SWEEPING REFORMS IN CORPORATE ACCOUNTABILITY PASSED

Last week, under intense political pressure to take action in light of the recent accounting and corporate scandals, Congress, by near unanimous vote, passed the Sarbanes-Oxley Act of 2002 (the "Act"). The Act, largely modeled on the strong Senate bill, institutes broad reforms concerning accounting and auditor oversight, corporate governance and executive responsibility. President Bush is expected to sign the Act into law early this week.

The Act will directly affect all publicly traded companies and requires a number of significant changes in the conduct of boards of directors and corporate officers. This memorandum summarizes the major provisions of the Act applicable to public companies and recommends certain initial steps in response to this significant new legislation.

As further described below, certain of the Act's provisions will become effective immediately, while others will not take effect until the Securities and Exchange Commission (the "SEC") issues implementing rules. The Act follows a host of similar initiatives by the SEC, the stock exchanges and other regulatory authorities; certain of these initiatives include proposals that overlap or exceed provisions of the Act. For example, last week the Nasdaq Stock Market, Inc. ("Nasdaq") and the American Stock Exchange ("AMEX") also approved extensive corporate governance reforms. These reforms require, among other things, boards of directors of listed companies to be comprised of a majority of independent directors and mandate shareholder approval of stock option plans. For a description of these reforms, please see our separate memorandum entitled "Nasdaq and AMEX Take Actions on Corporate Governance Reform." We expect the New York Stock Exchange ("NYSE") to shortly adopt similar reforms based on its previous proposals.

Congressional leaders have indicated that this Act is only a first step in implementing corporate governance and other reforms. When Congress returns from its August recess, we expect further initiatives to protect retirement savings plans and strengthen investor rights. We will keep you abreast of the latest developments in this quickly evolving and politically charged atmosphere. Please let us know how we can assist you in developing procedures to ensure compliance with these initiatives.

I. Executive Summary

- ***Prohibited Non-Audit Services; Lead Auditor Rotation.*** The Act prohibits auditors from providing many non-audit services to their public company audit clients. The lead audit partner must be rotated after auditing a company for five consecutive years.

- ***Audit Committee Requirements.*** Audit committees must be comprised *solely* of independent directors, oversee the company's auditors and establish whistleblower procedures.

- ***Public Company Accounting Oversight Board.*** The Act establishes a new entity that will oversee the audit of public companies, including the establishment of professional standards.

- ***CEO and CFO Certifications.*** CEOs and CFOs of public companies (*including* foreign companies) will each be required to personally certify as to their companies' SEC reports and financial statements.

- ***Prohibition on Personal Loans***. Public companies will be prohibited from extending loans to their directors and executive officers. Although existing loans will be "grandfathered," they are not permitted to be renewed or modified.

- ***Accelerated Disclosure of Securities Transactions***. Any change in the beneficial ownership of a company's equity securities by officers, directors or 10% owners must be reported before the end of the *second business day* following the execution of the subject transaction.

- ***Real Time Disclosure.*** Companies will be required to disclose, in plain English, on a "rapid and current" basis, information concerning material changes in their financial condition or operations.

- ***Off-Balance Sheet Transactions and Pro Forma Information.*** SEC quarterly and annual reports will be required to disclose all material off-balance sheet transactions. Pro forma financial information must be presented in a manner that is not misleading and must be reconciled with the company's GAAP information.

- ***Management Assessment of Internal Controls.*** Public company annual reports will have to include an "internal control report" containing an assessment of the company's internal controls.

- ***Analyst Conflicts of Interest.*** Rules will be adopted to promote greater objectivity and independence of stock analysts and compel analysts to disclose any potential conflicts of interest.

- ***Civil and Criminal Accountability.*** The Act creates a new federal crime for interfering with an audit, increases the fines and potential prison terms for a number of federal crimes, most notably securities fraud (with penalties of up to twenty-five years of imprisonment), and increases the statute of limitations for bringing private securities fraud actions.

- ***Corporate Attorneys.*** Corporate attorneys will be required to report evidence of a material violation of securities law, breach of fiduciary duty or similar violation to the company's chief legal counsel or CEO. If these officers do not "appropriately respond," counsel must report the evidence to the company's audit committee or to the entire board of directors.

II. Auditor Independence Requirements

Prohibited Non-Audit Services. In order to promote the integrity of the outside audit process, the Act prohibits auditors from providing many non-audit services to their public company audit clients. These prohibited non-audit services include:

- bookkeeping or other services related to the accounting records or financial statements of the audit client; financial information systems design and implementation;
- appraisal or valuation services, fairness opinions or contribution-in-kind reports;
- actuarial services;
- internal audit outsourcing services;
- management functions or human resources;
- broker or dealer, investment adviser or investment banking services;
- legal services and expert services unrelated to the audit; and
- any other service that the new accounting oversight Board determines is impermissible.

Other non-audit services, including tax services, may be provided, but only if they are pre-approved by the client's audit committee. Such approval must then be disclosed in the client's SEC reports.

Lead Auditor Rotation. The Act mandates the rotation of the lead or coordinating audit partner after auditing a company for five consecutive years and further calls for a study of the mandatory rotation of auditing firms. In addition, an audit firm may not serve as the outside auditor for a public company if a top officer (i.e. CEO, CFO, Controller) had been employed by such firm within the year prior to the start of the audit.

Reports to Audit Committee. Audit firms are required to report to the audit committee all critical accounting policies to be used, alternative treatments of financial information under GAAP and their ramifications, and material communications with management.

III. Audit Committee Requirements

Composition. National securities exchanges will be directed to de-list any company that does not comply with the audit committee requirements described below. Audit committees:

- must be comprised solely of independent directors;

  ⇒ To qualify as "independent" under the Act, the director must not have accepted any compensation from the company (other than in his or her capacity as a director or committee member) and must otherwise not be an affiliate of the company.

  ⇒ This definition remains subject to SEC rulemaking, as well as that of the NYSE, Nasdaq and AMEX.

- must be directly responsible for the appointment, termination and oversight of the company's auditors;

- must establish "whistleblower" procedures for (i) the collection and evaluation of complaints regarding a company's accounting methods and (ii) the confidential, anonymous submission of concerns regarding questionable auditing matters; and

- may engage independent counsel and other advisers, at the expense of the company, to help carry out their duties.

  ⇒ Companies should review their audit committee charters, and amend them if necessary, to provide for these provisions.

Financial Expert. Companies will be required to disclose in their periodic reports whether or not at least one member of their audit committee is a "financial expert," as defined by the SEC. In defining what constitutes a "financial expert," the SEC is to consider whether a person (whether as an officer or outside accountant) has:

- an understanding of GAAP and financial statements;

- experience in the preparation or auditing of financial statements of comparable companies;

- experience with internal accounting controls; and

- an understanding of audit committee functions.

⇒ Fear of unfavorable investor reaction will likely compel most companies to ensure that at least one member of their audit committee qualifies as a "financial expert." Although the precise qualifications remain to be outlined in SEC regulations, the statute contemplates that the expert must have had practical financial experience.

IV. Public Company Accounting Oversight Board

The Act establishes an independent Public Company Accounting Oversight Board (the "Board") to oversee the audit of public companies. The Board, to be comprised of five full-time members, will be a non-governmental entity subject to SEC oversight and enforcement authority and is to be appointed within the next 90 days. The Board and its related standard-setting body and staff will be funded by fees (to be determined) assessed on all publicly traded companies, allocated proportionally based on the average monthly market capitalization of all public companies over a 12-month period prior to the Board's fiscal year. The Board will:

- provide mandatory registration of public accounting firms that prepare audit reports for public companies;
- establish audit, independence and other standards for public companies and their auditors;
- inspect auditing firms (annually for firms that regularly provide audit reports for more than 100 companies); and
- investigate and discipline auditing firms and their associated persons.

Foreign public accounting firms that audit public companies will also be required to register with the Board and will generally be subject to the Board's rules and oversight.

V. Enhanced Executive Responsibility

CEO and CFO Certifications. CEOs and CFOs of public companies (*including* foreign companies) will each be required to personally certify in their companies' SEC quarterly and annual reports that they have reviewed the report and that, to their knowledge:

- the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading; and
- the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and

results of operations of the company as of, and for, the periods presented in the report.

Contrary to earlier versions of the bill, non-executive Chairmen are not required to make the certification.

This certification must also include the following additional elements:

- an acknowledgement of the officers' responsibility for establishing and maintaining adequate internal control structures and procedures for financial reporting;
- an assessment of the effectiveness of these internal controls, based on their evaluation of these controls within the 90-day period prior to the report;
- confirmation that any significant deficiencies or fraud with respect to such internal controls have been disclosed to the company's auditors and audit committee; and
- a statement as to whether or not there were significant changes in internal controls following evaluation of such controls.

A separate statement by the CFO and CEO must be included in each quarterly and annual report which certifies that (i) the report fully complies with the applicable sections of the Securities Exchange Act and (ii) information contained in the periodic report fairly presents, in all material respects, the financial condition and operations of the company. Knowingly certifying a false statement in violation of these requirements carries fines of up to $1,000,000 and/or imprisonment of up to 10 years; a willful violation is subject to more severe penalties.

⇒ These certification requirements are a legislative expansion of the SEC order issued last month requiring the CEOs and CFOs of almost 1,000 public companies to personally certify their companies' prior SEC filings. The SEC has been directed to enact rules implementing this new requirement; the first periodic report expected to be subject to the certification requirements of the Act is the 10-Q for the third quarter of 2002.

⇒ In anticipation of these certifications, CEOs and CFOs should follow the procedures and level of inquiry outlined in our July 15, 2002 client memorandum concerning that SEC order.

Prohibition on Personal Loans. The Act expressly prohibits public companies from extending credit, directly or indirectly, including through subsidiaries, to their directors or executive officers. Any personal loan in existence prior to enactment of the Act will

be "grandfathered;" however, existing loans are not permitted to be renewed or modified in any material respect. Certain loans involving home improvement, consumer credit and margin accounts for employees of securities firms that are generally of the type offered to the public will not be subject to these restrictions.

⇒ Since this prohibition takes effect immediately, companies should carefully review their credit programs. Note that new extensions of credit under existing credit programs are prohibited. Loan guarantees are not expressly addressed but are likely to be deemed "arrangements" for the extension of credit and thus also prohibited.

Accelerated Disclosure of Securities Transactions. Any change in the beneficial ownership of a company's equity securities by officers, directors or 10% owners must be reported (on SEC Form 4) before the end of the *second business day* following the execution of the subject transaction. This is a dramatic acceleration from the current rules, which require that transactions be reported within 10 days following the calendar month in which the transaction occurred.

⇒ This provision becomes effective 30 days after the Act's enactment. Companies should therefore immediately alert staff and counsel responsible for filing statements of beneficial ownership of securities (known as Forms 3, 4 and 5) about this important change and begin discussions about internal mechanisms to ensure compliance with these new disclosure requirements.

⇒ These filings must be filed electronically via EDGAR not later than one year after the Act's enactment. At the same time, the company must also post these filings on its corporate website no later than the end of business day following the filing.

Code of Ethics for Senior Financial Officers. Companies will be required to disclose in their periodic reports whether or not they have adopted a "code of ethics" applicable to their CFO and comptroller or other officers performing similar functions. Once adopted, any changes to or waivers under the code must be disclosed promptly either on a Form 8-K, through the Internet or other electronic means. The "code of ethics" is defined as standards to promote "honest and ethical conduct," "full and fair disclosure" in periodic reports filed by the company and compliance with "applicable governmental rules and regulations."

⇒ Fear of unfavorable investor reaction will likely compel most companies to adopt a code of ethics. We would be happy to work with you in developing such a code of ethics for your company.

Additional Provisions. The Act also:

- Mandates forfeiture by a CEO or CFO of bonuses or other incentive-based compensation and/or gains from the sale of company securities received in the 12 months following the first public filing of a financial statement that a company is subsequently required to restate, if such restatement is due to financial reporting misconduct. The misconduct need not be committed by the CEO or CFO;

- Implements a lifetime ban on persons found to be "unfit" from serving as directors or officers of public companies; and

- Prohibits insider trading during "blackout" periods that arise when at least half of a company's individual account retirement plan participants are not permitted to engage in purchases or sales of the company's equity securities.

VI. Enhanced Financial Disclosures

Real Time Disclosure. Companies must disclose, in plain English, on a "rapid and current" basis, information concerning material changes in their financial condition or operations, which may include trend and qualitative information and graphic presentations. The SEC is directed to issue rules implementing this requirement.

⇒ This provision appears to dovetail with outstanding proposed SEC regulations providing for an expanded list of items required to be disclosed on Form 8-K and a shortened time period for filing Forms 8-K by certain issuers.

Off-Balance Sheet Transactions and Pro Forma Information. The SEC is directed to issue rules:

- requiring that quarterly and annual reports disclose all material off-balance sheet transactions with unconsolidated entities or other persons that may have a material current or future effect on the financial condition of the company; and

- requiring pro forma financial information included in any quarterly or annual report, public disclosure or press release to be presented in a manner that is not misleading and to include a reconciliation with the company's GAAP financial information.

⇒ The SEC's position on the disclosure of off-balance sheet transactions is reflected in its previous releases issued prior to the Act's enactment. The SEC also recently issued a statement on the appropriate use of pro

forma financial information; however, these standards will be formalized and likely toughened in the wake of the Act. If you haven't done so already, you should carefully review your existing disclosure to ensure it complies with these requirements.

Management Assessment of Internal Controls. Public company annual reports will have to include an "internal control report" that states management's responsibility for establishing and maintaining adequate internal control structures and procedures for financial reporting. The report must also include an assessment, as of the end of the company's most recent fiscal year, of the effectiveness of these internal controls. The company's auditor is required to attest to, and report on, this management assessment. Here also, the SEC is directed to issue rules implementing this requirement.

⇒ This provision reinforces the new CEO and CFO certification of such internal controls. See above under "Enhanced Executive Responsibility - CEO and CFO Certifications."

Accuracy of Financial Reports. Effective immediately, all financial statements included in periodic reports that are required to be prepared in accordance with GAAP must reflect all material correcting adjustments identified by an auditing firm.

Enhanced Review of Public Filings by the SEC. Publicly traded companies will have their public filings reviewed at least once every three years. In scheduling reviews, the SEC will consider if a company:

- has issued material restatements of financial results;
- has a stock price with extreme volatility;
- has a large market cap (thus far undefined);
- is an emerging company with disparities in P/E ratios; and
- has operations that significantly affect any material sector of the economy.

VII. "Whistleblower" Protection

Public companies and their officers, employees, contractors, subcontractors or agents are prohibited from discharging, demoting, harassing or discriminating against an employee who assists an investigation conducted by a Federal agency, Congress or person who supervises such employee. Violators are subject to fine or imprisonment of up to ten years. Whistleblowers may be entitled to reinstatement, back pay and compensation for special damages.

⇒ This provision reinforces the above requirement that audit committees institute whistleblower procedures with respect to financial reporting. Companies should also establish clear internal protections for all categories of potential whistleblowers to avoid liability.

VIII. Analyst Conflicts of Interest

The Act mandates the adoption of rules by the SEC or a national securities exchange or registered securities association to promote the greater objectivity and independence of stock analysts and compel analysts to disclose in public appearances and research reports any potential conflicts of interest, including investment banking services, provided to a company in the year preceding the publication of a research report on such company.

⇒ Last week, the SEC proposed regulations that would require research analysts to certify the truthfulness of their views in research reports and public appearances and to disclose whether they have received any compensation related to the specific recommendation provided in those reports and appearances.

⇒ The NYSE and NASD have proposed similar rule changes relating to the conduct of analysts and their firms and the relationship of analysts with their firms' investment banking departments.

IX. Civil and Criminal Accountability

Securities Fraud. The Act creates a new criminal penalty applicable to any person who knowingly executes or attempts to execute a scheme or artifice to (i) defraud any person in connection with a public security or (ii) obtain, by means of false or fraudulent pretenses or representations or promises, any money or property in connection with the purchase or sale of a public security. This offense is punishable by fines and/or imprisonment of up to twenty-five years.

⇒ This provision would enhance the exposure for criminal liability to persons involved in financial irregularity both inside and outside the company, including legal, accounting and financial advisors.

Expanded Statute of Limitation for Civil Fraud Actions. Private lawsuits for securities fraud now have a longer statute of limitations: the earlier of either two years after the discovery of the facts constituting the violation (previously, one year) or five years after such violation (previously, three years).

Penalties for Altering Documents in Federal Investigations and Bankruptcies. The knowing alteration, destruction or concealment of any document with the intent to obstruct an actual or contemplated Federal investigation or proceeding or any case filed

under Chapter 11 of the Bankruptcy Code is punishable by fines and/or imprisonment of up to twenty years.

Interference in an Audit. The Act makes it unlawful to fraudulently interfere with an audit for the purpose of rendering an audit report materially misleading. The SEC is given sole civil enforcement authority (no private right of action is authorized).

Temporary Freeze on Extraordinary Payments. During an SEC investigation of securities law violations, the SEC may bring an order to stop a company, for up to 90 days, from making extraordinary payments (including compensation) to its directors, officers, employees or agents.

Retention of Corporate Audit Records. Auditors of public companies must retain audit workpapers for five years after the end of the fiscal period covered by the audit. Knowing and willful violations are is punishable by fines and/or imprisonment of up to ten years. The SEC has been directed to issue rules defining the scope of the documents required to be retained.

Additional Provisions.

- Any debts arising in connection with violations of Federal or state securities laws or liabilities (including settlements) resulting from common law fraud or deceit in connection with a securities transaction may not be discharged under Chapter 11 of the Bankruptcy Code.

- The SEC is authorized to censure or deny persons the privilege of practicing or appearing before it due to inadequate qualifications, unethical conduct or violations of securities laws. The SEC is also authorized to bar brokers and dealers that have been found guilty of fraudulent or deceptive conduct by a state regulator.

- Federal courts are authorized to prohibit persons from participating, either temporarily or permanently, in penny stock offerings.

- The prison terms for mail and wire fraud, and the terms and fines for criminal violations of ERISA, have been increased.

X. Corporate Attorneys

The Act directs the SEC to establish rules of professional responsibility for corporate attorneys, including a rule requiring both in-house and outside counsel to report evidence of a material violation of securities laws, breach of fiduciary duty or similar violation by the company to the company's chief legal counsel or CEO. If these officers do not "appropriately respond," counsel must report the evidence to the company's audit

committee, to another committee of independent directors or to the entire board of directors.

XI. Studies and Reports

The Act mandates various studies and reports on investment banks, credit rating agencies, SEC enforcement actions and consolidation of the accounting industry. Undoubtedly, as noted above, these studies will lead to further legislative and regulatory initiatives.

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If you wish to obtain additional information regarding this new legislation or other proposed initiatives, or assistance in developing a detailed program to help ensure compliance, please contact John S. D'Alimonte (212-728-8212, jd'alimonte@willkie.com), Yaacov M. Gross (212-728-8225, ygross@willkie.com), Jeffrey S. Hochman (212-728-8592, jhochman@willkie.com), or the partner who regularly works with you.

Willkie Farr & Gallagher is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000, and our facsimile number is (212) 728-8111. Our web site is located at www.willkie.com.

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