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EFFECT OF THE SARBANES-OXLEY ACT OF 2002

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President Bush signed the Sarbanes-Oxley Act of 2002 (the "Act") into law on July 30, 2002, after numerous business and accounting scandals had rocked the public markets, resulting in billions of dollars being lost by investors. The Act takes immediate steps to regulate the accounting profession, help investor confidence, and enhance penalties significantly for those violating federal laws relating to public companies.

The Act is directed at public companies as well as their officers, directors, and service providers. Highlights of our discussion of the Act include:

- **Corporate Responsibility, Reporting and Oversight**
- **Creation of Public Company Accounting Oversight Board**
- **Auditor Independence and Reporting**
- **Real Time and Increased Financial and Other Disclosures**
- **Industry Analyst and Conflicts of Interest**
- **SEC Enforcement and Heightened Criminal Penalties**
- **Stock Options**

Corporate Responsibility, Reporting and Oversight

The most visible aspect of the Act is that it imposes new and stricter corporate governance requirements for public companies. It also creates severe new penalties and increases existing penalties for public company executives and directors who engage in corporate misconduct. What has become known as the new "corporate responsibility" provisions are discussed below.

- **CEO and CFO Certification of Financial Reports.** The Act contains two separate provisions imposing more responsibility on a public company's officers. First, the Act requires each public company's chief executive officer and chief financial officer to provide a written certification with each periodic report containing financial statements filed with the Securities and Exchange Commission (the "SEC"). The certifications must state that the periodic report containing the financial statements complies with SEC requirements and fairly presents, in all material respects, the

Company's financial condition and results of operations. The persons signing the certification are subject to criminal penalties of up to $1,000,000 and 10 years in jail for knowingly filing a false certification.

In addition, the Act directs the SEC to adopt a new rule by the end of August that requires that each public company's principal executive officer and principal financial officer to certify in each annual and quarterly report filed with the SEC that, among other things, the officer has reviewed the report, that 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 contained in the report not misleading, that the report reflects the financial condition of the company, that the Company maintains proper internal controls, that the officer has disclosed any deficiencies or fraud to the auditors and audit committee, and that he has indicated in the report whether or not there were significant changes in internal controls or other factors that could significantly weaken them.

- **Audit Committees.** The Act requires that all public companies maintain an audit committee and it expands the role and responsibility of such committees. Audit committees must now be directly responsible for engaging, compensating, and overseeing their company's outside auditing firm. Further, the accounting firm must report directly to the committee rather than to management. Each member of an audit committee must be an "independent" member of the company's Board of Directors and must not be an "affiliated person" of the company or any of its subsidiaries. The committee must establish a program for receiving and treating anonymous complaints and concerns regarding accounting issues, internal accounting controls, and auditing issues. Any company that does not comply is subject to being delisted from national stock exchanges or from Nasdaq.

- **Improper Influence.** The Act makes it illegal for any "officer or director of an issuer, or any person acting under the direction thereof, to take any action to fraudulently influence, coerce, manipulate, or mislead" any independent public or certified accounting firm.

- **Bonus and Compensation Forfeiture.** If a company is required to prepare a restatement of its financial statements as a result of misconduct that leads to a material noncompliance with the Act or any securities laws, the CEO and CFO must reimburse the company for any bonus or other incentive-based or equity-based compensation received, and any profits realized from the sale of securities of the company, by that person during the twelve (12) months following the first public issuance or filing with the SEC of the financial reporting document.

- **Officer and Director Bars.** The Act amends the Securities Act of 1933 and the Securities Exchange Act of 1934 to allow the SEC to bar any individual from acting as a director or officer of a public company if it is found that individual's conduct demonstrates "unfitness" to serve as such an officer or director. This replaces the former standard, which required the SEC to make a finding that the conduct demonstrated "substantial unfitness."

- **Prohibition on Personal Loans.** The Act expressly prohibits any personal loans to directors and officers.

- **Blackout Freeze.** The Act prohibits executive officers and directors from acquiring, selling or otherwise transferring equity securities received as compensation during any "black-out periods" in which the company's employees are prohibited for more than three (3) consecutive business days from trading such securities under their company pension plans.

- **FAIR.** Any civil penalties levied by the SEC as a result of any judicial or administrative action will be directed to a fund (known as the FAIR account) for the benefit of harmed investors. The Act also requires the SEC to develop methods to improve collection rates of these penalties.

- **Professional Responsibility for Attorneys.** Finally, the Act requires that both in-house counsel and outside law firms must report evidence of a material violation of the Act or any securities laws or breach of fiduciary duty or similar violation by the Company or any of its agents. The attorney whistleblower must go to the chief legal counsel or chief executive officer of the Company, and if those individuals do not appropriately respond to the evidence, the attorney must report the evidence to the audit committee, to another committee of the board comprised solely of outside directors, or to the full board.

Creation of Public Company Accounting Oversight Board

The Act creates the Public Company Accounting Oversight Board (the "Board") to oversee the auditing of public companies and to protect the interests of investors, although the SEC maintains ultimate oversight and enforcement authority over the Board. The Board will be composed of five (5) full-time members selected by the SEC (after consultation with the Chairman of the Federal Reserve Board and Secretary of the Treasury) of which only two (2) members may be or have been CPA's, with the chairperson not having been a practicing CPA within the five (5) year period prior to appointment.

All accounting firms (both US and foreign) proposing to issue audit reports on the financial statements of public companies will be required to apply to the Board for registration. The registration, ongoing reporting, and inspection requirements will be thorough, and it will be illegal for any accounting firm to participate in the preparation of an audit report with respect to a public company without first being registered with the Board.

The Board is also required to adopt auditing standards, quality control standards, and ethics standards to be used by public accounting firms in the preparation and issuance of audit reports, including the maintenance of working papers for seven (7) years, providing a second partner review and approval of audits, and establishing and maintaining internal controls in both the public accounting firms and the companies they audit.

The Board's authority includes holding disciplinary proceedings and public hearings (including subpoena power) against any accounting firm or associated person, to conduct public hearings and to impose sanctions and significant fines for any violation of the Act,

rules of the Board or SEC and applicable securities laws or professional standards. Sanctions for intentional or reckless actions include temporary or permanent revocation of Board registration or an individual's license, and civil fines of up to $15,000,000 for firms and $750,000 for individuals.

Auditor Independence and Reporting

The Act also prohibits accounting firms from providing any "non-audit" services to a company whose financial statements the accounting firm is auditing. The Act identifies nine (9) "non-audit" services, including any service that the Board determines is prohibited, but allows firms to provide other services, including tax services upon approval of the public company's independent audit committee of the Board of Directors.

The Act also requires that the lead audit partner, as well as the second audit partner responsible for reviewing the audit, must rotate from providing audit services to a company after five (5) years. The Act also prohibits an accounting firm from auditing a company's financial statements if the company's CEO, CFO or similar senior financial officer was employed by that accounting firm and they participated in the audit of the company during the previous year.

Real Time and Increased Financial and Other Disclosures

These provisions require companies to disclose, on a rapid and current basis, material changes in their financial condition or operations when a company's executives and directors learn of them. The SEC is empowered to determine the most effective way these disclosures should be made in order to be useful for the protection of investors and not just used for the benefit of executives.

The timeliness and quality of the disclosures is enhanced by requiring that the company include in its quarterly reports filed with the SEC (i) any correcting adjustments proposed by independent auditors; (ii) all material off-balance sheet transactions, arrangements, obligations (including contingent obligations) and other relationships; and (iii) improved presentations of pro forma financial information. Additionally, the Act requires "real time issuer disclosures," requiring public companies to disclose on a "rapid and current basis," such additional information concerning their financial condition and operations as the SEC determines to be necessary or useful for the protection of investors.

Industry Analyst and Conflicts of Interest

The Act provides for the enhancement of firewalls between companies and securities research analysts and investment bankers by requiring the adoption of rules designed to prevent conflicts of interest. Such rules include the prohibition of prepublication clearance of analyst reports by individuals employed as members of the investment banking group of a company and establishing blackout periods for the issuance of research reports by a firm prior to and following the firm's participation in a public offering of a company's securities.

SEC Enforcement and Heightened Criminal Penalties

The Act increases the SEC's ability to fight financial fraud by providing for increased staffing, funding and strengthening its enforcement and compliance abilities and programs. New penalties include stiff prison terms (with maximum sentences from ten (10) to twenty-five (25) years) for various activities such as: (i) the improper destruction, alteration or falsification of records with the intent to impede, obstruct or influence any federal investigation or bankruptcy; (ii) the knowing and willful destruction of any audit records and review work papers less than five (5) years from the end of the audit; (iii) knowingly executing, or attempting to execute, a scheme to defraud investors; and (iv) knowingly making, or causing to be made, a false or misleading statement as to a material fact in an application, report, or document filed with the SEC.

Stock Options

One provision that did not make it into the Act was the requirement that companies expense stock options in financial statements. While it was asserted that options constitute a substantial percentage of executive compensation in today's corporate environment, it is widely believed that this issue was much too politicized for resolution. Nevertheless, some public companies have recently announced that they would begin voluntarily expensing stock options, so it is unlikely that the issue will go away in this election year.

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If you have any additional questions concerning the impact that the Act might have on your company or you, please do not hesitate to contact Lawrence W. Koltun or Paul D. Economon, at Koltun & King, P.C., (202) 331-0123. You may also reach us at lkoltun@koltunlaw.com or peconomon@koltunlaw.com.

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