ARNOLD & PORTER ADVISORY

The New Sarbanes-Oxley Act

August 2002

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act (the "Act"), the most significant corporate reform legislation since the 1930s. The Act broadly impacts the way public companies, officers, directors, audit committees, auditors and even counsel act, and imposes significant new responsibilities, liabilities and risks on each of these parties. The Act mandates important new corporate governance and financial reporting requirements intended to enhance the accuracy and transparency of public companies' reported financial results. It establishes new responsibilities for corporate CEOs, CFOs and audit committees in the financial reporting process. It backs these requirements with new SEC enforcement tools and criminal penalties, including new obstruction of justice and document destruction provisions effective immediately. It also increases the opportunity for more private litigation by lengthening the statute of limitations for securities fraud and providing new federal corporate whistleblower protection.

The legislation also provides for a Public Company Accounting Oversight Board to oversee auditors of public companies. Many of the Act's provisions apply with respect to "registered" public accounting firms and take effect when the new oversight board is officially recognized by the SEC and accounting firms register with it – which will take place sometime next year.

A number of other provisions relating to audit committee and management responsibilities also will take effect over time, subject to SEC rulemaking. As a practical matter, many companies will look to the new statutory provisions, as well as existing and proposed listing requirements of the exchanges and national securities associations, and will begin taking steps to prepare for these requirements. We believe the good news is that this process can be deliberate and take place over time, with appropriate regulatory guidance.

The news is not as good with respect to provisions of the Act that take effect immediately. Some of these are new criminal provisions that were added to the Act with little debate on the floor of the Senate. As a result, much of the language is broad and confusing and may not be susceptible to definitive guidance.

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A brief summary of the coverage of the Act is set forth below, beginning with those provisions of most immediate concern. Unless otherwise stated, timing references below refer to the number of days before a particular provision becomes effective after July 30, the day the Act was signed into law. Information in brackets refers to the section of the Securities Exchange Act or U.S. Code being amended.

I. Provisions of Immediate Concern

A. Officer Certifications

As more fully discussed below, the Act requires certain public company[1] officers to certify certain of the company's periodic reports filed with the SEC.

Certification Required Pursuant to the Act

Effective immediately, section 906 of the Act requires that each periodic report containing financial statements filed by a public company be accompanied by a statement of the CEO and CFO, certifying that the report "fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that the information contained [therein] fairly presents, in all material respects, the financial condition and results of operations" of the company. The Act provides criminal penalties for knowingly or willfully making a false certification. ***These certifications must accompany each periodic report that a public company files on or after July 30, 2002.*** [18 U.S.C. 1350]

Section 906 raises a number of questions about the form, content, and manner of transmission of the required certification. For example, it does not indicate how the certifications are to "accompany" a periodic report (i.e. as separate correspondence, filed as an exhibit, etc.) or whether it is permissible for the signing officers to indicate the basis for the statements they are required to certify. Also significant is the fact that the required certification *does not include a knowledge qualifier and is not subject to a materiality standard*. The Act provides for the imposition of criminal penalties, however, only for certification "knowing that the periodic report does not comport with the requirements" outlined in the certification. We plan to clarify these issues and applicable section 906 certification requirements when and if additional guidance becomes available.

Note that "fairly presents . . . the financial condition and results of operations" may not be synonymous with compliance with GAAP in the view of the SEC. Therefore, **CEOs and CFOs should take this into consideration in making the determination that the financial statements fairly present the company's financial condition and results of operations and, if necessary, provide additional disclosure or explanation in the periodic report**.

[1] Many of the Act's provisions are applicable to "issuers," which are companies that have securities registered under Section 12 of the Securities Exchange Act of 1934 (the "Exchange Act"), that are required to file reports under Section 15(d) of the Exchange Act, or that file a registration statement that has not yet become effective ("public companies"). The relevant provisions of the Act also appear to be applicable to foreign private issuers, as the Act does not exempt foreign private issuers from its provisions. Although many of the provisions of the Act are to be enforced by SEC rules, for which the SEC will have limited exemptive power, in general the SEC was not granted exemptive authority for entire classes of issuers. We therefore expect that most, if not all, of the SEC rules to be written pursuant to the Act will also apply to foreign private issuers.

Certification to be Required under SEC Rules

A separate provision of the Act, section 302, requires the SEC to issue ***by August 29, 2002*** rules that will require public companies' principal executive officer(s) and principal financial officer(s) to certify with each annual or quarterly report that:

- he or she has reviewed the report;
- based on his or her knowledge:
  - the report does not contain any material misstatements or omissions, and
  - the financial statements and other financial information included in the report fairly presents in all material respects the company's financial condition and results of operations; and
- the signing officers:
  - are responsible for establishing and maintaining internal controls,
  - have designed the controls to ensure that material information about the company and its consolidated subsidiaries is made known to them, particularly during the period in which the reports are being prepared,
  - have evaluated the effectiveness of the controls within 90 days prior to the report,
  - have presented in the report their conclusions as to the effectiveness of the controls based on that evaluation,
  - have also indicated in the report whether there were significant changes in internal controls or other factors that could significantly affect internal controls subsequent to their date of evaluation, and any corrective actions taken with regard to significant deficiencies and material weaknesses;
  - have disclosed to the auditors and the audit committee significant deficiencies in the internal controls and any fraud, whether or not material, involving persons with a significant role in the system of internal controls; and
  - have identified for the auditor any material weaknesses in the internal controls.

Thus, beginning with the next annual or quarterly report filed on or after August 29, 2002, a public company's principal executive and principal financial officer(s) will need to make these additional certifications, including evaluating and reporting on their evaluations of internal controls. We encourage companies to review their existing procedures for preparing SEC reports and to make any adjustments to the procedures as promptly as possible.

The certifications required pursuant to the Act are separate, and in addition to, the certifications required by SEC Order 4-460, dated June 27, 2002, applicable to the principal executive and principal financial officers of certain public companies with revenues in excess of $1.2 billion during their last fiscal year.

B. Prohibition of Loans to Directors and Executive Officers

Effective immediately, section 402 of the Act prohibits public companies from making, renewing or arranging for personal loans to their directors and executive officers. Loans in existence on the date of enactment may be maintained as long as there is no material modification or extension of such loans. Certain loans, including home improvement and manufactured home loans, consumer credit loans, credit under an open end credit plan, charge cards and margin loans not used to purchase the company's stock, are still permitted if made in the ordinary course of the company's business on market terms. Loans by FDIC-insured depository institutions are also permitted if covered by existing bank regulatory insider lending restrictions (i.e., Regulation O). **These narrow exceptions, however, may provide no room for certain types of credit arrangements that companies offer executive officers and directors, or certain compensation arrangements that may be construed as loans**, such as accepting promissory notes to purchase stock or exercise options. **Section 402 also does not specify whether mortgage loans made by financial institutions that are not FDIC-insured, including mortgage subsidiaries of FDIC-insured institutions, would fall within the exceptions.** [New Exchange Act subsection 13(k)]

C. Disclosure of Insider Transactions in the Company's Securities

Effective August 29, 2002 section 403 of the Act replaces section 16(a) of the Exchange Act with a statutory provision requiring a public company's officers, directors and beneficial owners of more than 10% of a registered class of the company's equity securities ("insiders") to report any changes in their holdings of the company's equity securities ***within two business days***. Currently, section 16(a) requires insiders to report any such changes by the 10th day of the following month (Form 4), although SEC rules currently exempt certain transactions in securities or allow insiders to defer the reporting of them until the 45th day of the following year (Form 5).

The Act empowers the SEC to modify the timing requirements by rule if it determines that the two-day period is not feasible. However, absent SEC action, **insiders should assume that, beginning August 29, they must report all changes in their company equity securities holdings**, even transactions currently exempt from reporting or eligible for delayed reporting, **within two business days**. In addition, **many**

companies may need to consider how to assist their insiders with reporting transactions within the accelerated timeframe, particularly under benefit plans, such as 401(K) and 423 stock purchase plans. The SEC has not indicated whether the Act will affect its pending rulemaking that would require public companies to report on Form 8-K transactions in company equity securities by their directors and executive officers.

Within one year, the forms reporting these transactions (but not Initial Statements of Beneficial Ownership on Form 3) must be filed electronically and made available on an SEC web site. In addition, if the company maintains a web site, it will be required to post the forms on its web site within one day of filing.

D. Preservation of Documents and Records

Effective immediately, section 802 provides, "whoever knowingly alters, destroys . . . 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 U.S. or any bankruptcy case filed under Title 11, "or *in relation to or contemplation of any such matter or case"* shall be subject to criminal fines and imprisonment. This broad language is intended to expand current obstruction of justice law, which requires either a pending proceeding or the anticipation of a specific proceeding. [18 U.S.C. 1519] The Senate Judiciary Committee report states that this provision:

> " . . . is meant to apply broadly to any acts to destroy or fabricate physical evidence so long as they are done with the intent to obstruct, impede or influence the investigation or proper administration of any matter, and such matter is within the jurisdiction of an agency of the United States, or such acts done *either in relation to or in contemplation of such a matter or investigation*. The statute is specifically meant not to include any technical requirement, which some courts have read into other obstruction of justice statutes, to tie the obstructive conduct to a pending or imminent proceeding or matter. It is also sufficient that the act is done 'in contemplation of' or in relation to a matter or investigation . . . so that the timing of the act in relation to the beginning of the investigation is also not a bar to prosecution."[2] (Emphasis supplied)

The statutory language, together with this legislative history, could be read broadly by a prosecutor to put at issue a document retention policy that was established in part with an eye toward the possibility of future government inquiries or proceedings.[3] Indeed, the minority views contained in the Senate Judiciary Committee report raise this concern.[4]

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[2] S. Rep. No. 107-146, at 14-15.

[3] The statute does not apply to private civil lawsuits.

[4] "We have voiced our concern that section 1519 . . . could be interpreted more broadly than we intend. In our view, section 1519 should be used to prosecute only those individuals who destroy evidence with the specific intent to impede or obstruct a pending or future criminal investigation, a formal administrative proceeding, or bankruptcy case.

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Although it may be unlikely that the Department of Justice would take such an extreme position, the Department may argue in future cases where individuals are charged with destroying documents that this statute forecloses reliance on a document retention policy, and that it applies if the policy was crafted in part to protect the company from future investigations.

This section also requires that a public company's auditor retain all audit or review workpapers for 5 years, directs the SEC within 180 days to issue rules relating to the retention of a broader category of records in connection with an audit or review, and provides penalties for violations of such rules. [18 U.S.C. 1520]

Also ***effective immediately***, a separate provision, section 1102, provides penalties for "corruptly" altering, destroying, mutilating or concealing records, documents or other objects, or attempting to do so, with the intent of impairing the object's integrity or availability for use in an official proceeding, or for obstructing, influencing or otherwise impeding any official proceeding or attempting to do so. [18 U.S.C. 1512] In a statement released upon his signing the Act, the President construed the term "corruptly" in this section as "requiring proof of a criminal state of mind on the part of the defendant." The President's statement did not construe the ambiguous language in new 18 U.S.C. 1519, discussed above.

In view of these new requirements, it would be prudent for companies to immediately review with counsel existing document retention policies and, where appropriate, develop new policies and procedures.

E. Whistleblower Protections

Effective immediately, under section 806 of the Act, a public company is prohibited from discharging or taking any action to demote, harass or "in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee" to provide information to a federal regulatory or law enforcement agency, the Congress, or a supervisor regarding violations of specified criminal statutes, the rules of the SEC, or any provision of Federal law relating to fraud against shareholders. This section also protects employees of public companies from retaliatory discharge or other adverse employment actions because of the employee's action to file, testify, participate in or otherwise assist in proceedings filed or about to be filed (with any knowledge of the employer) involving alleged violations of the securities laws or SEC regulations relating to fraud against shareholders. The employee must seek a remedy (reinstatement, back pay, special damages) first from the Department of Labor and then may pursue his/her claim in federal court. [18 U.S.C. 1514A]

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It should not cover the destruction of documents in the ordinary course of business, even where the individual may have reason to believe that the documents may tangentially relate to some future matter within the conceivable jurisdiction of an arm of the federal bureaucracy." S. Rep. No. 107-146, at 27.

Separately, ***effective immediately***, section 1107 of the Act provides criminal penalties for "knowingly, with the intent to retaliate, tak[ing] any action harmful to any person, including interference with lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission of any Federal offense." [18 U.S.C. 1513]

F. Forfeiture of Executive Incentive Compensation, Stock Profits

Effective immediately, section 304 provides that, if as a result of misconduct, a public company is required to prepare an accounting restatement because of material non-compliance with any financial reporting requirement under the securities laws, the CEO and CFO must reimburse the company for any bonuses and other equity- or incentive-based compensation they received and any profits on stock sales they realized within 12 months of the first public disclosure of such financial statements. **The Act does not define the term "misconduct," and therefore it is unclear what standard or level of culpability will be necessary to trigger the forfeiture provisions of section 304.**

These forfeiture provisions appear to apply regardless of whether the CEO or CFO engaged in the misconduct (although the Senate Report on the Act refers to "management . . . misleading the public and regulators about the poor health of the company"), or whether the CEO or CFO would have earned the compensation even under the restated financials. The SEC is authorized, however, to exempt any person from its application "as it deems necessary and appropriate."

II. Disclosure and Financial Reporting

A number of significant changes in disclosure and financial reporting requirements will be adopted through SEC rulemaking over the next year. Major areas of rulemaking and other activity mandated by the Act are discussed below.

A. Off-Balance Sheet Transactions

The SEC has issued guidance indicating that companies should discuss off-balance sheet transactions, arrangements and relationships that are likely to materially affect liquidity or the availability of or requirements for capital resources, but there is not a formal rule specifically requiring such disclosure.

Section 401(a) of the Act directs the SEC to issue, within 180 days, rules requiring public companies to discuss in their annual and quarterly reports all material off-balance sheet transactions, arrangements, obligations and other relationships of the company with unconsolidated entities or other persons that may have a material current or future effect on the company's financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources or significant components of revenues or expenses. [New Exchange Act subsection 13(i)]

B. Pro Forma Financial Presentations

Current SEC guidance provides that pro forma financial presentations should not be misleading and should clearly disclose the basis of the pro forma presentation and how it differs from GAAP. There is no requirement, however, that pro forma financial presentations include a reconciliation to GAAP.

Under section 401(b) of the Act, the SEC must issue, within 180 days, rules requiring that any pro forma financial presentation in any SEC filing, press release or other public disclosure, (1) not contain an untrue statement of material fact or omit to state a material fact necessary to make the presentation not misleading and (2) be reconciled with the company's financial condition and results of operations under GAAP.

C. Internal Controls

Section 404 of the Act requires the SEC to issue rules (no deadline is given for the issuance of such rules) requiring a public company's annual reports to include an internal control report that (1) states management's responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and (2) contains an assessment, as of the end of the company's most recent fiscal year, of the effectiveness of those controls. Each *registered* public accounting firm that prepares or issues the audit report must report on and attest to management's assessment of the company's internal controls under standards to be established by the new Board required under the Act to oversee auditors of public companies. (See discussion of the Board in Part IV below).

The SEC has a pending rule proposal that would require each public company to maintain procedures to provide reasonable assurance that it is able to collect, process and disclose the information required in its periodic reports, and requiring periodic review and evaluation of these procedures. Unlike the Act's provisions, the SEC proposal covers both financial and non-financial information and exempts foreign private issuers. The SEC's proposed annual certifications would include a statement that the officer has reviewed the results of their company's evaluation of these procedures.

D. Material Correcting Adjustments

Section 401(a) requires that each company "financial report" that contains financial statements required to be prepared in accordance with (or reconciled to) GAAP and filed with the SEC must reflect all material correcting adjustments identified by a *registered* public accounting firm in accordance with GAAP and SEC rules. [New Exchange Act subsection 13(i)]

E. Real Time Disclosure

Section 409 of the Act grants the SEC the power to issue rules requiring public companies to disclose "on a rapid and current basis" any additional information concerning material changes in the financial condition or operations of the company that the SEC considers necessary or useful and in the public interest. As described in a July 2002 memorandum available on our web site (arnoldporter.com), the SEC has proposed rules pending to increase and accelerate current reporting requirements on Form 8-K.

F. Code of Ethics

Section 406 of the Act requires the SEC to propose within 90 days, and issue within 180 days, rules requiring public companies to disclose in their periodic reports whether, and if not why not, the company has adopted a code of ethics for senior financial officers, including its principal financial officer and comptroller or principal accounting officer, or persons performing similar functions. Within the same time, the SEC must amend its Form 8-K disclosure regulations to require that public companies report any change to or waiver of such code "immediately" by filing of a Form 8-K, dissemination by the Internet or by other electronic means. Section 406 states that "code of ethics" means standards reasonably necessary to promote: honest and ethical conduct, including the handling of actual or apparent conflicts of interest between personal and professional relationships; full, fair, accurate, timely and understandable disclosure in the company's periodic reports; and compliance with applicable governmental rules.

G. Enhanced SEC Review of Periodic Disclosures

Section 408 of the Act mandates an enhanced program of regular and systematic SEC review of public company disclosures, including a requirement that the SEC review the filings of every public company at least once every three years.

III. The Audit Committee Structure and Statutory Responsibilities – in General

The Act defines an "audit committee" as being established for the purpose of overseeing the accounting and financial reporting processes of the company and the audits of the company's financial statements. If there is no audit committee, then the term as used in the Act applies to the entire board of directors.

Section 301 *directs the SEC to write rules within 270 days requiring changes in exchange and national securities association listing standards* to require that a listed company comply with the requirements of section 301, as outlined below. The SEC's rules must provide an opportunity for companies to cure any defects prior to delisting. Because there is no timing requirement for the adoption of such rules by the exchanges and associations, it is unclear when these requirements will become applicable. [New Exchange Act subsection 10A(m)]

A. Independence of Audit Committee Members

Under the required listing standard, a public company's audit committee must be independent, which will mean that audit committee members cannot, other than in their capacity as a director and a member of any board committee:

- accept consulting, advisory or other compensatory fees from the company; or
- be an affiliate of the company or any subsidiary.

Currently, NYSE, AMEX and Nasdaq listing standards require that the audit committee of companies listed or quoted thereon be comprised, with limited exceptions, of independent directors; current SEC rules provide that a company must disclose whether its audit committee members are "independent" under such listing standards, even if its securities are not listed or quoted. The requirements of the Act do not prevent national securities exchanges and associations from adopting listing standards in addition to those required by section 301.

B. General Responsibilities of the Audit Committee

The listing standards must provide:

- The audit committee will be directly responsible for appointing, compensating, and overseeing the work of any *registered* public accounting firm employed to conduct the company's audit, including the resolution of any disagreements between management and the auditors relating to financial reporting. The auditors must report directly to the audit committee. It is uncertain what responsibilities will follow from this requirement of direct reporting beyond the specific actions required by the Act.

- The audit committee must establish procedures to receive and address complaints regarding accounting, internal accounting controls or auditing issues, including providing for the company's employees to submit on a confidential, anonymous basis concerns regarding questionable auditing or accounting matters.

- The audit committee will have the authority to engage independent counsel and other advisers as deemed necessary for the committee to carry out its duties and the company must provide appropriate funding, as determined by the audit committee, to compensate the auditors and any advisers employed by the audit committee.

C. Disclosure Relating to Audit Committee Financial Expertise

Currently the NYSE and Nasdaq have rules requiring that at least one member of the audit committee have certain financial expertise, but there is no such universal requirement for all public companies. Under section 407 of the Act, within 90 days the SEC must propose, and within 180 days the SEC must issue, rules requiring public companies to disclose in their periodic reports whether or not, and if not why not, at least one member of the audit committee is a "financial expert" as shall be defined by the SEC pursuant to the considerations outlined in the Act.

IV. Public Company Accounting Oversight Board

Title I of the Act establishes a Public Company Accounting Oversight Board (the "Board") to oversee the audit of public companies. Within 90 days after enactment, the SEC must appoint the initial members of the Board, and within 270 days the Board must take actions (including hiring of staff, proposal of rules and adoption of initial and transitional auditing and other professional standards) to allow the SEC to determine that the Board is organized and has the capacity to carry out its mission. Within 180 days thereafter, each accounting firm that audits public companies must become a "registered public accounting firm" by registering with the Board. Foreign firms that audit U.S. issuers will have to register, and the Board can require registration of other foreign firms that substantially participate in the audits of U.S. issuers.

While Title I primarily addresses oversight of accounting firms, it provides that public companies will be assessed fees to pay the cost of running the new Board and will be affected by the Board's activities in a number of ways. The Board, which will need to hire hundreds of auditors in order to meet the congressional mandate that it inspect the largest accounting firms on an annual basis, will have access to all audit workpapers and related materials maintained by registered public accounting firms in connection with their audit work for public company clients. If the Board in conducting an investigation of an accounting firm needs documentation from audit clients, it may request the SEC to obtain the documents from them. Routine inspections and investigations of accounting firms subject to the new Board's authority could lead to investigations of audit clients by the SEC and other regulators.

The full impact of this new Board will not be known until accounting firms become subject to its regulation. As noted in the introduction, *provisions of the Act applicable to registered public accounting firms will not take effect for many months*, until the Board is up and running and firms have registered with it.

V. Public Companies' Relationship with Auditors

To the extent the provisions discussed below apply to a company's relationship with a *registered* public accounting firm, they will not be applicable for many months.

A. Provision of Non-Audit Services

Section 201 of the Act provides that a *registered* public accounting firm will be prohibited from providing to its public company audit clients the following services: (1) bookkeeping or other services related to the accounting records or financial statements of the company; (2) financial information systems design and implementation; (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker or dealer, investment adviser, or investment banking services; (8) legal services and expert services unrelated to the audit; and (9) any other service that the Board determines, by regulation, is impermissible. With the exception of expert services, these services are generally limited (with some exceptions) under current SEC independence rules. [New Exchange Act subsection 10A(g)]

A *registered* public accounting firm may provide any non-audit service not prohibited pursuant to section 201 only if the service is pre-approved by the company's audit committee. [New Exchange Act subsection 10A(h)]

B. Audit Committee Pre-Approval

Section 202 of the Act requires that the audit committee of a public company pre-approve all audit and permitted non-audit services to be provided by the company's outside auditors. If the audit committee approves the provision of any permitted non-audit service, the company must disclose such approval in its next periodic report filed with the SEC. The audit committee may designate to one or more of its independent members the authority to grant such pre-approvals. Pre-approval by such delegated members must be reported to the full audit committee at its next meeting. Although this provision refers to "auditors," the Senate Banking Committee report states that this provision applies to services provided by a *registered* public accounting firm. [New Exchange Act subsection 10A(i)]

C. Auditor Rotation

Pursuant to section 203 of the Act, (as further clarified by the relevant committee report) a *registered* public accounting firm must rotate its lead (or coordinating) partner and review partner on a public company audit so that no partner performs an audit on the same company as lead or review partner for more than five consecutive years. The current practice is to rotate engagement partners every seven years. There is no mandatory accounting *firm* rotation; section 207 of the Act requires a study on this issue. [New Exchange Act subsection 10A(j)]

D. Conflicts of Interest

Under section 206 of the Act, a *registered* public accounting firm may not provide audit services to a public company if that company's chief executive officer, controller, chief financial officer or chief accounting officer, or equivalent, was employed by the accounting firm and worked on the company's audit during the one-year period before the start of the audit. [New Exchange Act subsection 10A(l)] Current SEC rules prohibit an accounting firm from providing audit services to a public company if the company employs in a position having an accounting role or financial reporting oversight role a former partner, principal, shareholder or professional employee that still has certain managerial or financial ties to the accounting firm beyond set retirement payments.

E. Auditor Report to Audit Committee

Section 204 of the Act requires a public company's *registered* public accounting firm auditor to timely report to the audit committee (1) all critical accounting policies and practices to be used, (2) all alternative treatments of financial information within GAAP that have been discussed with management, the ramifications of their use, and the treatment preferred by the auditor, and (3) other material written communications with management, such as management letters and schedules of unadjusted differences. [New Exchange Act subsection 10A(k)]

VI. Pension Fund Blackout Period

Pursuant to section 306 of the Act, 180 days after enactment a company's executive officers and directors are prohibited from engaging in any transactions in the company's equity securities during a pension fund "blackout" period if they acquire such securities within their service as a director or executive officer. Generally, a blackout period is a period during which participants in the company's 401(K) and certain similar plans are precluded from trading in such plans for a period of more than three consecutive business days. The company is generally required to provide advance notice of a blackout period to executive officers and directors.

Section 306 directs the SEC to issue rules in connection with the operation of this requirement (and permits it to make exceptions), but the effectiveness of the blackout provisions is not dependent on such rulemaking. The Act provides that until the SEC issues the required rules, good faith compliance will be treated as compliance with these provisions.

VII. Other SEC and Civil and Criminal Penalties and Provisions

The new criminal and civil sanctioning provisions and new statute of limitations for securities fraud discussed below are ***effective upon enactment*** unless otherwise noted. The new criminal penalties and requirements discussed at the beginning of this memorandum are matters of immediate concern in view of the duties imposed on individuals and entities by those provisions. The provisions described below provide additional enforcement and sanctioning authority to the SEC and Department of Justice.

A. SEC Officer/Director and Other Bars

Effective immediately, section 305 of the Act lowers the threshold for a court to bar officers and directors of public companies from serving as such in SEC actions under sections 21(d)(2) and 20(e) of the Exchange Act from "substantial unfitness" to "unfitness." The Act also amends section 21C of the Exchange Act and section 8A of the Securities Act of 1933 ("Securities Act") by authorizing the SEC, in any administrative cease-and-desist proceeding for violations of section 10(b) of the Exchange Act or section 17(a)(1) of the Securities Act, to bar persons from serving as officers or directors of *any* public company if their conduct demonstrates unfitness to so serve.

Effective immediately, section 604 of the Act amends section 15(b)(4) of the Exchange Act and section 203(e) of the Investment Advisers Act of 1940 to authorize the Commission to bar from the securities industry any person who has been suspended or barred by a state securities, banking, or insurance regulator because of fraudulent, manipulative, or deceptive conduct. This amendment addresses situations where persons barred or suspended from participating in one industry, such as the insurance industry, for fraudulent, deceptive or dishonest conduct, move from that industry to the securities industry. Prior to this amendment, the SEC lacked the enforcement authority to preclude such persons from associating with or establishing a broker-dealer.

Effective immediately, section 603 of the Act amends section 21(d) of the Exchange Act and section 20 of the Securities Act by authorizing Federal courts, in a proceeding brought by the SEC, to bar persons who engaged in misconduct from participation in future penny stock offerings.

B. Other Equitable Sanctions

Effective immediately, section 305 of the Act amends section 21(d) of the Exchange Act by allowing for any equitable relief necessary or appropriate for the benefit of investors in an SEC proceeding. The Exchange Act currently provides set monetary penalties for securities violations, but no general power to impose equitable penalties.

C. Temporary Escrow of "Extraordinary Payments"

Effective immediately, section 1103 of the Act amends section 21C(c) of the Exchange Act by providing the SEC the power, during an investigation into securities law violations, to seek a temporary court order requiring a public company to escrow "extraordinary payments" likely to be made to any officer, director or other affiliate.

D. Improper Influence on Audits

Section 303 makes it illegal, in contravention of rules the SEC may prescribe, for an officer, director, or person under their discretion to fraudulently influence, coerce, manipulate or mislead any accountant engaged in the performance of an audit of the financial statements for the purpose of rendering the financial statements misleading. The SEC has 90 days after the date of the Act's enactment to issue proposed rules *and 270 days after such enactment date to issue final rules*, required by section 303. The SEC has testified that it has authority currently to prosecute officers, directors and third parties who assist them in misleading auditors.

E. Other Criminal Provisions

Effective immediately, section 807 of the Act creates a new criminal provision for securities fraud, for knowingly defrauding a person in connection with the issuance of any security of a public company or obtaining by fraud money or property in connection with the purchase or sale of any security of a public company (or attempting or conspiring to do so). [18 U.S.C. 1348] In the past, federal prosecutors have relied either on the mail and wire fraud statutes, which are punishable by up to five years imprisonment, or a patchwork of sometimes technical offenses in Title 15 of the U.S. Code, to punish securities fraud. According to the Senate Judiciary Committee report, the new securities law offense provides a "general and less technical provision" for securities law offenses.

Effective immediately, section 903 of the Act increases the maximum prison sentence for mail and wire fraud from 5 years to 20 years. [18 U.S.C. 1341, 1343]

Effective immediately, section 904 of the Act amends ERISA to increase its criminal penalties for violations. The maximum prison term is increased from 1 year to 10 years, and the maximum fines are increased from $5,000 to $100,000 for an individual and from $100,000 to $500,000 for a corporate entity. [29 U.S.C. 1131]

Effective immediately, section 1106 of the Act increases the criminal penalties for willful violations of the Exchange Act and the rules and regulations thereunder, and for false or misleading statements in SEC filings that are willfully and knowingly made. For natural persons, the maximum fine and imprisonment is increased from $1,000,000 and 10 years to $5 million and 20 years, and the maximum fine for entities is increased from $2.5 million to $25 million. [Exchange Act section 32(a)]

Effective immediately, section 902 of the Act clarifies that anyone who attempts or conspires to commit any criminal fraud offense is subject to the same penalties as those prescribed for the actual commission of the offense. [18 U.S.C. 1349]

F. Extension of Statute of Limitations for Securities Fraud

Effective immediately, section 804 of the Act extends the statute of limitations for private rights of action in connection with securities fraud to the earlier of two years after discovery of the facts constituting the violation or five years after such violation. The statute of limitations for claims under section 10(b) of the Securities Act, and Rule 10b-5 promulgated thereunder, the most common form of private federal securities law claim for fraud, had been one year/three years. [28 U.S.C. 1658]

G. Review of Sentencing Guidelines

Sections 805, 905, and 1104 of the Act direct the U.S. Sentencing Commission to review and (as appropriate) amend the Federal Sentencing Guidelines for white-collar crimes and obstruction of justice. Section 805(a)(5) directs the Sentencing Commission to review the organizational guidelines in Chapter 8 (including related policy statements) to ensure they are "sufficient to deter and punish organizational criminal misconduct" and to make amendments as appropriate. The Senate Judiciary Committee report states that this provision requires a "complete review" of the organizational guidelines "which are outdated and need to be toughened to deter corporate crime." **Changes to the Federal Sentencing Guidelines, which govern the actual sentence a criminal defendant receives, will have far more practical impact than will increases in statutory maximums**. There will likely be an opportunity for public comment before any guidelines are enacted.

H. No Bankruptcy Discharge of Securities Law Liability

Effective immediately, section 803 of the Act amends Federal bankruptcy law so that a debtor cannot discharge in bankruptcy debts arising under claims relating to the violation of federal or state securities laws or common law fraud, deceit or manipulation in connection with the purchase or sale of any security. [11 U.S.C. 523(a)]

VIII. Analyst Conflict of Interest Provisions

Title V of the Act addresses conflicts of interest issues relating to securities analysts. The Act amends the Exchange Act, directing the SEC to adopt rules in this area. Much of this legislation has already been addressed by the SEC on May 8, 2002, upon approving the new NASD conduct rule 2711 and NYSE rule 472 regarding research analysts.

The Act directs the SEC to: (i) limit the supervision that the investment banking departments of securities firms have over securities research analysts; (ii) define periods during which brokers or dealers who have participated in a public offering should not publish research reports regarding the issuer or securities; (iii) require broker dealers to establish structural safeguards to assure that research analysts are separated from investment banking activities; and (iv) require research analysts to disclose in public appearances and research reports, conflicts of interest that are known or should have been known by the research analyst to exist at the time of distribution.

IX. Securities Lawyer Responsibilities

Section 307 of the Act directs the SEC to issue rules setting minimum standards for attorneys appearing or practicing before the SEC, including a rule requiring counsel to report securities law violations, breach of fiduciary obligations, or similar violations by the company or any of its agents, to a public company's chief legal counsel or CEO, and if they do not respond, to the company's audit committee.

This advisory is only a general summary of the new Sarbanes-Oxley Act and should not be construed as providing legal advice. Arnold & Porter attorneys Marti Cochran (202-942-5228) and Geoffrey Aronow (202-942-5181) represented particular clients on aspects of the legislation. If you have any questions about the new Act, please feel fee to call them, or call Steven Kaplan (202-942-5998), Richard E. Baltz (202-942-5124) or your Arnold & Porter attorney. Questions regarding criminal law provisions of the new Act may also be directed to Robert Weiner (202-942-5855) or Robert Litt (202-942-6380).