

BAILEY CAVALIERI LLC

ATTORNEYS AT LAW

One Columbus 10 West Broad Street, Suite 2100 Columbus, Ohio 43215-3422
telephone 614.221.3155 facsimile 614.221.0479
www.baileycavalieri.com

SARBANES-OXLEY ACT OF 2002

**Prepared by
Dan A. Bailey**

The material in this outline is not intended to provide legal advise as to any of the subjects mentioned but is presented for general information only. Readers should consult knowledgeable legal counsel as to any legal questions they may have.

I. SARBANES-OXLEY ACT OF 2002

In response to incidents of corporate impropriety, including accounting irregularities and corporate scandal of unprecedented scale and severity, President Bush signed the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”) into law on July 30, 2002. Sarbanes-Oxley stands as the most sweeping new corporate governance legislation in decades, and addresses several areas of national concern regarding corporate accounting and auditing, fraud and officer liability, and corporate transparency, including the following notable provisions:

- The creation of an independent accounting board to oversee corporate accounting and auditing practices;
- The requirement that financial statements be personally certified by the CEOs and CFOs of public companies;
- A ban (with few exceptions) on corporate loans to officers and directors;
- The accelerated reporting of insider trades;
- The requirement that audit committees be composed entirely of “independent” directors; and
- The forfeiture of bonus and equity compensation for CFOs or CEOs in the event of a material restatement of a company’s financial statements.

Although the provisions of Sarbanes-Oxley are unquestionably significant, Sarbanes-Oxley generally does not change the way directors and officers should discharge their duties to a public corporation and its shareholders. Committing securities fraud, obstructing justice, intentionally destroying evidence, and filing false financial statements were all illegal before Sarbanes-Oxley. Many officers and directors have been doing exactly what they should be all along and have not been breaking or bending the federal securities laws or accounting rules. For these directors and officers, Sarbanes-Oxley should not significantly change the way they carry out their responsibilities, other than taking steps to implement a few new procedures or meet additional reporting requirements.

Following enactment of Sarbanes-Oxley, the number of shareholder lawsuits against public companies and their directors and officers is not expected to increase significantly due to the new legislation. However, in light of the recent media focus on corporate wrongdoing, the attention Sarbanes-Oxley brings to the actions of public company officers and directors, and a new and, in some ways unclear, set of laws and regulations which the plaintiff’s bar can use to craft shareholder lawsuits, the legal environment in which directors and officers serve has become increasingly dangerous.

While Sarbanes-Oxley was adopted on July 30, 2002, the implementation of many of its provisions occurs over a longer period of time. Many sections of Sarbanes-Oxley were effective upon adoption, by immediately amending or inserting sections into an existing statute or regulation. Other sections were not effective unless and until certain administrative actions were taken, such as the SEC adopting new rules. This fragmented implementation process has added to the difficulties directors and officers encounter in knowing *exactly* what is required of them under this new corporate governance regime. While most of Sarbanes-Oxley’s provisions were implemented by the end of January 2003, the SEC has provided, and will continue to provide,

interpretations, amendments and glosses to the requirements. As such, directors and officers should rely on legal counsel to keep them fully up-to-date on these issues.

The following summarizes those provisions of Sarbanes-Oxley that currently have the most significant impact on directors and officers and the organizations they operate.

A. CEO/CFO Certification of Periodic Reports

Sarbanes-Oxley requires certification by a company's CEO and CFO of all periodic reports that are filed with the SEC. This requirement applies to any company which:

- is registered under Section 12 of the Exchange Act;
- is required to file reports under Section 15(d) of the Exchange Act; or
- files, or has filed, a registration statement under the 1933 Act.

There are two distinct certification requirements under different provisions of the Sarbanes-Oxley Act: the Section 302 certifications and the Section 906 certifications.

Section 302 requires that the CEO and CFO certify the following:

- That they have read the report;
- That to their knowledge, the report is complete and not misleading;
- That to their knowledge, the financial information contained in the report, including the financial statements, "fairly present in all material respects the financial condition, results of operations and cash flows of the issuer as of, and for, the periods presented in the report;"
- That internal "disclosure controls and procedures" have been established so that the certifying officers are made aware of material information and events occurring during the reporting period and that an evaluation of these controls has been made within the 90-day period prior to filing the report;
- That the auditors and the audit committee have been apprised of any problems with the design or implementation of the issuer's "internal controls" as well as any fraud involving management or other employees who play a role in the issuer's internal control process.

The SEC has provided guidance on the terms "disclosure controls and procedures" as well as what constitutes a "fair presentation" of an issuer's financial condition in the adopting release for the Section 302 Certifications.¹ "Disclosure Controls and Procedures" are those protocols designed by the issuer to make certain that "information required to be disclosed by an issuer in its 1934 Act reports is accumulated and communicated to the issuer's management, including its principal executive and financial officers, as appropriate to allow timely decisions regarding required disclosure." A certification that the financial condition of an issuer is "fairly presented" goes beyond merely certifying that such statements have been presented in accordance with GAAP. The Commission considers this certification to be broader and requires

¹ SEC Release No. 33-8124 *Certification of Disclosure in Companies' Quarterly and Annual Reports*. (August 28, 2002).

that the “fair presentation of an issuer’s financial condition, results of operations and cash flows encompasses the selection of appropriate accounting policies, proper application of appropriate accounting policies, disclosure of financial information that is informative and reasonably reflects the underlying transactions and events and the inclusion of any additional disclosure necessary to provide investors with a materially accurate and complete picture of an issuer’s financial condition, results of operations and cash flows.”

Sarbanes-Oxley does not require CEOs and CFOs to become expert accountants and does not impose sanctions for minor or inadvertent errors. Officers can still rely in good faith on the expert advice of the company’s independent auditors. Sarbanes-Oxley simply requires the CFO and CEO make certain the financial information included in the company’s public reports are a fair representation of the company’s financial condition in all material respects, based on their knowledge of the company and reasonable internal controls. The aim is to require CEOs and CFOs to carefully oversee the information gathering and analysis process by creating internal controls to ensure that information relating to the company (and any subsidiaries) is reported to the officers and the auditors. Officers should seek to create a reporting and disclosure process that is completely transparent and in which information is traceable throughout the entire process.

Section 906 requires a written statement by the CEO and CFO to accompany a company’s periodic Exchange Act reports. The statement shall certify that the report containing the financial statements fully complies with the requirements of the Exchange Act and that information contained in the report fairly presents, in all material respects, the financial condition and results of operations of the company.

Under Section 906, a CEO or CFO who certifies a false statement he or she knows does not meet the Section 906 requirements will face a maximum fine of \$1 million and a maximum prison term of 10 years. If that CEO or CFO willfully certifies a statement he or she knows did not meet the Section 906 requirements, then the maximum penalties escalate to \$5 million and 20 years. Section 302 of Sarbanes-Oxley does not specifically provide penalties for non-compliance.

B. Corporate Governance

Sarbanes-Oxley formally requires issuers to adopt a number of practices that, while previously recommended as “best practices” for corporate governance, were not required under either state corporate law or federal securities laws before July 30, 2002. These practices include procedures to separate the interests of officers and directors, requirements of independent approval of management decisions and financial auditing, and personal involvement by the issuer’s chief executive officer and chief financial officer in the preparation of the issuer’s financial statements and Exchange Act reports. The following is a list of some of the significant “best practices” Sarbanes-Oxley now requires of public companies:

- *Prohibition on Director and Officer Loans.* Sarbanes-Oxley prohibits issuers, with certain narrow exceptions, from directly or indirectly extending,

maintaining, or arranging for the extension of credit in the form of a personal loan to its executive officers and directors.²

- *Requirement for Internal Control Structures and Procedures*. Sarbanes-Oxley requires an issuer's chief executive officer and chief financial officer to participate in establishing, maintaining and assessing the internal control structures and procedures for the issuer's financial reporting and to certify as to these matters in the issuer's quarterly and annual Exchange Act reports.³ In addition to certification, issuers will be required to include an "internal control report" in its annual report and the issuer's public accounting firm will be required to attest to management's assessment of its internal control structures.⁴
- *Required Participation of Management in the Reporting Process*. Sarbanes-Oxley requires an issuer's chief executive officer and chief financial officer to participate in the preparation of the issuer's Exchange Act reports and to certify to that fact, as well as to the accuracy of the financial information contained therein.⁵
- *Trading Restrictions During Pension Fund Blackout Periods*. Sarbanes-Oxley prohibits officers and directors of an issuer from trading in the issuer's stock during a pension fund blackout period. The issuer must also disclose, under new Item 11 of Form 8-K, any notice it provides to its officers and directors announcing an upcoming restricted trading period.⁶

C. Accounting and Audit Committee Provisions

Sarbanes-Oxley created the new Public Company Accounting Oversight Board (the "PCAOB") as a new administrative body, with plenary authority over public accounting firms. Accounting firms will be prohibited from performing audit services for public companies without being "registered" with the PCAOB and complying with the auditing, quality control and independence standards that have yet to be set by the PCAOB.⁷ Aside from the general regulation of public accounting firms, Sarbanes-Oxley included several provisions that directly affect the relationship between public companies and their independent auditors, including the following:

- *Auditor Communications with Audit Committees*. Sarbanes-Oxley requires a registered public accounting firm to report certain events to the issuer's audit committee, including (1) the critical accounting policies used in conducting the audit, (2) alternative treatments of the issuer's financial information within GAAP that the accounting firm discussed with the issuer's management, (3) the effect of the alternate treatment, (4) the treatment preferred by the independent auditor, and

² See 402 of Sarbanes-Oxley and new §13(k) of the 1934 Act.

³ See 302 and See 404(a) of Sarbanes-Oxley.

⁴ See 404 of Sarbanes-Oxley.

⁵ See 302 of Sarbanes-Oxley.

⁶ See 306 of Sarbanes-Oxley.

⁷ See 103 of Sarbanes-Oxley.

- (5) material written communications between the issuer’s management and the independent auditor.⁸
- *Audit Committee Requirements.* Sarbanes-Oxley requires that an issuer’s audit committee (1) be composed entirely of “independent” directors, (2) be directly responsible for the appointment, compensation and oversight of the audit work done by the issuer’s certified public accountant, (3) establish procedures for receiving, processing, and retaining complaints received by the issuer concerning accounting controls or auditing issues, (4) provide for the confidential, anonymous submission of complaints by the issuer’s employees, (5) be granted the authority to engage independent advisers, such as legal counsel and accounting advisers, to assist the audit committee in meeting its obligations, and (6) be provided the resources to pay its legal and accounting advisors. The issuer risks delisting should it fail to comply with any of these requirements.⁹
 - *Improper Coercion of Independent Accountants.* Sarbanes-Oxley makes it unlawful for an issuer’s officers or directors, or any person acting under their direction, to “fraudulently influence, coerce, manipulate or mislead any public or certified accountant” auditing an issuer in order to render such financial statements materially misleading. This prohibited activity includes, by way of illustration, pressuring the accountant to issue an inaccurate report, to omit to perform specified audit and review procedures, to fail to withdraw a previously issued report, or to fail to communicate relevant information to the issuer’s audit committee.¹⁰
 - *Conflict of Interests.* Sarbanes-Oxley prohibits a registered public accounting firm from performing audit services for a public company if certain of the issuer’s executive officers had been employed by the accounting firm and participated, in any capacity, in an audit of the issuer within the prior 12 months. The SEC, through its rulemaking process, clarified that this ban applies to any officer who has a “financial reporting oversight role” and not only to the lead and concurring partners of the accounting firm but also to any other member of the audit engagement team who provides more than 10 hours of audit, review or attest services for the issuer. There is an exemption for conflict situations created as a result of a business combination as well as other unusual or emergency situations.¹¹
 - *Auditor Rotation.* Sarbanes-Oxley requires the rotation of audit partners who serve as lead or concurring partners every five years. The SEC has supplemented this requirement by establishing a five-year cooling-off period for such partners before they can again provide services to the issuer. In addition, the SEC’s rules require the rotation of certain audit partners with *significant involvement* every seven years with a corresponding two-year cooling-off period. A *de minimus* exemption is available for auditing firms with five or fewer public clients and 10 or fewer partners.¹²

⁸ See 204 of Sarbanes-Oxley and new §10A(k) of the Exchange Act.

⁹ See 301 of Sarbanes-Oxley and new §10A(m) of the Exchange Act.

¹⁰ See 303 of Sarbanes-Oxley.

¹¹ See 206 of Sarbanes-Oxley and new §10A(l) of the 1934 Act.

¹² See 203 of Sarbanes-Oxley and §10A(j) of the Exchange Act.

- *Ban on Providing Audit and Non-Audit Services.* Sarbanes-Oxley prohibits the performance of certain enumerated non-audit services by an issuer’s independent auditors (the “Listed Non-Audit Services”). The Listed Non-Audit Services are divided into nine categories and include such activities as bookkeeping, financial information systems design, valuation services, internal audit outsourcing services, human resources management and legal services. With the pre-approval of an issuer’s audit committee, an auditor may provide non-audit services to the issuer, but only if those services do not fall within one of the categories of the Listed Non-Audit Services. The SEC adopted rules that modify these prohibited activities under the general interpretive stance that the auditor independence rules are violated whenever an auditor (1) functions in the role of management, (2) audits his or her own work, or (3) serves as an advocate for an issuer.¹³
- *Audit Committee Approval of Accounting Services.* Sarbanes-Oxley requires pre-approval by the audit committee of any non-audit services provided by the issuer’s independent auditor other than the Listed Non-Audit Services. The audit committee must also, in general, approve all auditing and non-auditing services.¹⁴ The SEC permits the audit committee to approve audit and non-audit services either by (1) approving such services on a case-by-case basis or (2) pre-approving such services based on established policies and procedures. However, such policies and procedures must be consistent with the provisions of Sarbanes-Oxley and must be disclosed in the issuer’s annual report.¹⁵
- *Prohibited Auditor Compensation Arrangements.* The SEC, through its rule making process, prohibits an accountant, at any point in his or her audit engagement with a public issuer, from earning or receiving compensation based on “selling” engagements for non-audit services to such issuer.¹⁶

D. Penalties

Sarbanes-Oxley provides incentives for directors and officers of public companies to comply with not only these newly created standards but also their pre-existing duties and obligations, specifically in the form of enhanced penalties. Sarbanes-Oxley also grants certain enhanced powers to federal administrative and judicial agencies to investigate and enforce the securities laws. These enhanced enforcement powers and penalties include, among others, the following:

- *Forfeiture of Bonus and Equity Compensation.* Sarbanes-Oxley provides the SEC with the ability to compel an issuer’s CEO and CFO to forfeit certain bonus and equity based compensation following a restatement of the issuer’s financial

¹³ See 201 of Sarbanes-Oxley and new §10A(g) of the Exchange Act.

¹⁴ See 201 of Sarbanes-Oxley and new §10A(h) of the Exchange Act.

¹⁵ See 202 of Sarbanes-Oxley and new §10A(i) of the Exchange Act.

¹⁶ See new Rule 2-01(c)(8) of Regulation S-X and Release No. 33-8183, *Strengthening the Commission’s Requirements Regarding Auditor Independence*; (January 28, 2003).

reports, provided the restatement is a result of the issuer's failure to comply with the federal securities laws.¹⁷

- *Certification Penalties.* Sarbanes-Oxley establishes significant penalties for any officer who certifies (up to \$1,000,000, 10 years in prison, or both) or who *willfully* certifies (up to \$5,000,000, 20 years in prison, or both) that the financial statements in an issuer's periodic report fully comply with the Exchange Act requirements and that all information contained in the periodic report itself "fairly presents, in all material respects, the financial condition and results or operations of the issuer" when that certifying officer knows that such statements are false.¹⁸ The curious thing about these penalties is that they apply only to the certification required by §906 of Sarbanes-Oxley, even though there are very specific certification requirements in §302 of Sarbanes-Oxley (and the supplementary rules adopted by the SEC) without *specific*; corresponding penalties for falsely making that certification.
- *Officer and Director Bars.* Sarbanes-Oxley provides the SEC with the ability to bar a person from serving as a director or officer of a public company after a finding of "unfitness" rather than the previous higher standard that required a finding of "*substantial* unfitness."¹⁹ A separate provision of Sarbanes-Oxley authorizes the SEC to conditionally, unconditionally, permanently or temporarily enjoin an individual from serving as an officer or director of a public company if the person has violated §10(b) of the 1934 Act or §17(a)(1) of the 1933 Act and such violation demonstrates unfitness to serve in that capacity.²⁰
- *Federal Charges for Document Destruction.* Sarbanes-Oxley provides that any person who "knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record...with the intent to impede, obstruct, or influence the investigation or proper administration of any matter" by an agency or department of the U.S. government may be charged with a federal crime, punishable by up to 20 years in prison.²¹ Another provision of Sarbanes-Oxley establishes a specific federal crime for the destruction of documents or other evidence in connection with an *official proceeding*, punishable by a fine, up to 20 years in prison, or both.²²
- *Federal Charges for Failure to Maintain Audit Records.* Sarbanes-Oxley provides that any accountant who conducts an audit of a public company may be charged with a federal crime, punishable by up to 10 years in prison, for his or her failure to maintain all audit review workpapers for a period of five years from the end of the fiscal period in which the audit or review was conducted. The SEC, through amendments to Regulation S-X, has extended the workpaper retention

¹⁷ See 304 of Sarbanes-Oxley. Sarbanes-Oxley itself appears to permit this action, as §304 neither amends or adds a statute or regulation nor directs the SEC to implement the provision through rulemaking, other than to permit it to issue exemptions "as it deems necessary and appropriate."

¹⁸ See 906 of Sarbanes-Oxley and new 18 U.S.C. §1350.

¹⁹ See 906 of Sarbanes-Oxley and new 18 U.S.C. §1350.

²⁰ See 1105 of Sarbanes-Oxley, new subsection (f) to §21C of the Exchange Act and new subsection (f) of §8A of the 1933 Act.

²¹ See 802 of Sarbanes-Oxley and new 18 U.S.C. §1519.

²² See 1102 of Sarbanes-Oxley and amended 18 U.S.C. §1512.

requirement from five to seven years for an audit or review of an issuer's financial statements to reconcile the requirements of both §802 and §103 of Sarbanes-Oxley.²³

- *Extension of Statute of Limitations for Securities Fraud.* Sarbanes-Oxley extends the statute of limitations for civil securities fraud claims to the earlier of either two years after discovery of the facts constituting the violation or five years after the violation.²⁴
- *No Discharge in Bankruptcy.* Sarbanes-Oxley grants authority to disallow the discharge of debts under the United States Bankruptcy Code for debts resulting from the debtor committing federal securities laws violations, common law fraud, or deceit or manipulation related to the purchase or sale of securities.²⁵
- *Retaliation Penalties.* Sarbanes-Oxley grants employees of public issuers a private right of action for claims of retaliation, including dismissal or other types of discrimination, by the issuer-employer because the employee provided information about a perceived securities law violation or participated in an investigation of such violations. However this action can be pursued only if the information was provided to, or the investigation was conducted by, a federal regulatory or law enforcement agency, a member of Congress or a Congressional committee, or a superior of the employee with the authority to investigate the alleged violations.²⁶ Sarbanes-Oxley also makes it a federal crime to retaliate (in the form of interfering with that person's "lawful employment or livelihood") against individuals providing information relating to the commission, or possible commission, of any federal offense, with the maximum penalty of a fine, 10 years in prison, or both.²⁷
- *Federal Securities Fraud Statute.* Sarbanes-Oxley establishes a new statute specifically related to securities fraud. Individuals may be charged with a federal crime for fraudulent conduct in connection with the securities of a public company. Potential fines, imprisonment for up to 25 years, or both are possible for those convicted under this new statute.²⁸
- *Conspiracy and Attempt Related to Criminal Fraud.* Sarbanes-Oxley imposes the same penalties on those who attempt or conspire to commit criminal fraud under the mail fraud provisions of the United States Code as those set forth for the underlying action the individual was attempting or conspiring to commit.²⁹
- *Increased Wire and Mail Fraud Penalties.* Sarbanes-Oxley increases the maximum prison terms for both wire and mail fraud to 20 years.³⁰
- *Increased ERISA Fraud Penalties.* Sarbanes-Oxley increases the penalties for violating the fraud provisions of ERISA by (1) increasing the maximum prison

²³ See 802 of Sarbanes-Oxley, new 18 U.S.C. §1520, new Rule 2-06 of Regulation S-X, and Release No. 33-8180, *Retention of Records Relevant to Audits and Reviews* (January 24, 2003).

²⁴ See 804 of Sarbanes-Oxley and amendments to 28 U.S.C. §1658.

²⁵ See 803 of Sarbanes-Oxley and amended 11 U.S.C. §523(a), including new subsection (19).

²⁶ See 806 of Sarbanes-Oxley and new 18 U.S.C. §1514A.

²⁷ See 1107 of Sarbanes-Oxley and amended 18 U.S.C. §1513, including new subsection (e).

²⁸ See 807 of Sarbanes-Oxley and new 18 U.S.C. §1348.

²⁹ See 902 of Sarbanes-Oxley and new 18 U.S.C. §1349.

³⁰ See 903 of Sarbanes-Oxley and amended 18 U.S.C. §§1341 and 1343.

- term for such violations from one year to 10 years, (2) increasing the maximum amount an individual can be fined from \$5,000 to \$100,000, and (3) increasing the maximum amount a company can be fined from \$100,000 to \$500,000.³¹
- *SEC Authority to “Freeze” Certain Payments.* Sarbanes-Oxley authorizes the SEC to petition a Federal district court in order to compel the escrowing of “extraordinary payments” by an issuer to any of its officers, directors, control persons, partners, employees or agents for an initial period of up to 45 days, with an additional 45-day extension possible.³²
- *Increased Penalties for Exchange Act Violations.* Sarbanes-Oxley increased the penalties for willfully violating the provisions of the Exchange Act or making false or misleading statements in connection with any report, application or document required under the Exchange Act. These penalties were raised from a maximum \$1,000,000 fine to a \$5,000,000 fine and from a maximum 10 years in prison to 20 years for individual violators. The maximum fine for company violations increased from \$2,500,000 to \$25,000,000.³³

E. New Disclosure Requirements

The aim of the new enhanced disclosure requirements is to require greater transparency in the reporting of financial and other information in the reports a public company (or issuer) files under the Exchange Act and to provide investors with information that is relevant and useful in making their investment decisions. Enhanced disclosure obligations also force an issuer’s directors and officers to examine their current procedures and determine the best process to gather and scrutinize information that is prepared for public distribution. Many of these new procedures, some of which are set forth below, will have a direct effect on the oversight responsibilities of the board as well as its audit committee:

- *Audit Committee Disclosures.* An issuer must now disclose in its annual report (1) whether its audit committee has at least one “audit committee financial expert,” the name of this expert, and whether he or she is an independent director, or (2) in the event the issuer has no such expert, a statement explaining why not.³⁴
- *Off-Balance Sheet Transactions.* An issuer must now provide explanations of those off-balance sheet arrangements that are “reasonably likely to have a material current or future effect” on the issuer and include such disclosure in the MD&A section of its annual and quarterly reports. This disclosure must be included in a separately titled subsection that describes (1) the purpose and nature of the arrangements, (2) the importance of such arrangements to the issuer in terms of, among other things, its liquidity and capital resources, (3) the impact of such arrangements on the financial position of the issuer, and (4) any known trends, events, or uncertainties affecting the arrangements.³⁵

³¹ See 904 of Sarbanes-Oxley and amended §501 of ERISA (29 U.S.C. §1131).

³² See 1103 of Sarbanes-Oxley and new subsection (3) of §21C(c) of the Exchange Act.

³³ See 1106 of Sarbanes-Oxley and amended §32(a) of the Exchange Act.

³⁴ See 407 of Sarbanes-Oxley.

³⁵ See 401(a) of Sarbanes-Oxley.

- *Contractual Obligations.* An issuer must provide disclosure in its annual and quarterly reports, in tabular format, regarding the issuer’s short-term and long-term contractual obligations. These obligations must be grouped under specific categories, including long-term debt, capital lease obligations, operating leases, purchase obligations, as well as other long-term liabilities reflected on the issuer’s balance sheet under GAAP. Issuers maintain the flexibility to further subdivide these required categories or to add additional categories as is appropriate for their respective businesses.³⁶
- *Reconciliation of Non-GAAP Financial Reporting.* If an issuer presents financial information on a basis other than in accordance with GAAP, the issuer must also provide the best comparable GAAP treatment of the financial information together with a reconciliation of the two methods of presentation.³⁷
- *Code of Ethics.* An issuer must now disclose in its annual report whether it has adopted a corporate code of ethics for its principal executive, financial, and accounting officers, its controller, or any individual who is performing an equivalent function. In addition, the issuer must file a copy of such code of conduct as an exhibit to its annual report. Subsequent amendments to or waivers of such code must now be disclosed as a new Item 10 on Form 8-K or via the Internet. In the event the issuer has not adopted such a code of ethics, it must provide an explanation as to why not.³⁸
- *Accelerated Section 16 Disclosures.* Officers, directors and greater than 10 percent stockholders are now required to report acquisitions or dispositions in an issuer’s securities on Form 4 no later than two business days following the transaction, with only certain narrow exceptions provided by the Commission.³⁹ Prior to Sarbanes-Oxley, insiders had until 10 days following the end of the month in which the acquisition or disposition of the stock occurred. Exemptions from the “two-day” rule have been made for transactions effected pursuant to a valid 10b-5(1)(c) trading plan and discretionary transactions under employee benefit plans, provided that, in both cases, the insider does not select the date of the execution.⁴⁰ In those two instances, the insider must file a report no later than two business days after *notification* of the acquisition or disposition, provided that such notification is provided no later than the third business day following the transaction. In addition, §16 insiders are required after July 30, 2003, to file §16 forms via EDGAR, and issuers maintaining a company website will be required to post such statements within one day of filing.⁴¹
- *Accelerated Exchange Act Reports.* Before Sarbanes-Oxley was enacted, the Commission proposed an accelerated filing schedule for Exchange Act reports. The Commission finalized these rules on September 5, 2002. They call for certain “accelerated filers” to submit their annual reports within 60 days after the end of their fiscal year and their quarterly reports within 35 days of the end of

³⁶ See 401(a) of Sarbanes-Oxley.

³⁷ See 401(b) of Sarbanes-Oxley.

³⁸ See 406 of Sarbanes-Oxley.

³⁹ See 403 of Sarbanes-Oxley, amended and restated §16(a) of the Exchange Act.

⁴⁰ See amended Rule 16a-3(g) under the Exchange Act.

⁴¹ See 403 of Sarbanes-Oxley and amended and restated §16(a)(4) of the Exchange Act.

their respective quarters. These accelerated reporting deadlines will be phased in over three years and will apply only to issuers that have (1) a public float of \$75 million or more, (2) filed at least one annual report, and (3) been subject to the reporting requirements of the Exchange Act for at least 12 months.

F. Loss Prevention Actions

While no preventive measures can completely ensure that lawsuits for violations of Sarbanes-Oxley are never filed, there are proactive measures which can be taken to make a public company and its directors and officers less attractive targets for such litigation. Such steps can also ensure that when and if such litigation is instigated, there is a sufficient evidentiary record of the decision-making and oversight processes of the board and management to counter any allegations to the contrary in such a suit. The following summarizes a number of suggested actions to reduce the risk of D&O litigation in light of Sarbanes-Oxley.

1. Consider carefully the advantages of retaining outside counsel to represent the board separately from the company.
 - Directors and officers should be advised that the company's outside counsel represents the company, and not any specific officer or director of the company.
 - The board may wish to have independent legal or financial representation to provide advice on how to effectively discharge their duties and meet their new responsibilities under Sarbanes-Oxley, as well as to take appropriate steps to protect them from any personal liability that may attach as a result of their service to the company.
 - Sarbanes-Oxley *requires* the Audit Committee to be provided the authority to engage separate legal and financial advisors.

2. Consider carefully the advantages of providing reasonable funds to the company's CEO and CFO to obtain independent financial and legal advisors to counsel regarding their separate and individual liability for Sarbanes-Oxley's new certification requirements.
 - CFOs and CEOs would benefit from specific advice in connection with the inquiries and investigations that should be made before signing off on financial reports, including what information will fairly present the financial condition and results of operations of the company.
 - Independent representation would increase the value of the CEO/CFO scrutiny of financial reports before they are filed with the SEC, which would also benefit the company and the investing public.

3. Set up procedures to support CEO/CFO certification.
 - The company should adopt policies that ensure that the CEO and CFO receive drafts of all Exchange Act reports with sufficient time to adequately review them before they are filed.
 - CEOs and CFOs should document their active involvement in revising and shaping such Exchange Act reports.
 - CEOs and CFOs should consider delegating portions of the reporting process to appropriate subordinate individuals. These individuals should be given the responsibility to report, in writing, directly to the CEO or CFO, including the possible certification by that individual as to all facts and circumstances under that person's supervision that affect the applicable portion of the report.
 - CEOs and CFOs should hold one or more meetings with the company's audit committee to allow for questions and answers on any issues that have come up during the report preparation, particularly questions about accounting practices and internal controls management.
 - Each CEO and CFO should maintain a comprehensive file containing all of the back-up information, reports and certifications relied upon in giving the CEO/CFO certification.

4. Take steps to timely file Form 4's for the company insiders.
 - Prepare a memorandum to affected officers and directors and those individuals and/or entities that prepare their Section 16 reports that transactions that were formerly reported on Form 4 within 10 days after the end of the month in which the transaction occurred must, after August 29, 2002, be reported within two business days of such transaction.
 - Include, as part of that memorandum, information to educate insiders and those who prepare their Section 16 reports that the company/insider transactions which could previously be deferred until the end of the company's fiscal year (such as qualifying option grants) are also subject to accelerated reporting.
 - Review any automatic option grants to make certain these provisions do not result in unintentional reporting violations.
 - The company should require "pre-clearance" of all insider trades with a specifically designated compliance officer.
 - The company should require insiders to conduct transactions with a single broker who is aware of the company's pre-clearance policies.
 - Insiders should grant the company a power of attorney to allow it to sign Section 16 reports on their behalf, giving the company the ability to quickly file such reports on their behalf.

- The company should retain a complete list of insider EDGAR filing codes to allow for faster electronic filing, and obtain filing codes for those insiders who do not have them.
 - The company should consider adopting a policy requiring all pre-established 10b5-1 trading plans of its insiders be publicly disclosed, in anticipation of stricter disclosure requirements relating to such pre-established trading plans.
5. Determine if a conflict of interest exists sufficient to replace the company's independent auditor.
- Determine if there is any conflict between any of the company's directors and officers who have a financial oversight role and the company's independent public accountants under the new auditor independence requirements.
 - Discharge an auditor if an impermissible conflict is discovered.
 - Review all services that the company's independent auditor has provided to the company to determine if it has provided any non-audit services, including:
 - Bookkeeping or accounting services;
 - Appraisal or valuation services, fairness opinions;
 - Actuarial services;
 - Internal audit outsourcing services;
 - Management or human resources functions, including compensation consulting;
 - Broker or dealer, investment adviser, or investment banking services; and
 - Legal services or other expert services unrelated to an audit.
 - If so, consider whether to:
 - Appoint a new independent auditor and allow the existing firm to continue providing the non-audit services; or
 - Maintain the company's existing independent auditor and seek a separate accounting firm to provide it with the non-audit services.
6. Replace members of the company's audit committee who are not "independent" under the SEC guidelines.
- Identify *any* member of the audit committee who has accepted any consulting, advisory or other compensatory fee from the company other than as a director.
 - Carefully consider whether any members of the audit committee have other relationships with the company that might call their independence into question.
 - Obtain resignations from directors who are not independent and appoint individuals to fill the resulting vacancies who qualify as independent.

7. Revise Audit Committee Charter.

- Require pre-approval of all audit and non-audit services performed for the company by any accounting, auditing or other financial services company.
- Require the audit committee to approve *any* transaction between an officer or director and the company, or any subsidiary or affiliate of the company, to ensure that such “related-party” transaction have been approved by an independent body as an “arm’s-length” transaction that benefits the company.
- Require independent auditors to report to the audit committee in writing all of the critical accounting policies to be used and all alternative treatments of financial information within GAAP that have been discussed with the company’s management, including the treatment the independent auditor has recommended.
- Provide the audit committee with the authority to directly appoint, supervise and compensate the company’s independent auditors.
- Direct the audit committee to discuss annual and quarterly financial statements during one-on-one meetings with each of the company’s auditors, management, internal accountants, and outside counsel.
- Circulate specific agendas for each meeting, prepare detailed records of each meeting, and consider having financial and legal advisors attend.
- Require the review of any representation letter that management provides to the independent auditor.
- Require the periodic review of the company’s risk management and risk assessment policies.
- Establish procedures for the audit committee to receive, retain, and deal with complaints relating to the company’s accounting controls.
- Establish procedures for the audit committee to receive submission of confidential and anonymous information about the company’s financial controls from the company’s employees.
- Provide the audit committee with the authority to engage, as well as fund the engagement of, independent counsel and other advisers regarding accounting or audit practices.
- The revised audit committee charter should be discussed at, and ultimately adopted at, a meeting of the company’s full board of directors.

8. Take no action as a board or as an individual director or officer that can be construed as interfering with the audit process.

- Directors and officers should avoid any action that could be construed as an attempt to exert such influence in order to avoid claims they breached their fiduciary duties, committed or assisted in the commission of securities fraud or other securities law violations, including:
 - Suggesting to the company’s independent auditors, either directly or indirectly, a “preferred” accounting treatment for any specific item or transaction;
 - Using the incentive of additional or increased use by the company of the independent auditor’s services to induce the independent auditor to utilize a “preferred” accounting method to the company’s financial audit; or
 - Providing any information to an independent auditor that is false or misleading in order to achieve a specific accounting result.
9. Determine if any member of the audit committee is a financial expert, and if not, consider appointing one.
- Determine if any of your audit committee members qualify as a “financial expert” by demonstrating, through education or experience, an understanding of GAAP and financial statements; experience in preparing or auditing financial statements of similar companies and applying such principles in connection with accounting for estimates, accruals, and reserves; experience with internal accounting controls; and an understanding of audit committee functions.
 - Consider appointing a financial expert if none is currently serving on the audit committee.
 - Consider the advantages of requiring *all* members of the audit committee to possess a defined level of financial skill.
10. Disclose all material off-balance sheet transactions and any material correcting adjustments.
- Counsel should discuss with directors and officers the need to disclose in the company’s periodic Exchange Act reports whether it has any off-balance sheet transactions, arrangements, obligations (including contingent obligations) or other relationships with unconsolidated entities or other persons that may have a material current or future effect on financial condition, changes in financial condition, results of operation, liquidity, capital expenditures or resources.
 - Counsel should discuss with directors and officers the need to disclose in the company’s periodic Exchange Act reports whether the independent auditor has informed the company of any material

correcting adjustments in accordance with GAAP and the SEC rules.

- Prepare all pro forma financial information included in Exchange Act reports in conformity with the new guidelines.
- Put procedures in place to “flag” these transactions for review on an ongoing basis.

11. Take steps to ensure the company does not grant any impermissible extensions of credit.

- Adopt and circulate clear policies and procedures to directors, officers and appropriate personnel stating that the company will no longer extend credit to directors and officers. The Ban should also preclude the company from “arranging” or otherwise assisting its directors and officers in obtaining credit even from unrelated third parties.
- Consider extending the credit ban to family members and affiliates of directors and officers, since Sarbanes-Oxley is unclear on who or what is meant by “an equivalent” of a director or officer.
- Issue clear policies and procedures regarding travel advances and company-supported credit cards where there is the potential for using such advances or credit cards for “personal” uses.
- Identify all loans or other extensions of credit the company has made to any officer or director, including loans made by any of the issuer’s subsidiaries, and set up procedures to prevent any modifications to existing credit agreements or further extensions of credit, even if future advances were contemplated by the original arrangement.
- Do not forgive loans previously made to directors and officers without careful consideration whether such forgiveness will be viewed as a “modification” of an existing credit arrangement
- While not required by Sarbanes-Oxley, consider cleaning up any existing credit arrangement that can be easily paid off.

12. Review and consider revising the company's document retention plan.

- The following key points should be kept in mind when creating and maintaining a records retention policy:
Policies should be applied uniformly.
There must be legitimate reasons for the policy and a rationale for the way documents are slated for destruction.
Policies should take into account any administrative or regulatory record-keeping requirements.
Policies should not be adopted in bad faith or with the primary purpose to avoid preserving potential evidence.

A document destroyed in accordance with company policy may nevertheless occur at a time when litigation was reasonably foreseeable, triggering a duty to preserve the document. Adequate safeguards must be in place so that an executive or general counsel can quickly notify the department or individual overseeing the records retention policy of the need to preserve records that may otherwise be slated for the shredder.