SECURITIES

Covington & Burling

a summary of

Sarbanes-Oxley Act of 2002

July 26, 2002

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Yesterday, Congress passed, and sent to President Bush for signature, the Sarbanes-Oxley Act of 2002. The legislation imposes new duties on public companies and their executives, directors, auditors, plan administrators and attorneys, as well as securities analysts. It creates a new regulatory system for the audit profession and sets new standards for auditor independence. It gives the Securities and Exchange Commission more authority and resources. It expands criminal and civil liabilities in the securities area. Some say this law will require a fundamental change in the way public companies are governed and operated. Others believe this to be the most significant securities statute since the New Deal. All are unified in their hope that the legislation will contribute to broad restoration of trust in the integrity of the disclosure and accounting practices that inform our capital markets.

Hyperbole aside, this is a significant law that requires careful reading and analysis. Over the coming weeks, we will do just that. As with most large legislation, there are still many unanswered questions and ambiguities. Also, the full implications of certain provisions will await further action by the Securities and Exchange Commission. For now, however, in order to assist you in understanding what the Sarbanes-Oxley Act covers, we have prepared a summary of its significant aspects. Instead of a traditional title-by-title analysis, we have arranged our summary around topics that may help in focusing your thinking. We welcome any questions or comments on this summary and look forward to working with you as we further our understanding of each of the legislation's provisions.

Please feel free to contact me at (202) 662-5128.

David B. H. Martin
Securities Practice Group

Executive Summary

This is a summary of key provisions of the Sarbanes-Oxley Act of 2002 (the "Act"), passed by Congress on July 25, 2002. The Act represents sweeping legislation intended, among other things, to hold corporate executives and auditors more accountable to the shareholders of public companies. The effects of the Act are potentially far-reaching, and Covington & Burling looks forward to working with its clients in their efforts to understand, and comply with, this landmark legislation.

Directors and Senior Executives of Public Companies. The Act imposes new obligations and restrictions on directors and senior executives of public companies. Perhaps most significantly, the Act requires CEOs and CFOs to make extensive certifications in respect of each annual and quarterly report filed with the SEC. The SEC rules for this certification requirement will take effect not later than 30 days after President Bush signs the Act into law, now expected to be on July 30, 2002. A CEO or CFO who knows a certification is wrong may be subject to a fine of up to $5,000,000 and imprisonment of up to 20 years.

Other significant provisions that apply to public company directors and senior executives include

- prohibition on loans to directors and executive officers unavailable to outsiders;
- forfeitures by CEOs and CFOs of incentive pay and securities trading profits when there are accounting restatements based on misconduct;
- ban on trading by directors and executive officers in a public company's stock during pension fund blackout periods;
- prohibition of "improper influence" by directors and officers in the conduct of audits;
- authority for barring persons from serving as officers and directors of public companies; and
- acceleration of reporting deadlines for trades of company stock by directors, executive officers and 10% equity holders to as short as two days.

Audit Process and Oversight. The Act establishes the Public Company Accounting Oversight Board (the "Oversight Board") to oversee independent auditing firms of public companies, both in the United States and abroad. Specific independence provisions restrict firms from engaging in non-audit services.

The Act creates greater accountability of outside auditors to audit committees. The Act requires audit committee members to be independent and grants audit committees the authority to engage independent counsel and advisers. Audit committees are also required to establish procedures to protect corporate "whistleblowers." The SEC must direct national securities exchanges to prohibit listing any security of a public company that fails to comply with these provisions.

Under the Act, the SEC must require annual "internal control reports," subject to management assessment and outside auditor attestation. CEOs and CFOs will have to certify as to the effectiveness of internal controls on a quarterly basis.

Public Company Disclosures. The Act contains a number of provisions regarding SEC review of and rules for public company disclosure. Significantly, the Act authorizes the SEC to require public companies to disclose material changes in financial condition or operations on a rapid and current basis. The SEC must review disclosures made by public companies at least once every three years.

Other disclosure rules will cover

- off-balance sheet transactions;
- audit committee financial expertise;

- codes of ethics for senior financial officers; and

- pro forma financial disclosures.

Public Company Accounting Oversight Board. The five-member Oversight Board will be established as a non-profit entity to create a more uniform, comprehensive and detailed oversight regime for the process of auditing public companies. The Oversight Board will be funded by fees from accounting firms and public companies. It will issue rules for auditing, quality control and ethical standards for registered public accounting firms and will have the authority to inspect, investigate and impose sanctions on such registered accounting firms. All Oversight Board actions are subject to SEC review, and no rules of the Oversight Board may become effective without SEC approval.

Enforcement and Penalties. On the criminal side, the Act creates new penalties aimed at corporate disclosures and individual wrongdoers. CEOs and CFOs, who now must certify financial reports of their companies, may suffer severe fines and prison sentences of up to 20 years for failing to comply (noted above). The Act mandates that auditors of public companies retain their records for five years after an audit or face possible imprisonment. It subjects individuals who alter or destroy records in order to impede an official investigation to fines and up to 20 years of imprisonment. The Act also imposes or increases penalties for other white-collar crimes, such as securities, mail and wire fraud.

On the civil side, the Act contains provisions designed to assist securities plaintiffs. Civil plaintiffs now enjoy an expanded statute of limitations for securities fraud claims—they may bring a securities fraud lawsuit within two years of the discovery of the violation, or five years after the violation occurred, whichever is earlier. Under the Act's "Fair Funds" requirement, any ill-gotten gains and fines paid by corporate wrongdoers will be put into a disgorgement fund to benefit injured investors. Finally, a company will no longer be permitted to discharge in bankruptcy any order or settlement arising from a securities-related action.

Pension Fund Blackouts. The Act bars trading by directors and executive officers during a blackout period under a public company's § 401(k) and other individual account retirement plans. Any profits from trading in violation of this bar are recoverable. The Act also amends ERISA to require the administrator of a § 401(k) or other individual account retirement plan to provide advance notice of a blackout period to affected participants and beneficiaries. Notice failures will subject administrators to fines.

Miscellaneous. The Act imposes obligations on attorneys appearing before the SEC to report violations of securities laws and breaches of fiduciary duty by a public company or its agents to the chief legal counsel or CEO of the company. Under the Act, the SEC must also adopt rules to address conflicts of interest facing securities analysts. Finally, the Act's appropriations to the SEC for fiscal year 2003 represent a 77.21% increase over the appropriation for fiscal year 2002.

Effective Dates. The final section of the summary is a table setting forth key effective dates and deadlines for issuance of SEC rules under the Act.

David B.H. Martin
John M. Vine
Molly E. Bishop
Stephen J. Hess
Patrick H. McCaffery

If you have any questions concerning this material, please call any of the following members of our securities practice group:

London	Kelly Vance	44.20.7067.2040
Washington	David Martin	202.662.5128
	Bruce Baird	202.662.5122
New York	Bruce Bennett	212.841.1060
	Larry Silverman	212.841.1092
San Francisco	Andi Vachss	415.591.7069

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Sarbanes-Oxley Act of 2002

Introduction

On July 25, 2002, Congress passed the Sarbanes-Oxley Act of 2002 (the "Act").[*] The Act is intended to address weaknesses affecting U.S. capital markets that have been revealed by large and highly publicized business and audit failures. The following summary covers those parts of the legislation that are likely to be of most interest. We have arranged this summary by topical categories as follows: (A) Provisions Applicable to Directors and Senior Executives of Public Companies; (B) Audit Process and Oversight; (C) Provisions Applicable to Public Company Disclosure; (D) Public Company Accounting Oversight Board; (E) Enforcement and Penalty Provisions; (F) Pension Fund Blackout Provisions (G) Miscellaneous Provisions and (H) Effective Dates.

If you would like to receive a copy of the Act, which we can transmit electronically, please contact Mark McMickle of Covington & Burling at (202) 662-5091, mmcmickle@ cov.com.

A. Provisions Applicable to Directors and Senior Executives of Public Companies

1. Corporate Responsibility for Financial Reports (§§ 302, 906)

a. CEO and CFO Certification of Financial Reports (§ 302). Under the Act, the Securities and Exchange Commission ("SEC") must adopt regulations requiring each principal executive officer and principal financial officer of a public company to certify in each annual and quarterly report filed under the Securities Exchange Act of 1934 (the "1934 Act") that:

- the signing officer has reviewed the report;
- 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 made, in light of the circumstances under which such statements were made, not misleading;
- based on such officer's knowledge, the financial statements, and other financial information included 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;
- the signing officers

[*] Sarbanes-Oxley Act of 2002, H.R. Rep. No. 107-610 (2002).

  - are responsible for establishing and maintaining internal controls;

  - have designed such internal controls to ensure that material information relating to the company and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic report is being prepared;

  - have evaluated the effectiveness of the company's internal controls as of a date within 90 days prior to the periodic report; and

  - have presented in the report their conclusions about the effectiveness of the internal controls based on their evaluation as of that date;

- the signing officers have disclosed to the company's auditors and the board's audit committee

  - all significant deficiencies in the design or operation of internal controls which could adversely affect the company's ability to record, process, summarize and report financial data and have identified for the company's auditors any material weaknesses in internal controls; and

  - any fraud that involves management or other employees who have a significant role in the company's internal controls; and

- the signing officers have indicated in the report whether or not there were significant changes in internal controls or other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

These certifications are a significant change from previously pending SEC rules on this topic. Those proposals required narrower and, as to internal controls, only annual, certifications. The SEC rules implementing these provisions must be effective not later than 30 days after the date of enactment of the Act. We anticipate that the SEC will modify its pending rulemaking on certification of periodic reports (Release No. 34-46079, Jul. 14, 2002) to implement these provisions.

b. Corporate Responsibility for Financial Reports (§ 906). Effective immediately, the Act mandates that the CEO and CFO of any public company provide a written statement to accompany each periodic report containing a financial statement that the company files with the SEC. The statement must certify that the report "fully complies" with the SEC's requirements for such report under the 1934 Act and "fairly presents, in all material respects," the financial condition and results of operation of the company. Note that these standards differ from those contained in Section 302 of the Act (described in the previous section).

Until now, a false statement made knowingly and willfully in a periodic report subjected a defendant to as much as five years in prison and a fine. The Act increases these penalties for CEOs and CFOs. A CEO or CFO who submits a certification "knowing" that the periodic report accompanying the statement does not comport with "all the requirements" of this provision is subject to a fine of up to $1,000,000 and imprisonment of up to 10 years. A CEO or CFO who "willfully" certifies such a false report is subject to a fine of up to $5,000,000 and/or imprisonment of up to 20 years.

It is significant that this provision provides for criminal penalties in some situations even if the behavior was not willful. This may be intended to limit the ability of senior executives to disavow knowledge of accounting practices and company operations. Nonetheless, criminal statutes usually require a showing that the defendant behaved "willfully," that is, with an intent to violate the law. Although it is not entirely clear from the language of this provision, penalizing a CEO or CFO whose conduct is less than willful could result in a defendant being incarcerated for non-competent performance, rather than for any intent to break the law.

This provision will also provide an additional enforcement mechanism for Section 302 of the Act (described above).

2. Prohibition on Personal Loans to Directors and Executives (§ 402). Subject to certain limited exceptions, the Act prohibits any public company from, directly or indirectly, making, maintaining or arranging for loans to or for any of its directors or executive officers. The exceptions to this prohibition include certain extensions (a) of credit in respect of home improvement and manufactured home loans, (b) of consumer credit under an open end credit plan or a charge card and (c) of credit by certain brokers and dealers, in each case that are:

- made or provided in the ordinary course of the consumer credit business of such public company;
- of a type that is generally made available by such company to the public; and
- made by such company on market terms, or terms that are no more favorable than those offered by the company to the general public for such extensions of credit.

An extension of credit maintained by the public company on the date of the Act is "grandfathered" and not subject to this prohibition, provided that there is no subsequent material modification to any term of, or any renewal of, any such extension of credit. In addition, the prohibition does not apply to a loan made by an FDIC-insured depositary institution if the loan is subject to the insider lending restrictions of the Federal Reserve Act.

3. Improper Influence in the Conduct of Audits (§ 303). The Act prohibits any director or officer of a public company, or any other person acting under the direction of such a director or officer, from taking any action to "fraudulently influence, coerce, manipulate or mislead" any independent public or certified accountant engaged in the performance of an audit of the financial statements of such company for the purpose of rendering such financial statements materially misleading. The SEC must adopt rules to implement these restrictions and is granted exclusive civil authority to enforce them.

4. Forfeiture by CEOs and CFOs of Incentive Pay and Trading Profits (§ 304). If, as a result of misconduct, a public company restates its financial statements due to material noncompliance with financial reporting requirements, the Act requires that the CEO and CFO must reimburse the public company for certain incentive pay and securities trading profits. Specifically, this will cover (a) any bonus or other incentive-based or equity-based compensation received from the public company, and (b) any profits realized from the sale of securities of the company, all during the 12-month period following the first public issuance of the financials being restated.

5. Officer and Director Bars (§§ 305, 911). Under current law, before an officer or director who has violated certain securities laws can be barred from serving as an officer or director of a public company, the SEC must prove that the conduct of such person demonstrates "substantial unfitness" to serve in such capacity. The Act eliminates "substantially," thus addressing concerns that the standard for such bars has been too demanding. In addition, the SEC is empowered to prohibit any person who violates Federal securities laws, rules or regulations from acting as an officer or director of *any* public company.

6. Accelerated Disclosure of Transactions Involving Directors, Executive Officers and Principal Stockholders (§ 403). The Act has increased the reporting burdens for directors, executive officers and 10% equity holders of a public company. The Act requires such persons now to report any change in their ownership, or any purchase or sale of a security-based swap agreement involving such equity security, before the end of the second business day following the day the transaction has been executed (or such other time as may be established by the SEC). *Unless the SEC extends or modifies this new deadline, which it is authorized to do, this is a significant change in the reporting obligations of insiders*. Previously, such reporting was required by the tenth day of the month following the month in which the transaction occurred. While there had been some discussion of shifting these reporting obligations to public companies themselves, the Act has not made such a change. Accordingly, individuals will bear the onus of this shortened time period. Beginning not later than one year after the date of enactment of the Act, these ownership and trading reports will be required to be filed electronically and made rapidly available on the Internet.

7. Corporate Tax Returns (§ 1001). The Act also provides that it is the "sense of the Senate" that the Federal income tax return of a corporation should be signed by the CEO of that corporation. In general, the person signing a corporate tax return is potentially liable for perjury should it be subsequently established that the return was false and the signer knew of the falsity. While a sense of the Senate provision is not binding, it may create an expectation in certain circles that CEOs should be signing tax returns for their public companies.

B. Audit Process and Oversight

1. Establishment of the Public Company Accounting Oversight Board (§ 101). The Act provides for the establishment of the Public Company Accounting Oversight Board (the "Oversight Board"). The Oversight Board will have broad oversight powers, subject to SEC action and review, over all accounting firms (both U.S. and foreign) that conduct audits of public companies and must be registered with the Oversight Board.

2. Auditor Independence Standards. The Act includes specific provisions designed to make auditors more independent from their clients. The SEC must adopt regulations to implement these provisions. The specific auditor independence provisions include:

a. Non-Audit Services (§ 201). The Act states that it shall be unlawful for a registered accounting firm to perform any of eight non-audit services at the same time that such firm is conducting an audit:

- bookkeeping and 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 or dealer, investment adviser, or investment banking services; and
- legal services and expert services unrelated to the audit.

The Oversight Board may add other services to this list and may also grant exemptions to specific companies, registered accounting firms or to specific transactions on a case-by-case basis.

b. Pre-Approval Requirements (§§ 201, 202). If a service, such as tax services, is not one of the eight prohibited services listed in the Act and is not otherwise prohibited by the Oversight Board, then the activity may be conducted contemporaneously with an audit if such activity is pre-approved by the company's audit committee. The audit committee must approve all audit and non-auditing services provided by the auditing firm (subject to a *de minimis* exception). Non-audit services performed by an accounting firm that is not auditing the public company do not require audit committee approval. All required audit committee approvals shall be disclosed to investors in periodic reports filed with the SEC.

c. Audit Partner Rotation (§ 203). The Act makes it unlawful for a registered accounting firm to conduct an audit of a public company if either the lead or coordinating audit partner responsible for reviewing the audit performed any audit services for that company in each of the previous five years.

d. Conflicts of Interest (§ 206). It will be unlawful for a registered accounting firm to perform any auditing services for a company for a one-year period starting from the date the company has hired, as CEO, CFO, controller, chief accounting officer, or any equivalent position, a person formerly employed by such accounting firm who previously participated in the audit of such company.

e. Disclosure of Accounting Issues to Audit Committee (§ 204). Each registered accounting firm performing an audit must make timely reports to the company's audit committee during the audit process concerning (i) critical accounting policies and practices to be used in the audit, (ii) all alternative treatments of financial information within GAAP discussed with management, including the ramifications of such treatment and the treatment preferred by the accounting firm, and (iii) all other material written communications between the auditor and management of the company.

3. Responsibilities of Audit Committees Relating to Registered Public Accounting Firms (§ 301). The Act makes the audit committee of a public company directly responsible for the appointment, compensation and oversight of the work of a registered public accounting firm employed for the purpose of preparing an audit report or related work. As part of these responsibilities, the audit committee is charged with resolving disagreements between management and the auditor regarding financial reporting. The accounting firm is required to report directly to the audit committee. In addition, the Act prohibits directors and officers of public companies from interfering with accounting firms engaged in the performance of an audit.

4. Independence of Audit Committee Members (§ 301). In response to criticism about the close ties between audit committee members and management, the Act requires each member of the audit committee to be "independent." In order to be deemed "independent", unless exempted by the SEC, each such member is prohibited from accepting any fees from the company other than for service as a member of the board of directors or committee thereof.

5. Authority to Engage Independent Counsel and Advisers; Funding (§ 301). The Act grants audit committees the authority to engage independent counsel and other advisers necessary to carry out their duties. Information supplied to any such independent counsel by the company may not be protected by the attorney-client privilege. In addition, the Act requires each public company to provide for appropriate funding, as determined by the audit committee, for payment of compensation to the registered public accounting firm for the audit report and to any advisers retained by the audit committee to assist in carrying out its duties.

6. Treatment of Certain Complaints (§ 301). The Act provides protection for corporate "whistleblowers." The audit committee must establish procedures for the treatment of complaints received by the public company regarding accounting, internal accounting controls or auditing matters and the confidential, anonymous submission by employees of the public company of concerns regarding questionable accounting or auditing matters.

7. Delisting from Exchanges (§ 301). The Act directs the SEC to adopt a rule instructing the national securities exchanges and national securities associations to prohibit the listing of any security of a public company that fails to cure any non-compliance with the requirements of Section 301 for audit committees.

8. Management Assessment of Internal Controls (§ 404). Under the Act, the SEC must adopt rules requiring each annual report to contain an "internal control report" prepared by management. Such report must (a) set forth the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting and (b) contain an assessment, as of the end of the most recent fiscal year of the public company, of the effectiveness of the internal control structure and procedures of the public company for financial reporting. The management's assessment of the internal control report must be attested to by the registered public accounting firm that prepares the audit report for the public company. In addition, as discussed above, Section 302 of the Act requires the principal executive officer and the principal financial officer of a public company to certify as to the effectiveness of the company's internal controls in all periodic reports, including quarterly reports. These provisions do not apply to investment companies registered under the Investment Company Act of 1940.

C. Provisions Applicable to Public Company Disclosures

1. Public Company Disclosures; SEC Review

a. Real Time Disclosures (§ 409). The Act calls for public companies to disclose, in plain English and on a rapid and current basis, such information concerning material changes in financial condition or operations as the SEC may require. Currently, the SEC has two projects underway to increase and accelerate current reporting requirements under Form 8-K. Further use by the SEC of its new authority under Section 409 of the Act, could subject public companies to so-called "evergreen" disclosure requirements, where existing disclosure is required to be updated as material events occur. Any such change might moot the need for the SEC's Regulation FD, a recently adopted rule designed to prevent selective disclosure of material inside information. Upon adoption, that regulation was criticized as unnecessarily restricting or complicating corporate communications. Under current SEC interpretations and judicial decisions, absent an obligation under Regulation FD, public companies are at times permitted to defer disclosures of material events if no "duty to update" exists at that time.

b. Enhanced Review of Periodic Disclosures by Public Companies (§ 408). The Act requires the SEC to review disclosures made by, and the financial statements of, public companies on a regular and systematic basis and, for each public company, no less frequently than once every three years. The Act also sets forth specific criteria upon which the SEC must base its scheduling of reviews, which include, among other factors:

- companies that have issued material restatements of financial results;
- companies that experience significant volatility in their stock price;
- companies with the largest market capitalization; and
- any other factors that the SEC may deem relevant.

c. Disclosures in Periodic Reports (§ 401). The Act requires each financial report filed with the SEC to reflect all material correcting adjustments identified by the registered public accounting firm in accordance with GAAP and SEC rules and regulations. Under the Act, the SEC must adopt rules regarding pro forma financial information disclosed by public companies, whether in reports to the SEC or in any public disclosure or release, including earnings releases. The SEC rules will require

- pro forma financial disclosures to be presented in a manner that does not contain any untrue statement or omission of a material fact necessary to make the financial information not misleading; and

- pro forma financial data to be reconciled with the corresponding results under GAAP.

In addition, the Act directs the SEC to issue rules requiring each annual and quarterly financial report filed with the SEC to disclose all material "off-balance sheet" transactions.

2. Disclosure of Audit Committee Financial Expert (§ 407). The Act directs the SEC to issue such rules as are appropriate to require each public company to disclose, in its periodic reports, whether the board's audit committee has at least one member who is a "financial expert." The Act provides suggested criteria for considering someone to be a financial expert.

3. Code of Ethics for Senior Financial Officers (§ 406). The Act directs the SEC to adopt rules requiring each public company to disclose, together with its periodic SEC reports, whether such company has adopted a "code of ethics" for senior financial officers, applicable to its principal financial officer, comptroller and principal accounting officer. In the event that the public company has not adopted such a code, the disclosure referenced above must set forth the reasons for such failure. The SEC is also directed to revise its regulations concerning matters requiring prompt disclosure on Form 8-K to require the immediate public disclosure of any change in or waiver of the code of ethics of the public company. A "code of ethics" must have standards that are reasonably necessary to promote (a) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships; (b) full, fair, accurate, timely and understandable disclosure in the periodic reports required to be filed by the public company; and (c) compliance with applicable governmental rules and regulations.

D. Public Company Accounting Oversight Board

1. Organization of Public Company Accounting Oversight Board (§§ 101, 103, 107). The five-member Oversight Board will be organized as a nonprofit corporation established to create a more uniform, comprehensive and detailed oversight regime for the process of auditing public companies. Members of the Oversight Board serve-five year terms and are appointed by the SEC in consultation with the Federal Reserve Board and the Department of the Treasury. Under the Act, the Oversight Board will establish rules to regulate the auditing process, conduct periodic inspections of accounting firms, investigate possible violations of auditing rules and, if applicable, impose sanctions. The Oversight Board will be financed by registration fees charged to accounting firms and annual accounting support fees from public companies. A public company may calculate its support fee by multiplying the Oversight Board's annual budget by that public company's percentage of the total equity market capitalization for all public companies.

2. Auditor Registration (§§ 102, 106). Under the Act, an accounting firm may not conduct an audit of a public company unless the accounting firm is registered with the Oversight Board. Both the registration application and annual reports will be publicly available, subject to confidentiality laws and excluding information "reasonably identified" by the accounting firm as proprietary.

Foreign accounting firms that play a substantial role in preparing audit reports for public companies are required to register with the Oversight Board and shall be subject to the Act in the same manner as any U.S. public accounting firm. Unlike U.S. accounting firms, however, registration itself shall not provide a basis for subjecting a foreign accounting firm to the jurisdiction of U.S. state and Federal courts except in controversies between such firms and the Oversight Board.

3. Rule-making Power of the Oversight Board (§ 103). The Oversight Board shall have broad discretion to establish or adopt standards, subject to approval by the SEC, in auditing, quality control and ethics regarding the preparation and issuance of audit reports by registered accounting firms.

4. Inspections and Investigations (§§ 104, 105, 106). The Oversight Board must establish an inspection regime to ensure compliance with applicable rules regarding the performance of public audits. The Oversight Board shall also have the power to investigate possible violations of these rules. The Act does not provide the Oversight Board with the authority to inspect or investigate public companies; however, the Oversight Board may refer any investigation to the SEC, any other appropriate Federal regulatory body, or, at the direction of the SEC, to the U.S. Attorney General, attorney general of one or more states or appropriate state regulatory authorities.

In certain instances, the Oversight Board and the SEC may claim the right to access the audit workpapers of a foreign accounting firm not registered under the Act. Where a foreign accounting firm issues an opinion or performs "material services" relied on by a registered accounting firm, then the foreign accounting firm will be deemed to consent to produce its audit workpapers for the Oversight Board or SEC in connection with any investigation. In addition, where a registered accounting firm relies upon the opinion of a foreign public accounting firm with regard to an audit, the registered accounting firm shall be deemed to have (a) consented to supplying the audit workpapers of the foreign firm if required by the Oversight Board or the SEC, and (b) to have secured the permission of the foreign firm to produce its workpapers as a condition of the registered firm's reliance on the opinion of the foreign accounting firm.

The Act provides that all information received through an inspection or investigation by the Oversight Board will be treated as confidential and privileged as an evidentiary matter in any Federal or state government proceeding, unless and until presented in connection with a "public proceeding," or released in accordance with any disciplinary proceedings conducted by the Oversight Board.

5. Disciplinary Powers (§ 105). The Act's disciplinary provisions, like those for inspections and investigations, do not apply to public companies. The sanctions that may be levied against registered accounting firms found to be in violation of applicable rules include censure, monetary fines, and temporary or permanent revocation of registration under the Act. The Oversight Board also has the ability to suspend or bar a registered accounting firm or associated person from being associated with any public company. Under the Act, it is unlawful for a public company that knew, or should have known, of such sanction to permit that person to become or remain associated with that company in any financial management capacity. The Act requires sanctions to be reported to the SEC, any appropriate state regulatory authority, any appropriate foreign accountancy licensing board and the public.

E. Enforcement and Penalty Provisions

1. Criminal Enforcement

a. New Criminal Provisions. The Act creates new criminal penalties for securities fraud; requires CEOs and CFOs to certify the accuracy of their corporations' financial statements and disclosure documents, at the risk of criminal penalties; mandates that auditors retain their records for five years after an audit or face possible imprisonment; and declares it a Federal crime to alter or destroy documents in order to impede an official proceeding or investigation.

i. Criminal Penalties for Defrauding Shareholders of Public Companies (§ 807). The Act expands the Federal mail fraud statute by making it a crime to defraud any person or to obtain any money or property fraudulently in connection with any security of a public company. Anyone convicted of securities fraud or attempted securities fraud under this provision is subject to a fine and up to 25 years of imprisonment.

ii. Corporate Responsibility for Financial Reports (§ 906). See Section A.1.b.

iii. Destruction of Corporate Audit Records (§ 802). Any accountant performing an audit of a public company must maintain all of his or her workpapers for five years after the end of the fiscal period in which the audit was concluded. Any auditor who "knowingly and willfully" fails to maintain its workpapers is subject to fines and/or up to 10 years of imprisonment. The SEC is required to promulgate rules and regulations to govern the auditors' retention of audit records.

iv. Criminal Penalties for Altering Documents (§ 802). The Act imposes fines and/or imprisonment of up to 20 years on anyone who knowingly alters, destroys, or falsifies a document with the intent of impeding a Federal investigation.

v. Tampering with a Record or Otherwise Impeding an Official Proceeding (§ 1102). The Act penalizes anyone who shreds, hides, or alters a document or other object in order to impede an official proceeding, or otherwise impedes an official proceeding, or attempts to do so. Persons convicted under this provision face a fine and/or imprisonment for up to 20 years.

vi. Attempts and Conspiracies to Commit Criminal Fraud Offenses (§ 902). The Act clarifies that anyone who attempts or conspires to commit any criminal fraud offense is subject to the same penalties that he or she would have suffered had the attempt or conspiracy been successful.

vii. Retaliation against Informants (§ 1107). The Act expands the Federal statute concerning retaliation against a witness to prohibit interference with the lawful employment or livelihood of a witness for providing information relating to the commission of a Federal offense. Anyone who retaliates risks a fine and/or imprisonment of up to 10 years.

b. Increased Criminal Penalties. The Act significantly increases the penalties for the following pre-existing crimes:

Crime	Previous Penalty	New Penalty Under the Act
Mail Fraud (§ 903)	Up to five years in prison	Up to 20 years in prison
Wire Fraud (§ 903)	Up to five years in prison	Up to 20 years in prison
Violations of the 1934 Act (§ 1106)	Fine for individual: $1,000,000	Fine for individual: $5,000,000
	Fine for entity: $2,500,000	Fine for entity: $25,000,000
	Up to 10 years in prison	Up to 20 years in prison
Violations of the Reporting and Disclosure Provisions of ERISA	Fine for individual: $5,000	Fine for individual: $100,000
	Fine for entity: $100,000	Fine for entity: $500,000
	Up to one year in prison	Up to 10 years in prison

c. Stiffer Federal Sentences (§§ 805, 905, 1104). The Act requires the United States Sentencing Commission to revise the Federal Sentencing Guidelines within 180 days of the effective date of the Act to ensure that the penalties for destruction of documents, obstruction of justice and securities and accounting fraud and related offenses are sufficient to deter and punish.

d. Expanded SEC Oversight Powers (§§ 1103, 1105, 305). The Act grants the SEC additional powers to:

- petition a Federal district court for a 45-day temporary freeze of the assets of a public company that it believes will make extraordinary payments to any of its directors, officers, partners, controlling persons, agents or employees;
- prohibit any person who violates Federal securities laws, rules or regulations from acting as an officer or director of any public company of securities; and
- seek equitable relief from a Federal court in any action brought by the SEC under any provision of the securities laws.

2. Civil Enforcement. In addition to increased criminal penalties, the Act also contains the following provisions designed to benefit plaintiffs who sue corporate wrongdoers in civil court.

a. Expanded Statute of Limitations for Securities Fraud (§ 804). The Act extends the statute of limitations for securities fraud. Under the previous law, a plaintiff was required to bring a securities law action within a year after the discovery of the violation, or three years after the violation occurred. The Act permits a private plaintiff to sue for securities fraud within two years after the discovery of the violation, or five years after the violation occurred, whichever is earlier. This change applies to all proceedings commenced on or after the date of the enactment of the Act. The Act is ambiguous about whether the new statute of limitations would apply to an action commenced after the effective date of the Act, but involving activity that took place before the effective date.

b. Whistleblower Protection for Employees of Public Companies Who Provide Evidence of Fraud (§ 806). The Act provides whistleblower protection for employees of public companies. No such company may fire, demote, suspend, threaten, harass, or otherwise discriminate against an employee because of the employee's involvement in a securities- or fraud-related investigation involving the company. Any employee who is adversely treated because of his or her whistleblowing activities may sue the company within 90 days after the date of the discriminatory act for compensatory damages and attorneys' fees. The employee must make a *prima facie* showing that his or her whistleblowing activities were a contributing factor in the unfavorable personnel action alleged in the complaint, while the employer must show by clear and convincing evidence that it would have taken the same unfavorable personnel action in the absence of the whistleblowing behavior.

c. Debts Nondischargeable in Bankruptcy if Incurred in Violation of Securities Fraud Laws (§ 803). The Act amends Federal bankruptcy laws to declare that a debtor cannot discharge in bankruptcy any order or settlement arising from a claim that the debtor has violated any Federal or state securities law or regulation, or from a claim of common law fraud, deceit or manipulation in relation to the purchase of a security.

d. Civil Penalties Added to Disgorgement Funds for the Relief of Victims (§ 308). In the so-called "Fair Funds" provision, the Act provides a mechanism to set up a fund to reimburse defrauded investors from fines paid by corporate wrongdoers. The Act requires that civil penalties levied by the SEC as a result of any judicial or administrative action be directed to a disgorgement fund for the benefit of harmed investors. The SEC is authorized to administer the disgorgement fund. The SEC is also required to analyze its enforcement actions involving disgorgements brought within the past five years and develop methods to improve collection rates. The SEC must present its report within 180 days of the effective date of the Act.

3. Other Enforcement Mechanisms

a. Public Company Accounting Oversight Board Investigations and Disciplinary Proceedings (§ 105). The Oversight Board is empowered under the Act to impose sizeable penalties on registered public accounting firms and individuals associated with them who violate Federal securities laws or regulations. These include suspension, monetary penalties of up to $100,000 for an individual or $2,000,000 for an entity, or penalties of up to $750,000 for an individual or $15,000,000 for an entity if the conduct at issue was intentional, reckless, or involved repeated instances of negligent conduct.

b. Improper Influence on Conduct of Audits (§ 303). The Act provides that the SEC may bring civil lawsuits against officers or directors of a public company, or any persons acting at their direction, who attempt to influence any accountant performing an audit for the purpose of rendering the company's financial statements materially misleading.

F. Pension Fund Blackout Provisions

1. Insider Trading During Pension Fund Blackout Periods (§ 306(a))

a. In General. The Act bars trading by directors and executive officers during a blackout period under a public company's § 401(k) and other individual account retirement plans.

b. Blackout Period. For purposes of the insider trading provision, a blackout period is defined by the Act as any period of more than three consecutive business days during which the ability of at least 50% of the participants or beneficiaries under all of the public company's individual account retirement plans (such as a § 401(k) plan) to purchase, sell, or otherwise acquire or transfer an interest in any of the public company's equity securities is temporarily suspended by such company or by a plan fiduciary. However, in accordance with regulations to be prescribed by the SEC, a blackout period does not include any regularly scheduled period in which plan participants and beneficiaries may not purchase, sell, or otherwise acquire or transfer an interest in any equity of the public company if that period is incorporated in the plan and timely disclosed to employees. A blackout period also does not include any suspension of activity that is imposed solely in connection with persons entering or leaving the plan as a result of a corporate merger, acquisition, divestiture, or similar transaction involving the plan or plan sponsor. The Act also includes an exception for certain one-participant retirement plans.

c. Ban on Trading By Insiders. In general, the Act makes it unlawful for any director or executive officer of a public company to purchase, sell, or otherwise acquire or transfer any equity security of the public company during a blackout period with respect to the equity security if the director or officer acquires the equity security in connection with service or employment as a director or executive officer. However, the Act authorizes the SEC to issue rules creating exceptions to this general prohibition.

d. Remedy. The Act provides that if a director or executive officer violates the ban on trading during a blackout period, any profit that he or she realizes will be recoverable by the public company, regardless of the director's or executive officer's intent in entering into the transaction. An action to recover these profits may be brought either by the public company or, on a derivative basis, by any stockholder if the public company fails to bring an action within 60 days after the date of a request to do so or if the public company fails to prosecute any such action diligently. Any such suit must be brought within two years after the date the profit is realized.

e. Notice to Insiders and the SEC. The Act provides that in any case in which a director or executive officer is subject to the ban on trading during a blackout period with respect to equity securities, the public company of the equity securities must "timely" notify the director or officer and the SEC of the blackout period.

f. SEC Rulemaking. The Act requires the SEC, in consultation with the Secretary of Labor, to issue rules clarifying the application, and preventing the evasion, of these provisions. The rules are to provide for the application of the ban on trading during a blackout period to affiliated companies and may also provide for "appropriate exceptions," including exceptions for purchases under an automatic dividend reinvestment program or purchases or sales made under an advance election.

g. Effective Date. The blackout period provisions take effect 180 days after enactment of the Act. There is a good faith standard of compliance before the issuance of applicable regulations.

2. Advance Notice of Pension Fund Blackout Periods (§ 306(b))

a. In General. The Act amends Part 1 of Title I of the Employee Retirement Income Security Act ("ERISA") to require the administrator of a § 401(k) or other individual account retirement plan to provide advance notice of a blackout period to affected participants and beneficiaries.

b. Blackout Period. The definition of blackout period for purposes of the advance notice requirement differs from the definition of blackout period for purposes of the Act's insider trading provision. For purposes of the advance notice requirement, the Act defines a blackout period as any period for which the ability of participants or beneficiaries under an individual account plan (such as a § 401(k) plan) to direct or diversify assets credited to their accounts, to obtain loans from the plan, or to obtain distributions from the plan is temporarily suspended, limited, or restricted for any period of more than three consecutive business days. However, a blackout period does not include a suspension, limitation, or restriction that (i) occurs by reason of the application of the securities laws, (ii) is a change to the plan which provides for a regularly scheduled suspension, limitation, or restriction that is timely disclosed to participants or beneficiaries, or (iii) applies to only one or more individuals, each of whom is a participant, an alternate payee, or any other beneficiary under a qualified domestic relations order. The Act also includes an exception for certain one-participant retirement plans.

c. Notice to Participants and Beneficiaries. Under the Act, the plan administrator must give advance notice of any blackout period to the affected participants and beneficiaries. The notice must include (i) the reasons for the blackout period, (ii) the investments and other rights affected, (iii) the expected beginning date and the length of the blackout period, (iv) in the case of investments affected, a statement that the participant or beneficiary should evaluate the appropriateness of their current investment decisions in light of their inability to direct or diversify investments during the blackout period, and (v) such other matters as the Secretary of Labor may require by regulation. In general, the notice must be furnished at least 30 days before the blackout period. However, the 30-day notice requirement does not apply where a plan fiduciary makes a reasonable written determination that (A) deferral of the blackout period would violate ERISA's standards of fiduciary responsibility or (B) the inability to provide the 30-day notice is due to unforeseeable events or circumstances beyond the control of the plan administrator. In either of these cases, however, notice must be furnished as soon as reasonably possible unless it is impracticable to send the notice before the end of the blackout period. The notice must be provided in writing, and may be provided in electronic or other form to the extent that it is reasonably accessible to the recipient.

d. Notice to the Public Company. The Act requires the plan administrator to provide "timely notice" of a blackout period to the public company of any employer securities subject to the blackout period.

e. Merger and Acquisition Relief. If a blackout period applies solely to individuals becoming or ceasing to be participants or beneficiaries by reason of a merger, acquisition, divestiture, or similar transaction, the notice may be provided to those participants and beneficiaries as soon as reasonably practicable, rather than 30 days in advance.

f. Change in Length of Blackout Period. If, after advance notice is provided, there is a change in the commencement or length of the blackout period, the plan administrator must notify the affected participants and beneficiaries as soon as reasonably practicable.

g. Regulations and Other Guidance. The Secretary of Labor is authorized to issue regulations providing for exceptions that the Secretary determines to be in the interests of participants and beneficiaries. The Secretary is also required to issue guidance and model notices. The Act requires the Secretary to issue initial guidance and a model notice no later than January 1, 2003. In addition, the Secretary is required to promulgate interim final rules no later than 75 days after enactment of the Act.

h. Civil Penalties. The Secretary of Labor is authorized to assess a civil penalty of up to $100 per day against a plan administrator from the date of the administrator's failure to provide notice to participants and beneficiaries. For this purpose, each violation with respect to a single participant or beneficiary is treated as a separate violation.

i. Plan Amendments. If the notice requirement necessitates an amendment to a plan, the plan amendment is not required to be made before the first plan year beginning on or after the effective date of the notice requirement if (i) the plan is operated in good faith compliance with the notice requirement and (ii) the plan amendment applies retroactively to the period after the notice requirement takes effect and before such first plan year.

j. Effective Date. The effective date of the notice requirement is 180 days after enactment of the Act. There is a good faith standard of compliance before the issuance of applicable regulations.

G. <u>Miscellaneous Provisions</u>

1. Rules of Professional Responsibility for Attorneys (§ 307). The Act requires attorneys appearing before the SEC on behalf of public companies to report evidence of a material violation of securities law or breach of fiduciary duty by the company or its agent(s) to the chief legal counsel or chief executive officer of the company. If the counsel or CEO does not respond appropriately, the attorney must report the evidence to the audit committee of the company's board of directors, to a committee composed entirely of outside directors, or to the board of directors as a whole.

2. Analyst Conflicts of Interest (§ 501). The Act directs the SEC, or a registered securities association or national securities exchange at the direction of the SEC, to adopt rules to address conflicts of interest facing securities analysts. Recently adopted rules of the NASD and the New York Stock Exchange cover many of the areas enumerated in the Act.

Specific elements covered by the Act include:

- restricting the ability of investment bankers to pre-approve research reports;
- ensuring research analysts are not supervised by persons involved in investment banking activities;
- preventing retaliation against analysts by employers in return for writing negative reports;
- establishing blackout periods for brokers or dealers participating in a public offering during which they may not distribute reports related to such offering; and
- enhancing structural separation in registered brokers or dealers between analyst and investment banking activities.

The Act also directs the SEC, or a registered securities association or national securities exchange at the direction of the SEC, to adopt rules to require specific conflict of interest disclosures (a) by research analysts making public appearances and (b) by brokers or dealers in research reports, regarding conflicts that are known, or should have been known, all at the time of such appearance or distribution of such report. The disclosures required by the Act include:

- whether the analyst holds securities in the public company that is the subject of the appearance or report;
- whether any compensation was received by the analyst, or the broker or dealer, from the public company that was the subject of the appearance or report (subject to exemptions based on preventing disclosure of material non-public information concerning potential future banking transactions);
- whether a public company that is the subject of an appearance or report is, or during the prior one-year period was, a client of the broker or dealer; and
- whether the analyst received compensation with respect to a research report, based upon banking revenues of the registered broker or dealer.

3. Commission Resources and Authority

a. Authorization of Appropriations (§ 601). The Act appropriates $776,000,000 to the SEC for fiscal year 2003, a 77.21% increase over the appropriation for fiscal year 2002. Of this amount, $102,000,000 is available to fund additional, so-called pay parity, compensation as authorized under the Investor and Capital Markets Fee Relief Act; $108,400,00 is available for information technology, security enhancements, and recovery and mitigation activities related to the September 11, 2001 terrorist attacks; and $98,000,000 is available to add no fewer than 200 additional qualified professionals to provide improved oversight of auditors and audit services required by Federal securities laws.

b. Appearance and Practice Before the Commission (§ 602). The Act empowers the SEC, subject to certain notice and hearing requirements, to censure persons appearing or practicing before the Commission if it finds, among other things, a person to have engaged in unethical or improper professional conduct.

c. Federal Court Authority to Impose Penny Stock Bars (§603). The Act authorizes Federal courts to prohibit persons from participating in penny stock offerings if the persons are subject to proceedings instituted for alleged violations of securities laws.

d. Qualifications of Associated Persons of Brokers and Dealers (§604). The Act expands the scope of the SEC's disciplinary authority by allowing it to consider orders of state securities commissions when deciding whether to limit the activities, functions, or operations of brokers or dealers.

4. SEC Recognition of Accounting Standards Body (§ 108). The Act seeks to strengthen independent accounting standards bodies, such as the Financial Accounting Standards Board, by providing for independent funding and a formalized relationship with the SEC. The Act amends the Securities Act of 1933 to allow the SEC to recognize accounting principles established by a "standard setting body" as "generally accepted" under the securities laws. In order to receive the designation as a standard setting body, the SEC must determine that such entity is capable of assisting the SEC in establishing financial reporting standards and guidelines for reporting requirements under the 1934 Act. A standard setting body, like the Oversight Board, will be funded by assessing an annual accounting support fee against public companies.

H. Effective Dates

Time From Date of Enactment	Action	Provision of Act	Internal Cross Reference
No Later Than ("NLT") 30 days	Rules required by § 302 shall become effective (Corporate Responsibility for Financial Reports)	§ 302(c)	1
30 days	§ 403 to become effective (Accelerated Disclosure of Transactions Involving Directors, Executive Officers and Principal Stockholders)	§ 403(b)	4
NLT 75 days	Secretary of Labor shall promulgate interim final rules necessary to implement the requirement that an administrator of a § 401(k) or other individual account retirement plan provide advance notice of a blackout period to affected participants and beneficiaries.	§ 306(b)	15
NLT 90 days	SEC shall appoint the members of the Oversight Board	§ 101(e)	8
	SEC to propose rules or regulations required by § 303 (Improper Influence on Conduct of Audits)	§ 303(d)	12
	SEC to propose rules to implement § 406 (Code of Ethics for Senior Financial Officers)	§ 406(d)	4
	SEC to propose rules to implement § 407 (Disclosure of Audit Committee Financial Expert)	§ 407(c)	8
NLT 180 days	SEC to issue final regulations under § 208 (Auditor Independence)	§ 208(a)	4-5
	SEC to issue rules under § 307 (Rules for Professional Responsibility for Attorneys)	§ 307	15
	SEC to report on methods to provide restitution to injured investors more efficiently	§ 308(c)	12
	SEC to issue final rules under § 401 (Disclosure of Off-Balance Sheet Transactions in Periodic Reports)	§401(a)	7-8

Time From Date of Enactment	Action	Provision of Act	Internal Cross Reference
NLT 180 days	SEC to issue final rules under § 401 (Presentation of Pro-Forma Figures in Periodic Reports)	§401(b)	7-8
	SEC to issue final rules to implement § 406 (Code of Ethics for Senior Financial Officers)	§ 406(d)	8
	SEC to issue final rules to implement § 407 (Disclosure of Audit Committee Financial Expert)	§ 407(c)	8
	SEC to report on the role and function of credit rating agencies in the operation of the securities market	§ 702(b)	N/A
	SEC to report on SEC enforcement actions involving violations of reporting requirements of the securities laws	§ 704(b)	N/A
	Comptroller General to report on whether investment banks and financial advisors assisted public companies in manipulating their earnings, including in the failures of Enron and Global Crossing	§ 705(b)	N/A
	SEC to promulgate rules and regulations relating to the retention of audit records	§ 802(a)	10
	Sentencing Commission to promulgate guidelines or amendments to the sentencing guidelines applicable to obstruction of justice and extensive criminal fraud	§ 805(b)	11
	Sentencing Commission to promulgate guidelines or amendments to the sentencing guidelines applicable to certain white-collar offenses	§ 905(c)	11
	Sentencing Commission to promulgate guidelines or amendments to the sentencing guidelines applicable to securities and accounting fraud and related offenses	§ 1104(c)	11
	§ 306 takes effect (Insider Trades During Pension Fund Blackout Periods)	§ 306(c)	13-14

Time From Date of Enactment	Action	Provision of Act	Internal Cross Reference
NLT Six months	SEC to report based on information for the period from 1/1/98-12/31/01 on securities professionals found to have violated Federal securities laws between, the laws violated, and the amounts of disgorgement in these cases	§ 703(b)	N/A
NLT 270 days	SEC determines whether Oversight Board is properly organized and has capacity to carry out the requirements of Title I	§ 101(d)	8
	SEC, by rule, to direct national securities exchanges and national securities associations to prohibit the listing of any security of a public company that is not in compliance with the provisions of § 301 of the Act (Public Company Audit Committees)	§ 301	6
	SEC to issue final rules or regulations required by § 303 of the Act (Improper Influence on Conduct of Audits)	§ 303(d)	12-13
NLT One year	SEC submits report regarding adoption of principles-based accounting to the Senate Banking Committee	§ 108(d)	N/A
	Comptroller General submits report to the Senate Banking Committee on mandating public companies to rotate auditing firms	§ 207(b)	N/A
	SEC adopts rules under § 501 (Analyst Conflict of Interest Provisions)	§ 501(a)	16
	SEC adopts rules under § 501 (Conflict of Interest Disclosure Provisions)	§ 501(b)	16
	Comptroller General to report to Senate Banking Committee on ways to increase competition among public accounting firms	§ 701(c)	N/A

Time	Action	Provision of Act	Internal Cross Reference
180 days after commencement of operations of the Oversight Board	Registered accounting firms prohibited from performing certain non-auditing functions contemporaneous with an audit	§ 201(a)	5
180 days after date of determination of the SEC regarding the Oversight Board in § 101(d)	No unregistered accounting firm may prepare or issue an audit report for a public company	§ 102(a)	8-9
NLT One year after adoption of off-balance sheet disclosure rules required by § 13(j) of the 1934 Act	SEC shall complete a study on extent of off-balance sheet transactions	§ 401(c)	7

David B.H. Martin
John M. Vine
Molly E. Bishop
Stephen J. Hess
Patrick H. McCaffery

If you have any questions concerning this material, please call any of the following members of our securities practice group:

London	Kelly Vance	44.20.7067.2040
Washington	David Martin	202.662.5128
	Bruce Baird	202.662.5122
New York	Bruce Bennett	212.841.1060
	Larry Silverman	212.841.1092
San Francisco	Andi Vachss	415.591.7069