Sarbanes-Oxley Act of 2002
Corporate Governance and Accounting Reform Legislation:
A Primer for Executive Officers
AUGUST 6, 2002

Highlights of the Act
The Sarbanes-Oxley Act of 2002 (the “Act”), the sweeping corporate reform legislation signed into law by President Bush on July 30, 2002, significantly alters the regulatory landscape applicable to public companies and their executive officers, directors, auditors, investment bankers and lawyers. Among its key provisions, the Act:

- Establishes new disclosure requirements applicable to public companies;
- Imposes CEO and CFO certification requirements of periodic reports with associated criminal liability;
- Prohibits company loans to executive officers and directors;
- Requires accelerated Section 16 reporting of transactions by executive officers and directors;
- Provides for forfeiture of bonuses and stock gains of CEOs and CFOs following an accounting restatement due to misconduct;
- Prohibits insider transactions during benefit plan “blackout periods”;
- Imposes new obligations on corporate audit committees;
- Establishes a new regulatory body to oversee the public company accounting profession;
- Prohibits auditors from contemporaneously providing non-audit services to their audit clients;
- Imposes new rules of professional responsibility on attorneys and securities analysts; and
- Enhances a variety of criminal penalties and enforcement measures for securities-related offenses.

What Companies Does the Act Apply To?
The Act applies to all publicly-owned U.S. companies and to all companies (whether U.S. or foreign) that have equity or debt securities registered under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), and certain provisions of the Act apply to companies that have filed a registration statement with the SEC that has not yet become effective or been withdrawn. Investment companies registered under Section 8 of the Investment Company Act of 1940 are exempt from the following Sections of the Act: 401 (Disclosure in Periodic Reports), 402 (Enhanced Conflict of Interest Provisions), and 404 (Management Assessment of Internal Controls).

Further Rulemaking and Interpretation Likely
The Act requires extensive SEC rulemaking to implement many of its provisions and expands on and conflicts with certain recent SEC pronouncements and rule proposals. The Act grants the SEC general author-
ity to adopt “such rules and regulations, as may be necessary or appropriate in the public interest or for the protection of investors, and in furtherance of” the Act. The SEC already has begun this process, and over the next few months, the SEC and other regulatory and self-regulatory organizations are likely to issue a flurry of interpretive releases, detailed analyses, and implementing and clarifying regulations.

Compliance with the Act
Because several provisions of the Act are effective immediately, public companies will be required to reexamine their corporate disclosure and governance policies and accounting practices—a process that should begin as soon as possible. This Stroock Special Bulletin highlights key provisions of the Act, reviews some of the more important changes and unanswered questions of the Act, and focuses on issues public companies should consider as they begin to comply with the Act. (A companion Stroock Special Bulletin focuses on issues of particular interest to directors and audit committees).

Part I summarizes the provisions of the Act that require your immediate attention, while Part II summarizes selected changes to the regulatory landscape.

The full text of the Act may be obtained at http://financialservices.house.gov/media/pdf/H3763CR_HSE.PDF.

Part I—Provisions that Require Immediate Attention

CEO/CFO Certification of Periodic Reports (Sections 906 and 302)
The Act requires CEOs and CFOs of public companies to make two distinct certifications relating to SEC filed periodic reports. These are in addition to the one-time SEC certification requirement, issued on June 27, 2002, which the SEC imposed on the CEOs and CFOs of the largest 947 U.S. based public companies. The certification provisions in Section 906 of the Act appear to be effective immediately for periodic reports filed by every domestic or foreign issuer on or after July 30, 2002, including any upcoming Form 10-Q filings.

These provisions require that any periodic SEC report that contains financial statements must “be accompanied by” a written statement of the CEO and CFO certifying that the report complies with the SEC requirements for periodic reports and fairly presents in all material respects the financial condition and results of operations of the company. While the certification is not qualified to the best of the officer’s knowledge, in contrast to the form of certification in the SEC’s June certification order and that required by the Act’s other certification provision, Section 302 (see discussion below), the Act provides for criminal penalties only for knowing or willful violations of this provision.

A knowing violation by a CEO or CFO of this certification requirement is punishable by a fine of up to $1 million and imprisonment for up to 10 years; a willful violation raises the maximum fine to $5 million and imprisonment to 20 years.

Section 302 of the Act provides for a separate certification requirement effective upon a final SEC rule to be implemented within 30 days of the enactment of the Act (e.g., August 29, 2002). This certification will require the CEO and CFO to certify, to the best of their knowledge, that:

- each quarterly and annual report is materially accurate and complete;
- the financial statements in the report present fairly the company’s financial condition and results of operations; and
- they have evaluated the adequacy of the issuer’s internal controls.

The full text of the certification, which is extensive, is set forth in the Act. While this certification is not expected to be effective until late August, companies, if they have not done so already, should promptly document and evaluate the effectiveness of their internal reporting processes.
On August 2, 2002, the SEC announced that the Section 302 certification requirement “essentially replaces” the certification rule proposed by the Commission on June 14.

**Ban on Personal Loans to Executive Officers and Directors (Section 402)**

Effective immediately, the Act amends Section 13 of the Exchange Act to prohibit public companies from making “personal loans” to executive officers and directors, subject to certain limited exceptions. Existing loans, provided they are not amended or extended, are “grandfathered”.

This provision raises many novel issues relating to executive compensation matters, and we advise all public companies to evaluate their existing compensation policies and arrangements to determine whether they involve “loans.” It should be noted that this ban on “loans” has no materiality exception and may prohibit such customary arrangements as advancing travel or relocation expenses or permitting cashless option exercises.

**Expeditied Disclosure of Insider Transactions (Section 403)**

Effective 30 days after enactment of the Act, Section 16 of the Exchange Act is amended to shorten the due date for Section 16 insiders (officers, directors and greater than 10% beneficial owners) to report transactions in their company’s stock and related derivative securities to two business days after the transaction (unless the SEC determines that two days is not feasible).

Within one year after enactment of the Act, insiders must file Section 16 reports electronically, and companies must post them immediately on their websites. This provision of the Act, together with the prohibition in the Act on loans to insiders, appears to render unnecessary many, but not all, of the SEC’s recently proposed Form 8-K insider transaction provisions. Because the SEC is likely to repose its proposed rules to comply with the Act, public companies should evaluate their existing procedures to assist insiders in meeting this accelerated Section 16 filing deadline.

**Forfeiture By CEO and CFO of Certain Bonuses and Profits upon Financial Statement Restatements (Section 304)**

Effective immediately, if an accounting restatement is required due to the material noncompliance of the company, as a result of misconduct, with any financial reporting requirement under the securities laws, the Act requires that CEOs and CFOs disgorge (1) any bonus or other incentive or equity based compensation received during the 12-month period following the first public issuance or filing with the SEC (whichever occurs first) of the noncompliant report, and (2) any profits realized from the sale of company securities during such period.

**Officer and Director Bars (Sections 305 and 1105)**

Effective immediately, the Act eases the standard governing judicial imposition of officer and director bars in SEC actions under Section 21(d)(2) of the Exchange Act and Section 20(e) of the Securities Act of 1933 from “substantial unfitness” to “unfitness” and now permits the SEC directly (without judicial order) to issue the bar order.

**Enhanced SEC Review of Periodic Disclosures (Section 408)**

Effective immediately, the Act directs the SEC to review the periodic reports of each public company at least once every three years and provides criteria for the SEC to consider in prioritizing reviews, including, among others, the occurrence of a restatement, volatility in an issuer’s stock price, market capitalization, and emerging companies with disparities in price-to-earnings ratios. The Act also provides for a significant increase in SEC funding (to $776 million in fiscal 2003).

**Real Time Disclosure (Section 409)**

Consistent with the SEC’s proposal to add new Form 8-K items, the Act will require issuers to disclose in plain English “on a rapid and current basis” such additional information concerning material changes in the financial condition or operations of the issuer as the
SEC determines is necessary or useful. This provision will be effective upon the SEC adopting implementing rules, but no deadline for these rules was provided in the Act. We believe public companies should comply immediately with this provision of the Act and the SEC’s prior guidance on expanded Form 8-K disclosure items.

**Increased Criminal Penalties and Other Remedies (Sections 801-807, 901-905 and 1101-1107)**

Effective immediately, the Act provides for expanded criminal penalties for a broad array of white-collar crimes and an increase in the statute of limitations for securities fraud lawsuits. The statute of limitations for private rights of action with respect to securities fraud is extended to the earlier of two years after the discovery of facts constituting the violation or five years after the violation.

In addition, the Act provides that debts arising from claims that result from violations of securities law cannot be discharged in bankruptcy, provides for a temporary freeze on extraordinary payments to employees of companies under investigation by the SEC, and makes it a crime to discriminate or retaliate against corporate whistleblowers.

The Act also imposes criminal penalties for the destruction, alteration and falsification of documents in federal investigations and bankruptcy proceedings, extends the maximum prison term to 25 years for securities fraud, enhances white-collar crime penalties and imposes corporate fraud accountability.

**Insider Trades During Pension Fund Blackout Periods (Section 306)**

Effective 180 days after enactment of the Act, the Act prohibits executive officers and directors from purchasing or selling the company’s equity securities during certain “black-out periods” (as defined in the Act) imposed on tax-qualified defined contribution plans, such as Section 401(k) plans, if such security was or would be acquired in connection with his or her service or employment as an executive officer or director. The Act provides that any shareholder on behalf of the company may institute an action to recover profits if the company fails to bring an action within 60 days of request. The Act also amends ERISA to require plan administrators to provide notice of black-out periods and related matters to plan participants. This provision is subject to certain exceptions and further SEC and Department of Labor rulemaking and clarification.

**Part II—Provisions Which Significantly Alter the Existing Regulatory Landscape**

**Enhanced Disclosure Provisions**

**Off-Balance Sheet Transactions; Pro Forma Financial Information; Material Correcting Adjustments (Section 401)**

The Act requires the SEC to establish within 180 days of enactment of the Act final rules regarding enhanced financial information disclosures in periodic reports filed with the SEC, including information on off-balance sheet transactions and reconciliation of any “pro forma” financial information with financial information resulting from application of GAAP. The provisions relating to “pro forma” financial information also require that the information be presented in a materially accurate and complete manner and apply to all SEC filings, press releases and other public disclosures or releases. In addition, each “financial report” that contains financial statements filed with the SEC must reflect all material correcting adjustments identified by the auditor in accordance with GAAP and SEC rules.

**Management Assessment of Internal Controls (Section 404)**

The Act requires the SEC to establish rules to require each public company’s annual report to contain an “internal control report” that:

- states management’s responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and
assesses, as of the end of the last fiscal year, the effectiveness of the internal control structure and procedures.

The company’s outside auditor will be required to attest to and report on management’s assessment in accordance with the standards for attestation engagements adopted by the Public Company Accounting Oversight Board established under the Act.

**Code of Ethics for Senior Financial Officers (Section 406)** The Act requires the SEC to issue proposed rules within 90 days of enactment of the Act and final rules within 180 days requiring each public company to disclose in its periodic reports whether it has adopted a code of ethics for senior financial officers, and if not, why not, and to disclose immediately on Form 8-K or by other electronic means any subsequent waivers or modifications to this code.

**Corporate Tax Returns**

Section 1001 of the Act provides that it is the sense of the Senate that CEOs should sign their companies’ federal income tax returns, but this provision is not law.

**Professional Responsibility Standards for Attorneys (Section 307)**

The Act requires the SEC to establish within 180 days of enactment of the Act minimum standards of professional conduct for attorneys appearing and practicing before the SEC in any way in representing public companies. The SEC standards must include a rule requiring an attorney to report to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof), evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, and in the absence of an appropriate response, to the audit committee of the board of directors of the issuer or the entire board of directors.

**Analyst Conflicts of Interest**

Section 501 of the Act requires the SEC or, if directed by the SEC, the NYSE or the NASD, to adopt rules within one year of enactment of the Act to address conflicts of interest arising between the provision of securities research and investment banking.

For further information about this Stroock Special Bulletin, please contact your Stroock attorney or Martin H. Neidell, a partner in Stroock’s Securities Practice Group, at 212-806-5836. Todd E. Lenson, an associate at Stroock, assisted with the preparation of this Stroock Special Bulletin.