlling persons, agents or employees.
 - Will this be used to control compensation to persons under investigation?
 - Will this be used to deny persons under investigation their rights to be defended or to be indemnified by their employer?
 - What is “extraordinary” to the SEC may be quite ordinary to the intended recipient.
 - It need not be related to any subject being investigated.

Fortunately, the escrowed frozen funds will accrue interest — if and when no charge is filed, the freeze order expires and the funds are returned to the company or the affected person. The freeze can last as long as 90 days, long enough to wreak considerable damage, depending upon the sums involved and whether the intended recipient can wait for the SEC’s anxieties to be satisfied.

IV. Whistleblower Protections

The Act gives protection to employees of public companies from “lawful” whistle-blowing.

- Employees are protected if they inform on or assist in the investigation of violations of mail fraud, wire fraud, bank fraud, the newest securities fraud (see below), any federal law relating to shareholder fraud, or SEC rules or regulations.
- The information or assistance can be to federal regulators, or to law enforcement agents, to Congress, or to a person who supervises the whistleblower or is investigating misconduct for the company. Already, the White House and Congress disagree as to whether tipping off a Congressman without an investigation underway is protected.
- Whistleblowers are protected if they file a proceeding involving the above-listed violations, or testify or assist in it.

Whistleblowers must complain first to the Secretary of Labor before suing on this new private cause of action. The statute of limitations is 90 days.

- In contrast, a bank employee who suffers retaliation as a consequence of informing on money laundering activities, has two years to file suit and need not ask the Treasury Secretary to act first. Not only is direct whistleblowing given its own federal cause of action, mere assistance to another, who might call a Congressional office or a bank regulator, becomes actionable.
- Assisting in a “proceeding” seems to include all forms of assistance, large or small, in a shareholder suit or arbitration.
- The only qualification on the integrity of the whistleblower, in order to deserve these protections, is that his/her act be “lawful.” It is unclear what “lawful” means in the context of the Act.

V. Attorneys

The Act requires the SEC to issue standards of professional conduct for “attorneys appearing and practicing before the Commission in any way in the representation of issuers . . .,” including a rule requiring the attorney to report evidence of securities violations or breaches of fiduciary duty to the company’s chief legal counsel or CEO (or equivalent).

- This provision is a reaction to a common belief that lawyers who were aware of corporate abuses in recently-publicized scandals did not do enough to prevent harm. The language is a reminder that a corporate lawyer's client is the corporation, not the individual officers and directors.
- The new law does not change the lawyer's duty to report to the client the discovery of abuses. Instead, it identifies the approved path of reporting abuses. There is no new requirement that a corporate lawyer ignore the attorney-client privilege which belongs to the client (the corporation) because the reporting requirement remains in-house.
- Attorneys "appearing and practicing before the Commission in any way" includes in-house and outside counsel. The phrase "in any way" suggests broad rule - making authority has been given to the Commission.
- Knowledge of a violation is not required. "Evidence" is.
- The language places the burden on every lawyer to decide what the "evidence" is, if it is "material," and what to do if the chief legal officer or CEO do not "appropriately respond to the evidence."
- Such language may prompt corporate counsel to seek independent advice or opinion letters.
- No new private cause of action is suggested.

VI. What's Next?

Given how quickly the Act was adopted and signed into law, it is likely there will be additional, substantial questions surrounding its provisions. The SEC, which has the responsibility for promulgating rules and regulations to carry out Congress' intent under the Act, will play a crucial role in the coming months fleshing out the details of the Act and settling many of these issues and uncertainties. Additionally, the possibility remains that Congress may take further action, particularly if new problems emerge.

Prior to adoption of the Act, the SEC in late 2001 had already begun a number of initiatives that were designed to address corporate misconduct and fraud abuses. The SEC's initiatives included: a review of all Fortune 500 companies; proposing expanded and accelerated disclosure of certain corporate events; requiring more detailed disclosure of corporate affairs, particularly in

management's discussion and analysis of financial statements; and directing the New York Stock Exchange and Nasdaq to review their corporate governance requirements and codes of conduct for their respective listed companies.

The National Association of Securities Dealers and NYSE are in the process of adopting corporate reform rules, subject to SEC approval, that will apply to companies listed on their respective exchanges.

Nasdaq is planning on approving as many as 25 new corporate governance proposals that will, among other things: require a majority of directors to be independent; mandate director continuing education; and require shareholder approval for all stock option plans.

The NYSE also has recommended to its board the following proposals: requiring listed companies to have a majority of independent directors; requiring listed companies to have a nominating/corporate governance committee proposed of entirely independent directors; requiring listed companies to have a compensation committee composed entirely of independent directors; increasing shareholder control over equity compensation plans; requiring the CEO of listed companies to verify to the NYSE each year compliance with NYSE standards; and enabling the NYSE to issue a public reprimand letter to any listed company that violates a NYSE listing standard.

VII. Summary

The Act and the other corporate reform measures that will be adopted by the SEC and the national stock exchanges will present corporate officers and directors with a rapidly changing landscape. In addition, Congress may take further action before the November elections that may further impact corporate governance, disclosure requirements, auditing and other related areas. Companies should move quickly to insure that they are adopting best practices to ensure they are in compliance with the provisions of the Act as they become effective, any new SEC rules promulgated under the Act and any of the measures being adopted by the national stock exchanges that may be applicable to them. The consequences of failing to comply with the Act are severe. Given the complexity and uncertainty surrounding the Act, if you are concerned about compliance with these new reform measures or other related issues you should consult with your legal counsel and auditors.