Congress passed the Sarbanes-Oxley Act of 2002 on July 25, 2002 and President Bush signed the Act into law on July 30, 2002. The Act aims to restore investor confidence in the public markets and seeks to prevent corporate and accounting fraud. Among other things, the Act:

- establishes a new regulatory body to oversee public company auditors;
- redefines the relationship between auditors and their clients;
- places direct responsibility for the audit relationship on audit committees;
- requires certification of periodic reports by CEOs and CFOs;
- bans most loans by public companies to officers and directors;
- restricts certain executive officer and director transactions;
- holds the CEO and CFO responsible for restatements due to misconduct;
- requires reporting of insider stock transactions within two business days;
- imposes new obligations and responsibilities on audit committees;
- imposes new rules of professional responsibility for lawyers and analysts; and
- increases criminal penalties and enforcement measures for securities-related offenses.

The Act’s provisions will become effective at different times, ranging from immediately upon enactment to later dates specified in the Act or the date on which the required implementing regulations become effective.

Matters Not Covered by the Act

The Act does not impose requirements with respect to several recent newsworthy topics such as:

- mandatory expensing of stock option compensation;
- additional protection of employee retirement plans;
- additional disclosure by foreign private issuers; or
- requiring public companies to switch audit firms periodically (though the Act requires that the SEC study this issue).
Analysis of the Act

A complete analysis of the Act is available on Schnader’s Web site at www.schnader.com. For more information about the Act, please contact one of the following Schnader attorneys:

Albert Dandridge at 215.751.2178 or adandridge@schnader.com

Clinton A. Stuntebeck at 215.751.2034 or cstuntebeck@schnader.com

Corporate Responsibility

• Audit Committees. Only independent directors may serve on a public company audit committee. Independent directors may not accept any consulting, advisory or other compensatory fees from the company (other than director and committee fees) and may not be an affiliate of the company or its subsidiaries. The audit committee must appoint and oversee the work of the company’s auditor. The audit committee must establish procedures for (1) the receipt, retention and treatment of complaints received by the company regarding accounting matters and (2) the confidential, anonymous submission of concerns by employees regarding questionable accounting matters. The audit committee must have authority and funding to hire independent counsel and other advisors. The auditor must report directly to the audit committee. (Section 301) [Effective not later than 270 days after enactment of the Act.]

• Certification of Financial Statements. Each annual or quarterly report filed with the SEC must be accompanied by a certification by the principal executive officer and principal financial officer that:

1. the signing officer reviewed the report;

2. based on the officer’s knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements, in light of the circumstances made, not misleading;

3. based on the officer’s knowledge, the financial statements and other financial information in the report, fairly present, in all material respects, the financial condition and results of operations of the company as of, and for, the periods presented in the report;
4. the signing officers (a) are responsible for establishing and maintaining internal controls; (b) have designed such internal controls to ensure that material information relating to the company and its consolidated subsidiaries is made known to the officers by others within the entity; (c) have evaluated the effectiveness of the internal controls within 90 days prior to the report; and (d) have presented in the report their conclusions about the effectiveness of the internal controls based on that evaluation;

5. the signing officers have disclosed to the auditors and the audit committee (a) all significant deficiencies in the design and operation of internal controls that could adversely affect the company’s ability to record, process, summarize and report financial data and have identified for the auditors any material weaknesses in internal controls, and (b) any fraud (whether or not material) that involves management or other employees who have a significant role in the internal controls; and

6. 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, including corrective actions. (Section 302) [Effective not later than 30 days after enactment of the Act.]

The Act also contains a second certification provision that requires the CEO and the CFO to certify that each periodic report containing financial statements fully complies with the requirements of the securities laws and that information in such report fairly presents, in all material respects, the financial condition and results of operations of the company. An officer who signs this second certification knowing that the report does not comport with the requirements being certified may be fined up to $1 million and/or imprisoned up to 10 years. A willful violation is punishable by a fine of up to $5 million and/or imprisonment of up to 20 years. (Section 906)

- **Improper Influence.** It is unlawful for an officer or director to fraudulently influence, coerce, manipulate or mislead any accountant engaged in an audit for the purpose of rendering financial statements materially misleading. (Section 303) [Effective not later than 270 days after enactment of the Act.]

- **Bonus and Compensation Forfeiture following Accounting Restatement.** If a public company is required to restate financial statements due to material noncompliance with the securities laws resulting from misconduct, the CEO and CFO must reimburse the company for any bonus, incentive-based or equity-based compensation, and any profits from the sale of the company’s securities, during the 12 months following the initial filing of the financial statements. (Section 304)
Insider Trades during Pension Fund Blackout Periods. Directors and executive officers are prohibited from purchasing or selling equity securities of the company during certain pension fund blackout periods. Any profits from such trades must be disgorged to the company. A company must notify officers, directors and the SEC of applicable blackout periods. There are additional ERISA notice requirements with respect to blackout periods for individual account plans. (Section 306) [Effective 180 days after enactment of the Act]

Enhanced Financial Disclosures

Accuracy of Financial Reports. Each report that contains financial statements filed with the SEC must reflect all material correcting adjustments identified by the auditor. (Section 401(a))

Off-Balance Sheet Transactions. Each annual and quarterly SEC report must disclose all material off-balance sheet transactions, arrangements, obligations and relationships of the company with unconsolidated entities or other persons that may have a material current or future effect on financial condition, results of operations, liquidity, capital expenditures, capital resources or significant components of revenues or expenses. (Section 401(a)) [Effective not later than 180 days after enactment of the Act]

Presentation of Pro Forma Financial Information. Pro forma financial information in SEC reports and press releases must be presented in a manner that (a) does not contain an untrue statement of a material fact or omit to state a material fact necessary to make the pro forma information not misleading, and (b) reconciles it with GAAP. (Section 401(b)) [Effective not later than 180 days after enactment of the Act]

Prohibition on Personal Loans to Officers and Directors. A public company may not, directly or indirectly, extend or maintain credit, or arrange for a personal loan to, any executive officer or director. An extension of credit maintained by a public company on the date the Act is enacted is not subject to this prohibition, provided that there is no material modification of any term or renewal of the extension of credit. Contracts providing for future loans to officers or directors (e.g. to cover stock option exercises or relocation expenses) are not expressly addressed by the Act. (Section 402)

Section 16 Reporting of Stock Transactions. Changes in equity ownership by directors, officers and 10% stockholders must be reported within two business days after the day of the transaction (unless the SEC determines that a longer deadline is necessary). Within one year of enactment of the Act, Section 16 filings will have to be filed electronically and posted on the company’s web site. (Section 403) [Effective 30 days after enactment of the Act.]
• **Internal Controls.** Annual reports must contain an internal control report, stating the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and containing an assessment of the effectiveness of the internal control structure and financial reporting procedures. (Section 404) [Effective date to be specified in future SEC rules.]

• **Code of Ethics for Senior Financial Officers.** Each issuer must disclose in Exchange Act reports whether or not (and if not, why not) it has adopted a code of ethics for senior financial officers. Changes in or waivers of this code of ethics must be promptly disclosed on Form 8-K. (Section 406) [Effective not later than 180 days after enactment of the Act.]

• **Audit Committee Financial Expert.** Exchange Act reports must disclose whether or not (and if not, why not) the audit committee is comprised of at least one member who is a financial expert, as such term will be defined by future SEC rule making. (Section 407) [Effective not later than 180 days after enactment of the Act.]

• **Enhanced SEC Review.** The SEC must review disclosures, including financial statements, made by public companies at least once every three years. (Section 408)

• **Real Time Disclosures.** Public companies must disclose in plain English and “on a rapid and current basis” such information regarding material changes in their financial conditions or operations, including trend and qualitative information and graphic presentations, as the SEC may mandate. (Section 409)

**Professional Responsibility Rules for Attorneys**

• The SEC will issue rules setting minimum standards of professional conduct for attorneys practicing before the SEC in the representation of public companies, 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 a company or its agents to the chief legal counsel or CEO of the company. If the chief legal officer or CEO does not appropriately respond, the attorney must report the evidence to the company’s audit committee, another board committee comprised solely of independent directors or the entire board of directors. (Section 307) [Effective not later than 180 days after enactment of the Act.]

**Public Company Accounting Oversight Board**

• **Accounting Oversight Board’s Responsibilities.** The Act establishes an independent Public Company Accounting Oversight Board to oversee the audit of
public companies and related matters. The new Board is subject to oversight by the SEC. The Board’s primary responsibilities include: (1) registering public accounting firms; (2) establishing standards relating to preparation of audit reports; (3) inspecting, investigating and disciplining registered public accounting firms; (4) performing duties as the Board or the SEC deems necessary to promote high professional standards among registered public accounting firms; and (5) enforcing compliance with the Act and other securities laws related to the preparation and issuance of audit reports. (Section 101)

- **Board Membership, Appointment and Term.** The new Board will be comprised of five full-time members, two of whom (and only two) must be certified public accountants. The SEC, after consulting with the Chairman of the Federal Reserve System, appoints Board members. Each Board member serves for a staggered five-year term, and may not serve for more than two terms. (Section 101(e))

- **Registration with the Board.** Each public accounting firm must register with the new Board in order to be permitted to serve as the auditor of a public company. Registered firms must file annual reports with the Board and are subject to registration and annual fees. (Section 102)

- **Auditing Standards.** The new Board must adopt auditing standards, including requirements that auditors: (1) retain audit work papers and other relevant information for at least seven years; (2) provide concurring partner review and approval of audit reports; and (3) describe in each audit report the scope of the auditor’s testing of the issuer’s internal control procedures. (Section 103)

- **Inspections and Sanctions.** The Board must inspect accounting firms for violations of the Act, Board rules, SEC rules and professional standards - annually for firms auditing more than 100 issuers and at least every three years for other firms. The Board may impose civil sanctions on firms of up to $15 million for intentional and knowing violations and up to $2 million for other violations. Limits of $750,000 and $100,000 apply to individuals. (Sections 104 and 105)

- **Funding.** Public companies will pay fees to fund the Board based on the company’s market capitalization. (Section 109).

[The SEC must appoint the initial members of the Board not later than 90 days after enactment of the Act. The Board must take all necessary and appropriate action to enable the SEC to determine that the Board is organized and capable of carrying out and enforcing the Act not later than 270 days after enactment of the Act]
Auditor Independence

• **Prohibited Non-Audit Services.** Registered public accounting firms may not provide specified non-audit services to their public company audit clients, including: (1) bookkeeping or services related to accounting records or financial statements of the company; (2) financial information systems design and implementation; (3) appraisal and valuation services, fairness opinions or contribution-in-kind reports; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker/dealer or investment adviser or investment banking services; and (8) legal services and expert services unrelated to the audit. (Section 201(a)) [Effective 180 days after the date of commencement of the new Board.]

• **Audit Committee Preapproval of Audit and Non-Audit Services.** Audit services and permitted non-audit services, including tax services, must be approved in advance by the public company’s audit committee. A de minimus exception applies if (a) the aggregate amount of non-audit services does not exceed 5% of the total revenue paid by the company to its auditor during the fiscal year in which the non-audit services are provided; (b) such services were not recognized by the company as non-audit services at the engagement; and (c) such services are promptly brought to the audit committee’s attention before the completion of the audit and approved by the audit committee or by one or more designated members of the audit committee who are empowered by the committee to grant preapprovals. Audit committee approval of non-audit services must be disclosed in Exchange Act reports. (Sections 201 and 202)

• **Audit Partner Rotation.** The lead (or coordinating) audit partner and the lead review partner assigned to a public company audit client must be rotated at least every five years. (Section 203)

• **Reports to Audit Committee.** An auditor must report to the audit committee on critical accounting policies used in the audit, alternative treatments of financial information discussed with management, and material written communications between the auditor and management, such as any management letter or schedule of unadjusted differences. (Section 204)

• **Conflicts of Interest.** A registered public accounting firm cannot perform any audit service if the company’s CEO, CFO, CAO or controller was employed by that accounting firm and participated in the audit of the company during the previous year. (Section 206)
Other Provisions

• **Research Analysts.** The SEC must adopt rules addressing conflicts of interest arising from research analysts recommending securities in research reports and public appearances. (Section 501) [Effective not later than 1 year after enactment]

• **Criminal Provisions.** The Act imposes criminal penalties for the destruction, alteration and falsification of documents in federal investigations and bankruptcy proceedings, extends the maximum prison term to 25 years for securities fraud, enhances white-collar crime penalties and imposes corporate fraud accountability. (Sections 802, 807, 901, 905)

• **Debts in Bankruptcy.** Debts arising from claims that result from violations of securities law cannot be discharged in bankruptcy. (Section 803)

• **Extended Statute of Limitations for Securities Fraud Claims.** The statute of limitations for private rights of action with respect to securities fraud is extended to the earlier of two years after the discovery of facts constituting the violation or five years after the violation. (Section 804) [Effective for all proceedings commenced after the date of enactment.]

• **Whistleblower Protection.** Public companies may not terminate, demote, threaten, harass or otherwise discriminate against an employee who lawfully provided information or assisted in an investigation relating to a violation of the securities laws or securities fraud. (Section 806)

• **Corporate Tax Returns.** It is the sense of the Senate that the CEO should sign a company’s federal tax return. (Section 1001)

• **Temporary Freeze Authority.** During a securities law investigation of a company’s directors, officers, controlling persons, agents or employees, if it appears to the SEC that the company is going to make extraordinary payments to any of the foregoing persons, the SEC may petition a federal court for a temporary order requiring the company to escrow those payments for 45 days. (Section 1103)

• **Officer and Director Bars.** The Act lowers the threshold for obtaining officer and director bars so that a finding of “unfitness,” rather than “substantial unfitness,” is required. The SEC is granted authority to prohibit a person who has violated the antifraud provisions of the securities laws from acting as an officer or director of a public company if the person’s conduct demonstrates unfitness to serve. (Section 305 and 1105)
Studies. The Act requires studies to be conducted of: (1) the adoption of a “principles-based” accounting system (Section 108(d)); (2) mandatory rotation of registered public accounting firms (Section 207); (3) past SEC enforcement actions to identify how such proceedings may be used to provide restitution to injured investors (Section 308(c)); (4) off-balance sheet transactions (Section 401(c)); (5) the consolidation of public accounting firms (Section 701); (6) credit rating agencies (Section 702); (7) securities professionals, including accountants, lawyers and investment bankers, involved in violations of securities laws (Section 703); (8) all enforcement actions involving violations of reporting requirements and restatements (Section 704); and (9) whether investment banks and financial advisers have assisted public companies in manipulating their earnings (Section 705).

Action Items for Public Company Executives in light of the Sarbanes-Oxley Act of 2002

Public company executives should be aware of the following practical actions required to comply with the Act:

Rapid Reporting of Stock Transactions. Beginning August 29, 2002, report changes in equity ownership within two business days after the transaction, rather than as in the past, waiting until the tenth day of the month following the transaction. Certain formerly exempt transactions, such as gifts and certain stock option exercises, also must be reported within two business days, rather than as in the past, waiting until the start of the year following the transaction.

Personal Loans. Do not borrow money from the company or materially modify any term of an existing company loan. The Act permits public company directors and officers to maintain existing loans, but prohibits new loans.

Certifications. Ensure that the company’s annual and quarterly reports filed with the SEC meet the certification requirements necessary to satisfy the corporate accountability provisions of the Act and the white collar criminal provisions of the Act.

Real Time Disclosures. Disclose in plain English and “on a rapid and current basis” information regarding material changes in the company’s financial condition or operations, including trend and qualitative information. The Act permits the SEC to establish rules to provide further guidance to companies on the scope and timing of these disclosures.

Audit Committee Adjustments. Ensure that all audit committee members are independent. Independent directors may not accept any consulting, advisory or other compensatory fees from the company (other than director and committee fees) and may not be an affiliate of the company or its subsidiaries. In addition, identify at least one audit committee member who is a financial expert, as that term will be defined by future SEC rule making.
Evaluate Non-Audit Services. Plan now to transition non-audit services from your company’s accounting firm to other providers. Beginning on January 26, 2003, the accounting firm that audits your company’s financial statements may not provide specified non-audit services to your company, such as financial information systems design and implementation, appraisal or valuation services or legal services.