SARBANES-OXLEY: A PRIMER FOR PUBLIC COMPANIES, AND THEIR OFFICERS AND DIRECTORS, AND AUDIT FIRMS

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Two years after the collapse of Enron, complaints regarding the damaging effect on corporate growth of the Act spawned by Enron can be plaintively heard. However, continuing corporate scandals involving household name companies, including the Italian food giant Parmalat, and the health services company, HealthSouth, have kept the issue of corporate accountability prominently before the public.

In fact, in response to scandals involving the New York Stock Exchange and several prominent mutual funds, the Securities and Exchange Commission ("SEC") and other regulators and law enforcement officials have called for additional regulation of the securities markets.

OVERVIEW OF THE ACT

The focus of the Act and this article is the regulation of the accounting profession and of the auditing and financial reporting process of public companies. For this purpose, a public company is a company, the securities of which is registered under Section 12 of the Exchange Act, or which is required to file reports under Section 15(d) of the Exchange Act, or that files,

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2. See Floyd Norris, Too Much Regulation? Corporate Bosses Sing the Sarbanes-Oxley Blues, N.Y. TIMES, Jan. 23, 2004, at C1. According to a survey of global chief executives released by PricewaterhouseCoopers at the World Economic Forum, fifty-nine percent of global chief executives surveyed viewed overregulation as a significant risk and more of a threat to corporate growth than global terrorism or currency fluctuations. See id.
or has filed a registration statement that has not yet become effective under the Securities Act. In addition, the Act also significantly regulates the corporate functions of public companies, particularly regarding corporate governance, as well as their executives, directors, and outside advisers. Accordingly, this article also discusses the more significant aspects of the Act's impact on these individuals.

The Act affects:

- **public companies**, by subjecting them to enhanced disclosure requirements and requiring them to adopt strict corporate governance standards;
- **officers and directors of public companies**, by requiring them to certify their company's annual and quarterly reports (including, specifically, the financial statements), return profits and bonuses relating to false financial statements and forego loans to them by the company, except in limited circumstances;
- **auditors of public companies**, by requiring them to register and be subject to regulation by a newly-created independent audit review board, and by placing additional restrictions on their ability to perform non-audit services to their audit clients;
- **employees of public companies**, by insulating them from retaliation for reporting questionable corporate activities;
- **securities lawyers who represent public companies**, by requiring them to report to the company's CEO or general counsel, or qualified legal compliance committee, and in some cases, the board of directors, evidence of material violations of securities laws or breaches of fiduciary duty; and
- **investment banks employed by public companies and the research analysts** who are employed by investment banks to follow public companies for investment banks, by subjecting them to increased regulation regarding conflicts of interest between analysts and the banking arm of the investment banks, including increased disclosure of actual and potential conflicts of interest.

The Act also added and increased criminal penalties for certain violations of the U.S. securities laws and increased the statutes of limitation for certain existing private rights of action for violations of certain existing securities laws.

The Act is part of an enhancement of the public company regulatory regime that includes rulemaking by the SEC, other SEC initiatives, changes in stock exchange listing standards and actions by private groups, such as the Financial Accounting Standards Board and the American Institute of Certified Public Accountants, and stricter regulation and enforcement by the secu-
rities law administrators of the individual states. The Act contemplates that the SEC and the stock exchanges, including the New York Stock Exchange ("NYSE") and the Nasdaq Stock Market ("Nasdaq"), will implement their provisions through rules adopted by them. In some cases, the Act provides significant discretion to these regulators as to how its provisions may be implemented. In other cases, the Act requires specific acts of compliance.

Some of the provisions of the Act are immediately effective. However, in the case of the Public Company Accounting Oversight Board, the Board was not required to become fully functional until April 26, 2003, and auditors were not required to register with the Board until 180 days afterward. In the case of the requirement to file internal control reports with company annual reports, the requirement becomes effective in 2004 for larger U.S. companies and in 2005 for other U.S. companies and for non-U.S. SEC-reporting companies.

In some cases, the Act required expedited rulemaking and implementation of the Act's requirements. For example, the SEC was required to, and did, adopt regulations regarding the accelerated reporting requirements for public company insiders that became effective on August 29, 2002.

The breadth and depth of the regulatory changes effected by the Act, and the unknown impact of existing and future rulemaking and interpretation, make the Act's practical requirements and effect difficult to currently evaluate. Moreover, it is unclear at this time what additional exemptions the SEC may adopt to, or alternative versions of, the Act's requirements insofar as they relate to non-U.S. persons and small business issuers.

What follows is a brief summary of the more significant general provisions of the Act. It is not intended to be comprehensive and should not be relied upon as legal advice. Moreover, it generally only reflects developments through August 2003.

THE ACT'S EFFECT ON PUBLIC COMPANIES

"Real Time" Disclosure Requirements

The Act accelerates a public company's reporting obligations by requiring "real time" "plain English" disclosure of material changes in the financial condition or operations of a public company. The Act suggests that such


4. See Section 409 of the Act which amended the Exchange Act by adding a new paragraph (i) to Section 13 thereof as follows:
Disclosure may include trend and qualitative information and graphic presentations. These disclosures would require subjective determinations by the issuer regarding the materiality of agreements, reduction in revenues from major customers, material direct or contingent financial obligations and material write-offs and impairments. Under the final Rule amending Form 8-K disclosure requirements and deadlines, these judgments, are required to be made within the constraints of a four-business day filing requirement. There are significant consequences for inaccurate or late filings (though the final Rule ameliorates some of those consequences if appropriate disclosure is made by the time of the next required periodic report under the Exchange Act). Compliance with these requirements promises to pose significant challenges for U.S. public companies.

This requirement is a significant departure from existing U.S. law. Previously, companies had broad latitude in the timing of the disclosure of material corporate developments so long as insiders were not trading on the basis of their knowledge. Although not part of the Act, the SEC has also accelerated the filing date requirements for annual reports on Form 10-K and quarterly reports on Form 10-Q. These requirements will be phased-in over three years and do not apply to small business issuers or companies with less than $75 million in public float.

Management Report on Internal Controls

The Act requires management to establish an internal control structure. Management is also required to prepare a report, to be included in the company’s annual report, which assesses the effectiveness of these controls and procedures on the company’s financial reporting for the past year. The com-


5. See additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Release Nos. 33-8400 and 34-49424 (March 16, 2004), available at http://www.sec.gov/rules/final/33-8400 (last visited April 8, 2004). The Final Rules expand the list of disclosure items under Form 8-K (adding, among others, disclosure regarding 1) material agreements, 2) material financial obligations, 3) sales of unregistered securities, 4) material modifications to the rights of securities holders and 5) actions to delist the company's securities from a national securities exchange or SRO) and shorten the filing deadline for most Form 8-K items to four business days. The expanded disclosure and accelerated reporting requirements are effective as of August 23, 2004 and will operate prospectively only.
pany's outside auditors that prepare its audit report must attest to, and report on, management's internal control assessment. The SEC has adopted rules providing details regarding the content of the report. These reports are required to be included in a public company's annual report on Form 10-K, 20-F, or 40-F, as applicable, beginning with the annual report for its first fiscal year ending on or after June 15, 2004 for accelerated filers; and April 16, 2005 in the case of other U.S. companies and all non-U.S. SEC reporting companies.

This requirement will likely cause senior officers of public companies and their significant subsidiaries of public companies to assume greater responsibility for the accuracy of the financial reports generated by the business operations under their management.

Use of Pro Forma Financial Information

The Act addresses some of the perceived abuses relating to the use of pro forma financial information. It does this by requiring that pro forma financial information, whether appearing in a company's SEC reports or in a company press release or other public disclosure:

- comply with the U.S. federal securities law's standard for accuracy and completeness (that is, the disclosure does not contain an untrue statement of a material fact or omit to state a material fact necessary to make the disclosure not misleading); and
- include a reconciliation with the company's financial statements prepared in accordance with U.S. generally accepted accounting principals ("GAAP").

The SEC has adopted Regulation G, which governs the use of non-GAAP financial measures in all public disclosures, including earnings releases containing non-GAAP financial measures. Under Regulation G, a non-GAAP financial measure is a numerical measure of a company's past or future financial performance, financial position or cash flows that:

- excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the most directly comparable measure calculated and presented in accordance with GAAP; or

includes amounts, or is subject to adjustments that have the effect of excluding amounts, that are excluded from the most directly comparable measure calculated and presented in accordance with GAAP.

Regulation G requires that when a company makes a public disclosure that includes material non-GAAP financial information, it must include a presentation of the “most directly comparable” financial measure calculated and presented in accordance with GAAP and a reconciliation of the differences between the non-GAAP financial measure with the “most directly comparable” financial measure calculated and presented in accordance with GAAP.

Other Financial Information Requirements

In a requirement of potentially far-reaching consequence, the Act requires public companies to provide in each annual and quarterly SEC filing disclosure of all material that may have a material current or future effect on the company’s (i) financial condition, (ii) changes in financial condition, (iii) results of operations, (iv) liquidity, (v) capital expenditures, (vi) capital resources, or (vii) significant components of revenues or expenses, including:

- off-balance sheet transactions, arrangements, obligations (including contingent obligations); and
- other relationships of the company with unconsolidated entities or other persons.

Audit Committees

The Act requires all audit committee members to be independent. The Act also requires companies to grant their audit committee authority over the selection, compensation, and oversight of outside auditors. Compounding the difficulty of complying, the Act sets a stricter standard for determining independence. A person is considered “independent” only if he does not receive any consulting or similar fees from, and is not affiliated with, the company or any of its subsidiaries, other than in his capacity as a director.

In addition, the Act requires public companies to disclose whether or not its audit committee has at least one member who is a “financial expert,” and, if not, an explanation of why not. The SEC has defined “financial expert” in its rulemaking as a person who has the following attributes:
(i) An understanding of generally accepted accounting principles and financial statements;
(ii) The ability to assess the general application of such principles in connection with the accounting for estimates accruals and reserves;
(iii) Experience preparing, auditing, analyzing, or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more person engaged in such activities;
(iv) An understanding of internal controls and procedures for financial reporting; and
(v) An understanding of audit committee functions.  

Under the Act, the SEC has directed the national securities exchanges (that is, the NYSE, AMEX, and Nasdaq) to prohibit the listing of the securities of companies that do not have an audit committee that complies with the requirements of the Act.

Both the NYSE and Nasdaq have adopted rules relating to corporate governance standards that in some respects are stricter than the standards included in the Act. For example, both the NYSE and Nasdaq rules require that the nominating and compensation committees of public companies consist solely of independent directors. Moreover, to empower non-management directors, the rules of both NYSE and Nasdaq require non-management directors to meet regularly and participate more directly in approval of related party transactions, the nomination of directors, and the determination of CEO compensation.

**Enhanced SEC Review of Periodic Reports and Enforcement Powers**

The Act requires the SEC to review disclosures, including financial disclosure, made by public companies that have a class of securities listed on a national securities exchange or Nasdaq "on a regular and systematic basis" and, in any case, at least once every three years. This provision of the Act is intended expressly to include review of the periodic filings of non-U.S. companies.

The Act gives the SEC and the U.S. federal courts additional enforcement and injunctive powers. For example, the SEC now has the power to impose a forty-five-day freeze (which can be extended in some circum-

7. See Instruction to paragraph (h)(1) of Item 401 of Regulation S-K.
stances) on extraordinary payments to a company's directors, officers, agents or employees by a company that is under investigation.

In addition, the Act amends current law to permit a court, in an action brought by the SEC, to prohibit a person who violates the antifraud provisions of the securities laws from acting as an officer or director of a public company when the conduct indicates the "unfitness," versus the current standard of "substantial unfitness," to serve as an officer or director. The SEC may also issue orders to such effect in some circumstances.

THE ACT'S EFFECT ON DIRECTORS AND OFFICERS

Certifications of Periodic Reports

Under the Act, the chief executive and chief financial officers of public companies must comply with two separate certification requirements with respect to their company's periodic reports filed with the SEC. The Act does not indicate, and the SEC has provided no guidance as to, whether the two separate certification requirements can be satisfied by use of one certification. In addition, the NYSE's corporate governance rules require CEOs of NYSE-listed companies to certify annually to the SEC as to their company's compliance with NYSE corporate governance listing standards.

In the certification required by Section 906 of the Act, chief executive officers and chief financial officers must certify in a written statement accompanying the filing of their company's period reports that:

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

These certifications may not be qualified as being to the knowledge of the officer giving the certifications. However, the officer is only subject to criminal penalties when the officer has knowledge of the non-compliance. The Act provides no guidance on what it means for the certification to "accompany" the report. The approach most commonly used to date has been to file the certification as an exhibit to the report. Another approach is to file the certification in a non-public EDGAR (the SEC's electronic filing system for public companies) correspondence format along with the report, and to concurrently file the certification with the SEC on a current report (Form 8-K for domestic companies; Form 6-K for foreign private issuers).
The Act makes it a federal crime, punishable by imprisonment, to make a false certification. An officer who certifies that a report complies while "knowing" that the report in fact does not comply, can be fined up to $1 million or imprisoned up to 10 years. If this false certification is made "willfully," the officer may be fined up to $5 million and imprisoned for up to 20 years, or both. The Act does not address the consequences of failing to file the certification or filing a certification that does not comply with the Act.

In addition, under Section 302 of the Act, pursuant to rules adopted by the SEC and effective August 29, 2002, a public company's principal executive officer and principal financial officer must certify the contents of the company's quarterly and annual reports. The certification must provide that the 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 in which they were made, not misleading;
- the officer and the other certifying officers of the company:
  - are responsible for establishing and maintaining "disclosure controls and procedures" for the company;
  - have designed such disclosure controls and procedures to ensure that material information is made known to them;
  - have evaluated the effectiveness of the company's disclosure controls and procedures within 90 days of the date of the report; and
  - have presented in the report their conclusions about the effectiveness of the disclosure controls and procedures based on their evaluation;
- the officer and other certifying officers have disclosed to the company's auditors and to the audit committee of the board:
  - 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, whether or not material, that involves management or other employees who have a significant role in the company's internal controls; and
- the officer and other certifying 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 any corrective actions with respect
to significant deficiencies and material weaknesses.

In connection with the adoption of Section 404 of the Act’s rules con-
cerning management reports on internal controls and related auditor’s attesta-
tion reports, the SEC amended the required certification regarding the ade-
quacy of disclosure controls and procedures. This certification requires the
evaluation of disclosure controls as of the end of the period covered by the
registrant’s report under the Exchange Act. Moreover, the final rules
adopted by the SEC make clear that the certification relates to an evaluation,
not only of the issuer but also of its consolidated subsidiaries.8

**Code of Ethics**

Pursuant to the Act, the SEC adopted rules requiring all public compa-
nies, including non-U.S. companies, to disclose in their periodic reports
whether they have adopted a code of ethics for their senior financial officers.
The final rules, as adopted, extended this requirement to the issuer’s prin-
cipal executive officer, as well as its principal financial officer and principal
accounting officer or controller or officer with similar functions. If the com-
pany has not adopted a code, it is required to disclose the reasons why it has
not adopted a code, thus placing an onus on any company that fails to adopt a
code of ethics. Moreover, the Act requires a public company to immediately
disclose any change or waiver of any provision of a code of ethics for any
principal executive officer or senior financial officers on Form 8-K, or by
dissemination on the Internet or other electronic means.

In addition, the NYSE’s and Nasdaq’s corporate governance rules ex-
and the requirements of the Act. These proposals contemplate the manda-
tory adoption of a code of ethics. These codes of ethics govern the conduct
of all directors, officers and employees of public companies listed on the
NYSE or Nasdaq and promptly disclose any waivers of the code for directors
and executive officers. Non-U.S. companies are exempt from the NYSE rule
and are also probably exempt from the Nasdaq requirement.

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8. See Item 601(b)(31) of Regulation S-K.
Disgorgement of Bonuses and Profits

Under the Act, if the material noncompliance of the company with the financial reporting requirements of the securities laws results from "misconduct:"

- the Act "requires" a public company to restate its financials; and
- the CEO and CFO of the company must reimburse the company for any bonus or other incentive or equity-based compensation received by the officer from the company during the twelve-month period following the first public issuance or filing with the SEC of the financial information, as well as any profits realized from the sale of securities of the company during such period.

However, the Act does not provide any guidance regarding:
- how to determine whether the restatement resulted from the misconduct (or what constitutes "misconduct"), or whose misconduct is relevant; or
- when such restatements are "required," as opposed to when they are discretionary by the company.

Companies and commentators are seeking clarification of these requirements from the SEC.

The SEC has the authority to exempt any person from these provisions and non-U.S. companies are expected to lobby to obtain exemptions for their officers.

Prohibition on Personal Loans to Directors and Executive Officers

The Act makes it unlawful for any company, directly or indirectly, including through a subsidiary, "to extend or maintain credit, to arrange for the extension of credit, or to renew any extension of credit, in the form of a personal loan to or for any director or executive officer (or the equivalent thereof)" of the company. Although most types of loans that have historically been made to management are now prohibited, the Act grandfathers extensions of credit in place on the date of adoption of the Act (but not material modifications thereto or renewals thereof). Among others, the Act prohibits companies from making officer relocation loans and loans to officers to enable them to purchase company equity. The application of the prohibition to some compensation arrangements (such as split dollar insurance policies) is currently unclear.
Although many questions remain, some practitioners have focused on the language of Section 402 of the Act and suggested that the prohibitions of the Section apply only to transactions that meet two separate requirements:

- the transaction must take the form of a loan, and not merely be an extension of credit (such as an advance of funds for indemnification, or where the intent is to confer a compensation benefit such as a tax indemnity payment); and
- the loan must be a "personal loan."

Under this view, a loan is not a "personal loan" if the primary purpose of the loan is to advance the business of the company. This would exclude business travel advances and use of company credit cards and company cars. Under this view the following transactions would be permitted:

- travel and similar advances;
- personal use of a company credit card, if the individual is required to repay within a reasonable period of time after the charges have been presented;
- personal use of a company car, if limited and ancillary to business use and reimbursement is required to be settled within a reasonable period of time;
- relocation payments (treated the same as travel since primarily for a business purpose);
- "stay" and "retention" bonuses subject to repayment, if they must be repaid and they are contingent upon employment or a similar condition;
- indemnification advances;
- deferred compensation in which an executive officer makes an "investment" (through deferring compensation) in an index or notational assets with terms giving them a favorable return;
- tax indemnity for payments to overseas-based executive officers;
- loans from 401(k) plans;
- loans from annuities and other broad-based employee benefit plans; and
- "cashless" option exercises.

**Acceleration of Section 16 Reporting Obligations**

The Act amends the Exchange Act to require directors, officers, and ten percent shareholders to disclose any change in their ownership of equity securities before the end of the second business day following the day on which the change in ownership occurs. The SEC has modified this deadline
in the case of certain transactions where the insider does not select the date of execution of the transaction resulting in the ownership change such as:

- transactions pursuant to Rule 10b5-1(c) plans (which provide a safe harbor from the antifraud provisions of Rule 10b5 under the Exchange Act) that provide for purchases and sales triggered by the occurrence of certain events; and
- specified transactions under employee benefit plans, such as fund-switching transactions.

The Act also requires that insiders file electronically with the SEC the forms disclosing changes in ownership within one year of the effective date of the Act. The SEC is required to publish such statements on an Internet accessible site no later than the end of the business day following the filing and companies are required to put the statements on their corporate websites, if they have one.

Improper Influence on Conduct of the Audit

The SEC has adopted rules making it unlawful for any officer or director of a public company to fraudulently influence, coerce, manipulate, or mislead any accountant for the purpose of rendering a company’s financial statements materially misleading. Rule 13b2-2 prohibits officers and directors of an issuer, and persons acting under their direction, from directly or indirectly taking any action to coerce, manipulate, mislead, or fraudulently influence any independent public or certified public accountant engaged in the performance of an audit or review of the financial statements of that issuer that are required to be filed with the SEC if they knew or should have known that such action, if successful, could result in rendering the issuer’s financial statements materially misleading. In the case of registered investment companies, the rule also covers officers and directors of the investment advisor to the investment company and an investment company’s sponsor, depositor, trustee, and administrator.

Restrictions on Trades During Pension Plan Blackout Periods

The Act prohibits directors and executive officers from purchasing, selling, or otherwise acquiring or transferring any equity security acquired as part of their compensation during a “blackout period.” A “blackout period” is a period designated by the company and applicable to not less than fifty percent of the participants or beneficiaries in plans maintained by the company that prohibits trades during a period of more than three consecutive
business days. The profits from any transactions made in violation of this prohibition must be paid to the company. The Act provides a private right of action to compel such payment or, if the company fails to bring suit within 60 days of a request, by a securityholder in the name of the company. Companies must provide notice of blackout periods to the SEC, as well as to officers and directors of the company.

The Department of Labor will likely take additional regulatory action, pursuant to the Employee Retirement Income Security Act of 1974 ("ERISA"), that will require companies to provide notice to employees of blackouts and may also prohibit discriminatory exercises by executives during a blackout period.

IMPLICATIONS FOR AUDITORS

Public Company Accounting Oversight Board

Under the Act, the SEC has established a five-member Public Company Accounting Oversight Board ("Board"). The initial Board was appointed in October, 2002. The SEC retroactively approved the Board's by-laws effective January 2003. (These by-laws were adopted by the Board on January 9, 2003 and amended on April 25, 2003.) Three of the Board's members must be non-accountants and two members must be or have been certified public accountants. All members must be "prominent individuals of integrity and reputation." The SEC approved William J. McDonough, the former president of the Federal Reserve Bank of New York, to be chairman in May 2003. Mr. McDonough's appointment followed the resignation of William H. Webster as a result of concerns about his role as an audit committee member of a financially troubled company.

The Board's jurisdiction extends to registered public accounting firms and their associated persons. The Board does not regulate accounting firms that perform services only for private companies.

The primary purpose of the Board is to:

- register public accounting firms;
- establish or adopt auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports;
- conduct inspections of registered public accounting firms;
- conduct investigations and disciplinary proceedings concerning registered public accounting firms and associated persons; and
- enforce compliance with the Act, the Board's rules, professional standards, and the securities laws relating to the preparation of audit reports by registered public accounting firms and associated persons.
The Board members are authorized to propose rules and adopt auditing and other professional standards subject to the approval and oversight of the SEC.

**Mandatory Registration with the Board**

Every public accounting firm that prepares or issues, or participates in the preparation or issuance of, any audit report with respect to any public company must be registered with the Board. This requirement means that any accounting firm that participates in the audit of a public company or one of its consolidated subsidiaries must be registered. Mandatory registration becomes effective 180 days after the date that the SEC determines that the Board is capable of carrying out its obligations (which occurred on April 25, 2003). Non-U.S. public accounting firms that participate in audits of U.S. or non-U.S. Sec reporting companies were granted an 180-day grace period and must register by April 19, 2004.

The Board has developed a form application for registration. The registration application includes a “consent” to cooperation in and compliance with any request for testimony or production of documents made by the Board. The application also includes an agreement to secure similar consents from each of the firm’s “associated persons.”

Although non-U.S. accounting firms are generally subject to the same requirements as their U.S. counterparts, the Board’s rules permit a certain narrowing of the scope of the disclosure required of non-U.S. public accounting firms in the registration process such as:

- a non-U.S. public accounting firm is permitted to limit disclosure to the associated accountants with status as proprietor, partner, principal, shareholder, officer or manager of the firm, as opposed to all accountants in the case of U.S. firms, and who provided at least ten hours of audit services to an issuer client during the last calendar year; and
- a non-U.S. public accounting firm is permitted to withhold from its application information prohibited from disclosure under a non-U.S. law, by submitting 1) a copy in English of the conflicting non-U.S. law, 2) a legal opinion regarding the conflict, and 3) an explanation regarding the applicant’s efforts to eliminate the conflict by seeking consents or waivers, if applicable.
Auditing, Quality Control, Ethics and Independence Standards

The Board's auditing standards must include at least the following standards for all registered public accounting firms:

- the firm must retain for at least seven years audit work papers and other information in sufficient detail to support the conclusions reached in the audit report;
- the Board may require the retention of records (not otherwise required) for purposes of Board inspections; and
- the firm must provide a concurring or second partner to review and approve each audit report and must describe in each audit report the scope of the auditor's testing of the internal control structure and procedures of the public company and present, in its report or a separate report, the firm's findings from such testing, an evaluation of the internal control structure, and a description of material weaknesses in such internal controls and circumstances or instance of noncompliance with the Board's rules and standards.

Inspections, Investigations and Disciplinary Procedures

The Act requires the Board to conduct a program of inspections to assess compliance by each registered public accounting firm and its associated persons with the Act, and SEC and Board rules, and professional standards. Board inspections replace the existing "peer review" system and must be conducted annually for each registered firm that regularly provides audit reports for more than 100 issuers and less often for other firms. The results of these inspections will be available for public review, subject to the protection of confidential and proprietary information. However, no portion of the report that contains criticism or defects in quality control systems shall be made public if the firm addresses these criticisms or defects within twelve months after the date of the inspection report.

Except to the extent discussed above, non-U.S. accounting firms that sign audit reports for any SEC registrant are fully subject to the Act. In addition, accounting firms, even if they do not issue audit reports, but nonetheless play a substantial role in the preparation and furnishing of reports for particular public companies, are also required to register with the Board. This appears to require all firms that audit subsidiaries of public companies, including non-U.S. accounting firms, to register with the Board.
Auditor Independence

A primary focus of the Act is auditor independence. To ensure an auditor's independence the Act prohibits a company's auditors from concurrently providing certain specified categories of services while also providing audit services to the company, whether or not approved by the company’s audit committee. These services are:

- bookkeeping;
- financial information systems design and implementation;
- appraisal or valuation services;
- fairness opinions, or contribution-in-kind reports;
- actuarial services;
- internal audit outsourcing services;
- management or human resources services;
- broker or dealer, investment adviser or investment banking services;
- legal services and expert services unrelated to the audit; and
- expert services unrelated to the audit.

The Board is authorized to exempt companies or audit firms from these prohibitions on a case-by-case basis. Such exemptions would probably be restricted to situations where the discontinuation of an auditor’s non-audit services would result in extreme hardship to the company.

The Act permits a company's auditors to perform any other non-audit services (such as "tax services," which could encompass a broad range of services) for the company, but only if approved in advance by the company's audit committee. More broadly, the Act requires a public company's audit committee to pre-approve audit and non-audit engagements by firms that provide audit services to the company and to disclose the approval in the company’s periodic reports filed with the SEC. Under Rule 2-01(3)(1) an accountant is not independent unless either:

- before the accountant is engaged by the issuer or its subsidiaries to render an audit or non-audit service, the engagement is approved by the issuer’s audit committee, or
- the engagement to render the service is entered into pursuant to pre-approval policies and procedures established by the audit committee of the issuer, subject to:
  - the requirement that the policies and procedures must be detailed as to the particular service;
  - the audit committee is informed of each service; and
such policies and procedures do not include delegation of the audit committee’s responsibilities to management.

The pre-approval process extends also to audit and non-audit services provided by accounting firms other than the issuer’s principal auditor. The audit committee has no required role, however, regarding non-audit services provided by a firm that is not involved in the audit of the SEC-filed financial statements.

Under the rules, issuers must also disclose aggregate fees billed by their accountants for audit services, audit-related services, tax services, and all other services for each of the last two fiscal years. In addition, the rules require issuers to disclosure the audit committee’s pre-approval policies and procedures.

Auditor Reports to Company Audit Committees

The Act requires auditors that perform an audit for a public company to report to the company’s audit committee:

- the “critical accounting policies” and practices to be used in the audit;
- all “alternative treatments” of financial information permitted by GAAP that have been discussed with management officials, the ramifications of the use of the “alternative disclosures” and the treatment preferred by the audit firm; and
- any other material written communications between the audit firm and the company’s management, such as a management letter or schedule of unadjusted differences.

Other Provisions of the Act Affecting Auditors

In addition, the Act requires the rotation of 1) the lead (or coordinating audit) partner who has primary responsibility for the audit or 2) the audit partner who reviews the audit every five years. The Act also prohibits an audit firm from auditing a company if the company’s CEO, controller, CFO, CAO, or any person serving in an equivalent position was employed by the auditor and participated in any capacity in the audit of the company within one year prior to the date of the initiation of the audit.

The SEC has also adopted rules under the Act regarding audit partner rotation, reports to audit committees and the cooling-off period requirements, and a rule relating to compensation of audit partners not mandated by the Act. These rules:
require rotation of certain audit partners after five or seven years, depend-
ing on the partner’s role in the audit engagement;
prohibit compensation of audit partners based upon procuring non-audit
services for audit clients;
require a one-year cooling-off period prior to employment by an issuer of
certain former members of the accountant’s audit engagement team; and
mandate that auditors and audit committees communicate about critical
accounting policies and alternative GAAP treatment for material items.

WHISTLEBLOWER PROTECTION

The Act protects employees of a public company who assist or partici-
pate in investigations by U.S. enforcement or regulatory authorities of certain
fraud-related activities. The Act provides for the payment of compensatory
and special damages to such employees and makes it a crime, punishable by
fine and up to ten years of imprisonment to retaliate against an employee
who provides truthful information to a law enforcement officer relating to the
commission or possible commission of a federal offense.

ATTORNEY PROFESSIONAL RESPONSIBILITY

The Act requires attorneys, including in-house and outside counsel, to
report evidence of corporate wrongdoing to the boards of directors of the
companies that they represent. Specifically, the Act requires attorneys to
report evidence of a material violation of securities law or breach of fiduci-
ary duty to the company’s general counsel or chief executive officer. If the
general counsel or CEO does not respond appropriately to the evidence, the
attorney must present the evidence to the company’s board of directors, or
audit committee or other committee of the board of directors comprised
solely of directors who are not members of the issuer’s management.

The SEC has adopted rules to implement Section 307’s requirement for
the establishment of minimum standards of professional conduct for attor-
neys practicing before the SEC in the representation of issuers. These rules
go beyond the requirements of Section 307 and are arguably the most con-
troversial of all provisions adopted by the SEC to implement the Act.

The rules require covered attorneys who become aware of “credible
evidence” of a “material violation” on the part of the issuer or its agent to
report such evidence “up-the-ladder” within the issuer and to determine
whether an “appropriate response” has been undertaken. The final rules ex-
clude, the controversial requirement of “noisy withdrawal” from representa-
tion of the issuer and notification of the SEC if the issuer has not appropri-
ately responded to the attorney’s report of the issuer’s violation and permit
the report of the perceived violation to a qualified legal compliance commit-
tee, if established by the issuer, as an alternative to "up-the-ladder reporting". However, simultaneously with the adoption of the final rules, the SEC pro-
posed an alternative withdrawal and notification procedure that would re-
quire a covered attorney faced with "credible evidence" of a "material viola-
tion" to withdraw and notify the issuer. The issuer would be required to dis-
lose the withdrawal and attendant "circumstances" to the SEC within two
business days on Form 8-K, 20-F or 40-F, as applicable.

The rules for the most part do not apply to non-U.S. attorneys and non-
practicing attorneys.

OTHER IMPORTANT PROVISIONS OF THE ACT

Lengthening of Statute of Limitations for Private Securities Fraud Actions

The Act extends the statute of limitations for private securities law
fraud actions to the earlier of two years (from one year) after the date of dis-
covery of the facts constituting the violation, or five years (from three years)
after the violation itself.

Securities Fraud Debt Not Dischargeable in Bankruptcy

The Act effects a change in U.S. bankruptcy law by providing that debts
incurred in violation of securities fraud laws, or as part of a common law
fraud in connection with the purchase or sale of a security, and that result
from a judgment, settlement, or other resolution of a judicial or administra-
tive proceeding, are no longer dischargeable in a U.S. bankruptcy proceed-
ing.

New Criminal Penalties

The Act makes it a crime under federal law to commit securities fraud
involving a public company. The Act provides for fines or imprisonment or
both for any person that knowingly executes, or attempts to execute, a
scheme or artifice (i) to defraud any person in connection with any security
of a public company or (ii) to obtain by means of false pretenses, any money
or property in connection with the purchase or sale of any security of a pub-
lic company.

The Act also makes it a crime to destroy records in any federal investi-
gation or bankruptcy. The Act states that "whoever knowingly alters, de-
strys, mutilates, conceals, covers up, falsifies, or makes a false entry in any
record, document, or tangible object with the intent to impede, obstruct or
influence the investigation or proper administration of any matter within the
jurisdiction of any department or agency of the United States or any case
filed under" the bankruptcy code, will be fined or imprisoned for not more
than twenty years or both.

**Increased Federal Criminal Penalties**

The Act increases the penalties for a “willful” violation by an individual
of the Exchange Act from a fine of up to $1 million to a fine of up to $5 mil-
lion, and from imprisonment of up to ten years to imprisonment up to twenty
years. The maximum fine for entities is increased from $2.5 million to $25
million.

The Act also increases the penalties for mail fraud and wire fraud from
a maximum of five years imprisonment to a maximum of twenty years im-
prisonment. In addition, the Act increases criminal penalties for violations of
ERISA from one year to ten years imprisonment, with additional increases in
the fines permitted.

Moreover, the Act extends these same penalties to persons who attempt
or conspire to commit an offense such as wire fraud, mail fraud, and securi-
ties fraud.

**Disgorgement Fund**

Section 308 of the Act authorizes the SEC to establish a disgorgement
fund using the civil monetary penalties and settlements in enforcement ac-
tions for securities law violations for the benefit of the victims of those viola-
tions.

Although the effective date of this provision is July 30, 2002, the SEC
has interpreted the Section’s provisions to be applicable based on the date
that the funds are received. For example, the SEC has applied the $500 mil-
lion cash and $250 million stock settlement received as a civil penalty from
WorldCom in connection with the settlement approved by the court on July
7, 2003 of an action brought relating to the company’s accounting fraud, an
event that pre-dated the enactment of the Act. The SEC has also announced
its intention to direct payments of $135 million and $125 million to be re-
ceived from J.P. Morgan Chase & Co. and Citigroup Inc., respectively, to the
disgorgement fund. These payments relate to settlement of claims brought
by the SEC for these banks’ roles in several structured finance transactions
of Enron and Dynergy (in the case of Citigroup) that were allegedly used to
distort the companies’ financial picture.
Research Analysts

Section 501 of the Act addresses concerns about conflicts of interests that may arise when securities analysts recommend equity securities in research reports and public appearances and seeks to enhance the objectivity of research and provide investors with more useful and reliable information.

The rules adopted by the self-regulatory agencies and approved by the SEC impose a number of restrictions designed to limit the ability of member firms to use research to obtain investment banking business and to reduce conflicts of interest that research analysts may have, either because of the firm’s investment banking business or because of personal relationships that the analyst may have with the companies covered by the analyst, including those relating to securities ownership.

Rating Agencies

Section 702 of the Act requires the SEC to conduct a study of the role and function of credit rating agencies in the operation of the securities markets. The study’s scope includes six areas:

- the credit agencies’ role in evaluating issuers;
- the importance of that role to investors and the markets;
- any impediments to accurate appraisals by the agencies;
- any entry barriers to the credit agency business and measures needed to remove those barriers;
- measures to improve dissemination of rating agency appraisals of issuers; and
- conflicts of interest in rating agency operations and ameliorative measures.

SUMMARY OF IMMEDIATE CONCERNS

For Companies and Their Management

CEO/CFO Certifications

- Non-U.S. companies should immediately begin the internal process to support certifications and review and revise internal control systems as appropriate
- U.S. companies may require officers of their subsidiaries and divisions to certify to the financial controls and results as they relate to their local operations
Loans to Directors and Executive Officers

- Prohibitions on loans and extensions of credit will have an immediate effect on management of public companies and will make it more difficult to attract and retain top management personnel.
- Exceptions to the Act’s prohibition mitigate this burden for banks and other financial institutions.
- The impact on routine corporate extensions of credit is still uncertain but it seems likely not to prevent:
  - travel and similar advances
  - use of company credit cards
  - use of company cars
  - relocation payments
  - “stay” and “retention” bonuses
  - indemnification advances
  - deferred compensation arrangements
  - tax indemnity loans to overseas-based executives
  - 401(k) plan loans

Whistleblower Protection

- Management will need to review their personnel policies for possible changes.

Forfeiture of Bonus and Share Trading Profits

- CEOs and CFOs of public companies could be made to reimburse the company for any bonus or other incentive-based compensation, as well as profits from the sale of company securities, received during the twelve-month period following initial publication of financial statements required to be restated as the result of material noncompliance with financial reporting requirements due to misconduct.

Restrictions on Trades During Pension Plan Blackout Periods

- The prohibition on trades made during benefit plan “black-out” periods may cause companies to revise plan procedures for their management.
Audit Committees

- Members of audit committees must be “independent” as defined in the Act, significantly restricting the ability of committee members to receive compensation from the company or be affiliated in any manner with the company; and
- The entire board of directors of public companies that do not have an audit committee will be considered the audit committee and thus subject to these restrictions.

“Real Time” Disclosure

- An expanded Form 8-K may be used by public companies to report significant events on a current (four days after occurrence) basis;
- Trend and qualitative information may be required to be included in a company’s MD&A.

Internal Controls Disclosure

- Public companies must establish and maintain an adequate internal control structure and financial reporting procedure
- Management will be subject, both directly and indirectly, to the requirement to prepare internal controls reports

Pro Forma Financial Information

- The Act requires companies reporting results on a pro forma basis to reconcile these results with financial results prepared in accordance with GAAP

Extension of Statute of Limitation for Private Securities Actions

- Investors now have two years after the disclosure of an alleged fraud or five years after the violation itself to initiate a suit based on violation of Rule 10b-5 of the Exchange Act, rather than the one and three year limits that previously applied.
For Audit Firms

Auditor Oversight Board

- Audit firms that audit SEC-registered companies will be required to be registered with the Board;
- The Board may require by rule the registration of accounting firms that audit subsidiaries and divisions of public companies or which otherwise play a "substantial role" in the audits of such companies;
- The Board will adopt and administer accounting rules that auditors that are registered with the Board will be required to follow.

Auditor Independence and Rotation

- Audit firms that audit a public company will be prohibited from providing specified non-audit services to the companies they audit, and may only provide other services with the consent of the audit committee;
- Such firms will also be required to rotate audit partners;
- Audit partners may no longer be compensated based on the generation of non-audit service-related business from audit clients;
- Public companies will be restricted from employing their former auditors within one year of such individuals' involvement in auditing the company.