Honigman Miller Schwartz and Cohn LLP's *August 2002*

Securities Law Update

The Sarbanes-Oxley Act of 2002

Prompted by recent corporate accounting scandals and a corresponding loss of investor confidence in U.S. capital markets, Congress recently approved the Sarbanes-Oxley Act of 2002 (the "Act"), and on July 30, 2002, President Bush signed the Act into law. The Act, applicable to foreign and domestic issuers which file periodic reports, is broad and is intended to expeditiously increase accountability of corporate executives, establish procedures for comprehensive oversight of corporate accounting practices, and impose more rigorous disclosure requirements on public companies. To that end, a number of the Act's provisions became effective immediately on July 30, 2002, while other provisions will become effective in the near future. In order to assist you in your compliance with the Act, we have prepared this categorical summary of certain key provisions.

This document is a general summary of various provisions of the Sarbanes-Oxley Act of 2002 and has been prepared solely for informational purposes. There are a number of exceptions to the rules discussed below that could have important consequences to issuers.

A. Implications for Directors and Corporate Executives.

1. Chief Executive Officer/Chief Financial Officer Certifications. Under the Act, chief executive officers and chief financial officers of all issuers are subject to two separate certification requirements pursuant to Sections 906 and 302 of the Act.

(a) Section 906 Certification. Effective immediately upon enactment, all quarterly and annual reports containing financial statements filed by issuers must be accompanied by a written statement by the chief executive officer and chief financial officer:

- that the report fully complies with the requirements of Section 13(a) or 15(d) of the Securities and Exchange Act of 1934 (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 issuer.

As a result, a certification to this effect must accompany any periodic report filed with the Securities and Exchange Commission (the "Commission") after July 30, 2002. Violation of this provision by a chief executive officer or chief financial officer who executes a certification "knowing" that the report does not comport with "all the requirements" of this provision is subject to a fine of up to $1,000,000 or imprisonment of up to 10 years, or both. The penalty is increased to a fine of up to $5,000,000 and/or imprisonment of up to 20 years if a chief executive officer or chief financial officer "willfully" executes a certification "knowing" that the report does not comport with "all the requirements" of this provision. The difference between a "knowing" and a "willful" violation is not made clear by the Act.

(b) Section 302 Certification. No later than August 29, 2002, the Commission must issue rules requiring chief executive officers and chief financial officers of all issuers to certify in each annual or quarterly report filed or submitted with or to the Commission that:

- the chief executive officer and chief financial officer have reviewed the report;

- based on knowledge of the chief executive officer and chief financial officer, the report does not contain any untrue statement of material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which the statements were made, not misleading;

- based on the knowledge of the chief executive officer and chief financial officer, the financial statements fairly present in all material respects the financial condition and results of operation of the issuer as of, and for, the periods presented in the report;

- the chief executive officer and chief financial officer are responsible for establishing and maintaining internal controls, have designed internal controls to ensure that material information relating to the issuer is made known to such officers by others within the issuer, have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report, and have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of such date;

- the chief executive officer and chief financial officer have disclosed to the auditors and audit committee any significant deficiencies in the design and operation of internal controls which could adversely affect the issuer's ability to record, process, summarize, and report financial information, any material weaknesses in the internal controls, and any fraud that involves management or other employees who have a significant role in the issuer's internal controls; and

- the chief executive officer and chief financial officer have indicated in the report whether or not there were significant changes in the internal controls or other factors, current or prospective, that could affect the internal controls.

After enactment, the Commission issued "Certification of Disclosure in Companies' Quarterly and Annual Reports," Release No. 34-46300, a release indicating that the Commission intends to revise its previously issued proposed certification requirements in accordance with Section 302 of the Act.

2. Disclosure of Transactions by Directors, Officers and Shareholders. The Act amends the reporting requirements of directors, executive officers and 10% equity holders of issuers under Section 16 of the Exchange Act, imposing a stricter time frame for reporting change of ownership transactions by such individuals. Specifically, a director, executive officer, or 10% equity holder must report a change in ownership of, or a purchase or sale of a security-based swap agreement involving, any equity securities of the issuer, before the end of the second business day following the day on which the subject transaction was executed. This amendment to Section 16 of the Exchange Act will become effective August 29, 2002. The Act also provides that beginning not later than July 30, 2003, reports disclosing such

transactions will be required to be filed electronically.

3. Extension of Credit; Loans to Executives. The Act prohibits issuers from, directly or indirectly, extending credit, loans or acting as a guarantor of loans to directors and executive officers. This provision is inapplicable to arrangements in place prior to or on the date of enactment, as long as such arrangements are not subsequently materially modified or renewed. The Act, however, provides a few limited exceptions to this provision, such as credit issued by financial institutions pursuant to the requirements of the Federal Reserve Act.

4. Code of Ethics for Senior Financial Advisors. Under the Act, the Commission is required to adopt, by January 26, 2003, rules requiring issuers to disclose, together with their periodic reports required pursuant to Section 13(a) or 15(d) of the Exchange Act, whether or not, and if not, the reason why, the issuer has adopted a code of ethics for senior financial officers, applicable to its chief financial officer and comptroller or principal accounting officer. Furthermore, the Commission is required to revise its regulations regarding prompt disclosure on Form 8-K to require immediate disclosure, by filing the requisite forms electronically, of any change in or waiver of the code of ethics for senior financial officers. The Act defines the standards meeting the definition of the term "code of ethics" as standards implemented to promote honest, ethical conduct, full disclosure, and compliance with governmental rules and regulations.

5. Disgorgement of Pay and Profits. The Act provides that, effective immediately upon enactment, the chief executive officer and chief financial officer must reimburse an issuer for:

- any bonus or other incentive-based or equity-based compensation paid by the issuer, or

- profits realized from the sale of securities of the issuer,

during the 12-month period following the first public issuance or filing with the Commission (whichever occurs first) of the financial document containing a financial report that is required to be restated due to material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws.

6. Blackout Periods. Subject to limited exceptions, the Act prohibits directors or executive officers of an issuer from consummating a trade of its equity securities during "blackout periods" under the issuer's benefit plans. Specifically, a director or executive officer may not, directly or indirectly, purchase, sell or otherwise acquire or transfer equity securities of the issuer during a blackout period if the individual acquires or acquired such equity security in connection with his or her service or employment. A blackout period generally is any period of more than three consecutive business days during which at least 50% of the participants or beneficiaries of the issuer's individual account retirement plans are prohibited or restricted with respect to their ability to trade equity securities of the issuer held in such plans. Violation of this provision could result in a disgorgement of profits by the director or executive officer to the issuer (or to its shareholders if the issuer does not recover the profits within 60 days after the request for disgorgement), irrespective of the individual' s intent in consummating the trade.

This provision of the Act, effective January 26, 2003, mandates issuers to provide "timely" notice of a blackout period to

directors, executive officers and the Commission.

B. Corporate Governance Implications.

1. Audit Committees. While the Act does not specifically require issuers to have an audit committee, it sets forth certain standards and composition requirements of an issuer's audit committee and mandates the Commission to adopt a rule, by April 26, 2003, directing securities exchanges and national associations to prohibit the listing of securities of issuers that have not complied with such standards and requirements. Specifically, the audit committee must:

- be directly responsible for the appointment, compensation and oversight of the work of the issuer's auditing firm, and the auditing firm must report directly to the audit committee;

- be composed of independent directors who are not affiliates of the issuer or its subsidiaries and who do not receive compensation, other than director's fees;

- have the ability to engage independent counsel and other advisers; and

- establish procedures for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls and auditing matters and confidential, anonymous submissions by employees of concerns regarding questionable accounting or auditing matters.

Additionally, the Act requires the Commission to adopt, no later than January 26, 2003, rules requiring issuers to disclose, together with their periodic reports, whether or not, and if not, the reasons why, at least one member of the audit committee is a "financial expert." The Act sets forth certain considerations for determining whether an individual is a financial expert for purposes of the Act.

2. Provision of Auditor Reports to the Audit Committee. The Act amends Section 10A of the Exchange Act to require accounting firms to timely report to an issuer's audit committee:

- all critical accounting policies and practices to be used;

- all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management officials of the issuer, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the auditing firm; and

- other material written communications between the auditing firm and the management of the issuer.

3. Regulation of Audit and Non-Audit Services. The Act prohibits an auditing firm that provides auditing services from also providing non-auditing services contemporaneously with the audit of an issuer, including:

- bookkeeping and other services related to accounting records or financial statements;

- 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; and
- legal services and expert services unrelated to the audit.

The Act further provides that an auditing firm may provide to an audit client any non-audit service not specifically prohibited by the Act, provided that the activity is approved by the issuer's audit committee. In such cases, the issuer's audit committee's approval of the provision of non-auditing services by its auditors must be disclosed by the issuer in its periodic reports.

4. Management's Assessment of Internal Control. The Commission is required to issue rules requiring issuers to include an "internal control report" in each annual report, disclosing: (i) the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (ii) an assessment of the effectiveness of such internal control structure and procedures. Management' s assessment of the effectiveness of such internal control structure and procedures of the issuer must be attested to by the auditing firm that prepares or issues the issuer's audit report.

C. Corporate Disclosure and Reporting Implications.

1. Correcting Adjustments. In amending Section 13 of the Exchange Act, the Act requires any financial report filed with Commission containing financial statements to reflect all material correcting adjustments that have been identified by the auditing firm in accordance with generally accepted accounting principles and the rules and regulations of the Commission. This provision became effective upon enactment.

2. Off-Balance Sheet Transactions. The Commission is required to issue rules, not later than January 26, 2003, requiring issuers to disclose, in any quarterly or annual report filed with the Commission, any material off-balance sheet transaction, arrangement, or obligation, or other relationships of the issuer that may have a material current or future effect on the issuer's financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources or significant components of revenues or expenditures.

3. Pro Forma Figures. The Act specifically addresses the presentation of pro forma financial information in Commission filings and press releases. The relevant provision directs the Commission to issue rules providing that pro forma financial information included in any periodic or other report filed with the Commission or in any public disclosure or press release shall be presented in a manner that:

- does not contain any untrue statement of material fact or omit to state a material fact necessary in order to make the pro forma financial information, in light of the circumstances under which it is presented, not misleading; and
- reconciles the pro forma financial information with the financial condition and results of operations of the issuer under generally accepted accounting principles.

The Commission is required to adopt such rules not later than January 26, 2003.

4. Real Time Disclosures. The Act amends Section 13 of the Exchange Act to mandate issuers that are required to report under Section 13(a) and 15(d) to disclose to the public on a rapid and current basis, in plain English, such additional information concerning material changes in the financial condition or operations of the issuer as the Commission may require.

5. Enhanced Commission Review. Under the Act, the Commission is required to review disclosures made by issuers, including financial statements, on a regular and systematic basis. At a minimum, the Commission must review issuers no less than once every three years. In determining the schedule for review of issuers, the Commission will consider factors such as:

- issuers that have issued material restatements of financial results;
- issuers that experience significant volatility in their stock price as compared to other issuers;
- issuers with the largest market capitalizations;
- emerging issuers with disparities in price to earnings ratios; and
- issuers whose operations significantly affect any material sector of the economy.

D. <u>Other Implications</u>.

1. Public Accounting Oversight Board. The Act establishes the Public Accounting Oversight Board (the "<u>Oversight Board</u>"). The Oversight Board will be comprised of five individuals and will be responsible for:

- registering public accounting firms that prepare audit reports;
- establishing auditing, quality control, ethics, independence and other standards relating to the preparation of audit reports; and
- conducting investigations and disciplinary proceedings of registered public accounting firms.

The Oversight Board must be organized to carry out the directives of the Act not later than April 26, 2003.

2. Registration of Auditors. An accounting firm may not prepare or issue, participate in the preparation or issuance of, an audit report with respect to an issuer until it is registered with the Oversight Board, beginning 180 days after the Commission determines that the Oversight Board is operational.

3. Penalties.

(a) <u>Criminal</u>. In addition to the criminal penalties applicable to directors and executive officers in connection with the certification requirements imposed by the Act, the Act creates new criminal penalties and expands certain other criminal penalties. Specifically, the Act provides that:

- anyone who knowingly alters, destroys, conceals, covers up or falsifies a document, record or tangible object with the intent to impede an investigation is subject to fines and/or up to 20 years imprisonment;
- anyone convicted of securities fraud or attempted securities fraud is subject to fines and/or up to 25 years imprisonment; and

- any auditor who "knowingly and willfully" fails to maintain his or her workpapers for five years after the end of the fiscal period for which the audit of an issuer was concluded is subject to fines and/or up to ten years imprisonment.

(b) Civil. Implications of the Act with respect to civil penalties include:

- an expansion of the statute of limitations for securities fraud from one year after discovery of a violation or three years after a violation occurred to the earlier of two years after the discovery of the facts constituting the violation or five years after the violation occurred; and

- the amendment of bankruptcy laws to prohibit a debtor from discharging any debt arising out of civil or criminal penalties imposed as a result of fraud, deceit, or manipulation in connection with the purchase or sale of any security or a violation of any federal or state securities laws.

4. Attorney Duty to Report. The Act mandates the Commission to issue rules, no later than January 26, 2003, providing minimum standards of professional conduct for attorneys appearing and practicing before the Commission on behalf of issuers, including a rule that requires an attorney to report evidence of a material violation of securities laws or breach of fiduciary duty by the issuer or its agents to the chief executive officer or chief legal counsel. If the chief executive officer or chief legal counsel do not appropriately respond to the evidence, the attorney will be required to report such evidence to the issuer's audit committee or to another committee comprised entirely of outside directors, or to the board of directors of the issuer.

What Should Issuers Do?

As is indicated above, significant portions of the Act are not effective immediately, but instead are either effective at a later date or require Commission or stock exchange rulemaking action. Practices and procedures for complying with the Act's requirements will continue to be developed for quite some time to come. Nevertheless, issuers should be in the process of preparing for the changes that are effective in the near future, and must make other immediate changes in response to the Act. Two items, in particular, warrant especially prompt attention.

First, most issuers have policies and provide guidance to their directors and executive officers with respect to compliance with the securities laws. Those policies, and any guidance memoranda, will need to be updated to reflect the new and changed requirements of the Act. Given that new requirements are effective August 29, 2002 that impose significantly more rapid filings than were previously required, this area should be attended to immediately.

Second, procedures should be considered in connection with the certification of financial statements required of the signing officers. The Act does not specify the level of diligence to be exercised by the officers, and the appropriate steps to be taken will differ from issuer to issuer depending on a number of factors and each company's circumstances. Issuers, and signing officers, should consider the following measures:

- Establish adequate procedures for gathering information and preparing reports; the chief executive officer and chief financial officer should be actively involved in establishing these procedures.

- Thoroughly document the process itself, and the steps taken, to demonstrate how the officers were justified in relying on the issuer's processes and other corporate employees when certifying the results. An internal record of compliance with issuer's procedures should be created.

- The issuer's reports should be read in their entirety (the officers should give them a thoughtful, detailed review in light of their knowledge of the issuer).

- If there are any items that are not well understood, probing questions should be asked of subordinates.

- Consider obtaining certifications from subordinate corporate officers as to information that is their primary responsibility.

- The signing officers should fully understand the issuer's business practices, the issues facing the issuer, and the Commission's disclosure requirements.

- The signing officers may want to request written reports on which they intend to rely and obtain legal advice from the issuer's counsel and accounting advice from the accounting staff and outside auditors.

- Consideration should be given to application of accounting principles, and judgments made in connection with preparation of the financial statements, including an analysis of the effects of alternate GAAP methods on the financial statements.

- Review areas that have proven to present problems to other companies, such as reserves, revenue recognition policies, off-balance sheet structures, transactions with special purpose entities, derivative and non-exchange traded contracts, capitalization of expenses, exposure to customers and suppliers with financial difficulties, related party transactions and policies regarding critical accounting estimates.

- Review with the independent auditor any audit problems or difficulties and management's response. This may involve reviewing with the auditor any accounting adjustments that were noted or proposed by the auditor but were not made, because they were deemed immaterial or for other reasons. Consider communications between the audit team and the audit firm's national office respecting auditing or accounting issues presented by the engagement, and any internal control letter issued, or proposed to be issued, by the audit firm to the issuer.

* * * * * * * * *

The members of the Corporate Department at Honigman Miller Schwartz and Cohn LLP will be delighted to discuss any of the issues raised by this Update with you, and to work with you to assist you to respond appropriately to the Act.