Recent Rulemaking Activity by the Securities and Exchange Commission Under the Sarbanes-Oxley Act of 2002

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The SEC has been extremely active lately on the rulemaking front, particularly with regard to the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley" or "SOA"). Over the past six months, the Commission has issued no fewer than ten releases containing final rules promulgated pursuant to Sarbanes-Oxley, and eight final releases have been issued in the past three weeks alone. Additional proposed rules have yet to be finalized, and the Commission is still seeking comment on certain proposed rules including a proposed requirement that, under certain circumstances, attorneys practicing before the Commission effect a "noisy withdrawal" from representation of an issuer associated with material violations of the securities laws or breaches of fiduciary duty. The following paper summarizes the various rules promulgated pursuant to Sarbanes-Oxley.

While the following paper is intended primarily as a general overview of the various rules promulgated pursuant to Sarbanes-Oxley, a few preliminary comments may be in order. Sarbanes-Oxley represents a sweeping attempt by the Congress and the Commission to provide "protection" to investors against the consequences of corporate wrongdoing and fraud. The Act and the rules promulgated pursuant to the Act seek to improve corporate governance and the capital markets by three principal means. First, although the risk of inadvertent or technical violations of SEC rules may be increased, the final rules evidently seek to make violations of the securities laws less likely to occur than in the past by tightening the rules with respect to certain key disclosures and by compelling officers and directors to focus more intently on quality disclosure. For example, the rules include heightened disclosure requirements for off-balance sheet financing as well as new rules governing the use of non-GAAP reporting. The rules also impose certification and code of ethics disclosure requirements on senior financial and executive officers. Secondly, the final rules evidently seek to make detection of material violations of the law more likely occur. In that regard, the rules contain extensive requirements relating to auditor independence and the standards of professional conduct for attorneys, as well as a prohibition on improper attempts to influence the conduct of an audit. Thirdly, the Act – though not the rules – significantly increases criminal and civil penalties for certain violations of the law affecting the securities markets. The Act, for example, increases the maximum penalty for mail and wire fraud from five years to twenty years per violation.[1]

Although certain of Sarbanes-Oxley's reforms, like the auditor independence standards, have been fermenting for some time, several of the reforms have a discernable "fighting the last battle" quality to them. Indeed, many of the reforms in the Act and in the Rules promulgated pursuant to the Act are directed at very specific problems encountered in one or more recent high profile cases – most notably, of course, Enron – and one is entitled, therefore, to inquire about the coherence and likely efficacy of such reforms. One is also entitled to wonder about the social benefits flowing from such reforms. It is, for instance, far from clear to what extent corporate wrongdoing really caused or even contributed significantly to investor losses over the past year-and-a-half. One major and non-nefarious cause was clearly the unsustainable valuations (even relying on strict GAAP

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[1] See "Increased Penalties Under the Sarbanes-Oxley Act of 2002," United States Sentencing Commission (January 2003)(available at http://www.ussc.gov/r_congress/S-Oreport.pdf.).

accounting) prevailing in the market for much of the 1990s.[2] Nevertheless, with a few exceptions -- notably, the Professional Standards of Conduct for attorneys and the enhanced criminal penalties -- the Rules and the Act are not likely to work much harm either and, indeed, may help promote integrity and the appearance of integrity in corporate governance and the capital markets.

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The specific rules promulgated in the recent weeks and months by the Securities and Exchange Commission (herein the "SEC" or the "Commission") pursuant to Sarbanes-Oxley are as follows:

Title II/Section 208(a) – Auditor Independence

SOA – Sections 201 through 208 impose a number of restrictions on public company audit representations, including a general prohibition of a range of non-audit services (Section 201), strengthened auditor conflict of interest standards (Section 206), a requirement of auditor partner rotation and second partner review (Section 203), and enhanced standards governing the relationship between an issuer's audit committee and its independent auditor (Sections 202 and 204). Section 208 specifically directs the Commission to promulgate rules delineating these auditor independence standards.

Rulemaking Status – The Proposing Release was issued December 2, 2002 and the comment period expired January 13, 2003. The final rules were issued January 28, 2003.

Summary –The amendments to the Commission's standards regarding auditor independence are lengthy and complex. The final rules effect changes principally to Regulation S-X and Regulation S-K and they generally cover three spheres of activity: (1) the relationship between issuer and audit engagement team; (2) the provision of non-audit activities by an issuer's auditors; and (3) the oversight role and responsibilities of the issuer's audit committee.

- *"Cooling Off" Period and Audit Partner Rotation* – The final rules require a "cooling off" period for an audit engagement team member wishing to go "in-house" at the audit client. 17 CFR § 210.2-01. The final rules also require regular rotation of audit engagement team partners on a particular client's account. Id. If these requirements are not met, the firm employing the audit engagement team in question would not be deemed to be independent of the issuer.

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[2] For example, by early 2000, just before the market bubble burst, Yahoo posted a p/e ratio in excess of 1,700 and eBay's p/e ratio, at that time, was greater than 2,100. Kara Swisher, "On-line Auctioneer Attracts Slew of Possible Partners But May Stand Alone," Wall Street Journal at B1 (March 20, 2000) ("The negatives of a Yahoo-eBay merger are also clear -- although Yahoo's stock is richly valued, with a price/earnings ratio of 1,726, eBay's is moving toward insanity, at 2,145. Plus, funny money or not, eBay would be a costly purchase; its valuation is $27.7 billion -- a big chunk of Yahoo's $90.8 billion).

- *Mandatory "Cooling Off" Period* – The final rules require that, to remain independent of the issuer, any member of an audit team who is a lead/concurring partner or who performs a minimum amount of audit and/or review services for an issuer must wait for at least one year after leaving the audit engagement team before they may assume a "financial reporting oversight" position with the issuer.

    - "Financial reporting oversight role" – The term is defined by the rules to apply more broadly than the Act and, in particular, is not limited to the positions of CFO, chief accounting officer or controller, as provided by the Act. See SOA at § 206. Rather, the term refers to "any individual who has direct responsibility for oversight of those who prepare the registrant's financial statements and related information" and is intended by the Commission to apply more broadly to persons at the issuer other than the CFO, CAO and controller. Release No. 33-8183 at 6.

    - Persons Covered – The rule applies to the lead partner, the concurring partner and to all members of the audit engagement team who have performed more than 10 hours of audit services for the issuer. 17 CFR § 210.2-01; see also Release No. 33-8183 at 10.[3] If any of the forgoing takes a "financial reporting oversight" position prior to the expiration of the cooling off period, then the accounting firm formerly employing such person loses its independence as auditor of the issuer.

    - Length of cooling off period – The mandatory cooling off period lasts for one entire audit cycle as determined by reference to the date of the filing of the issuer's annual report. 17 CFR § 210.2-01(c)(2)(B)(3). Each audit engagement period is deemed to commence on the day after the periodic annual report is filed. Id. The "cooling off" period must last for at least one such audit cycle. Suppose, for example, an issuer's 2002 and 2003 annual reports will be filed on March 31, 2003 and March 31, 2004. In that case, the next annual audit cycle would not begin under the rule until April 1, 2003 and would not end until March 31, 2004. See Release No. 33-8183 7-10. If a member of the audit team provides audit, attest or review services at any time prior to March 31, 2003, he or she could not join the issuer in a "financial reporting oversight role" until at least April 1, 2004 without undermining the accounting firm's independence. Id.

- *Mandatory Partner Rotation* – The new rules provide that the lead partner and concurring partner on the audit team must rotate off of an account

[3] Citations herein to page numbers in the relevant SEC releases refer to the page numbers from the printed version of the releases downloaded from the SEC's website at www.sec.gov.

every five years and all other "audit partners" must rotate off of an account every seven years. 17 § CFR 210.2-01(c)(6)(A); see also Release No. 33-8183 at 47. The lead partner and concurring partner, moreover, must remain off of the account for a "time out" period of five years while other audit team members subject to the rotation requirement must remain off of the account for a "time out" period of two years. 17 CFR 210.2-01(c)(6)(B).

  - "Audit partners" subject to the rotation requirements are defined by the Rule to include partners on the engagement team who have significant responsibility for audit, accounting or reporting decision-making or who are in regular contact with the issuer's audit committee or with management. Release No. 33-8183 at 47. The term "audit partners" specifically excludes all partners serving a subsidiary (including the lead partner on those subsidiary) where the subsidiary makes up less than 20% of the issuer's assets and revenues. For subsidiaries making up more than 20% of the issuer's assets or revenues, only the lead partner is subject to rotation; all other partners serving the subsidiary are not subject to the rotation requirement. Id. The term "audit partner" also excludes specialty partners and "national office" partners. Id. at 48.

- *General Prohibition on Non-Audit Services* -- The cornerstone of Title II of the Act is a prohibition against accounting firms performing a range of "non-audit" services to their audit clients. The final rules likewise generally prohibit the provision of such services to audit clients. The Commission notes in the release accompanying the final rules that "[t]he Commission's principles of independence with respect to services provided by auditors are largely predicated on three basic principles, violations of which would impair the auditor's independence: (1) an auditor cannot function in the role of management, (2) an auditor cannot audit his or her own work, and (3) an auditor cannot serve in an advocacy role for his or her client." Release No. 33-8183 at 18.

  - Specific Services Covered – Like the Act, the final rules generally prohibit accounting firms from providing the following "non-audit" services to an audit client: (i) Bookkeeping services; (ii) financial information systems services; (iii) Appraisal, valuation services or fairness opinions, (iv) actuarial services; (v) internal audit services; (vi) management functions; (vii) human resources services; (viii) broker dealer, investment advisor or investment banking services; (ix) legal services; and (x) certain expert services. 17 CFR § 210.2-01(c)(4)(i)-(x); Release No. 33-8183 at 20-39.

  - Limited Ban on Certain Services – The final rules further provide that: (i) bookkeeping services; (ii) financial information systems services; (iii) appraisal, valuation, fairness opinions; (iv) actuarial services; and (v)

internal audit outsourcing may not be provided "unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements." Release No. 33-8183 at 20-21.

- Tax Services Excepted – The release accompanying the final rules notes that "accounting firms have historically provided a broad range of tax services to their audit clients." Generally, the final rules permit audit firms to continue to provide tax compliance, tax planning and tax advice services -- to their audit clients. Release No. 33-8183 at 40.

➢ *Audit Committee Oversight* – The final rules require the prior review and approval by the audit committee of all permissible non-audit services and all audit engagements. 17 CFR § 210.2-01(c)(7). The final rules generally require that the audit committee review and approve all services provided by the firm's auditors but permits the audit committee to establish its own policies and procedures for approving the services.[4]

Section 302(a) – Corporate Responsibility for Financial Reports

SOA – The Act requires that the Commission issue rules requiring that the chief executive officer and the chief financial officer certify in each quarterly and annual report that: (i) the certifying officer has read the report, (ii) based on the officer's knowledge, the report does not contain any material misstatements or omissions; (iii) based on the officer's knowledge, the financial statements, and other financial information included in the report, fairly present the result of operations of the issuer; (iv) the officers are responsible for establishing and maintaining internal controls and have, in fact, designed such internal controls to ensure that material information is made know to the certifying officers, particularly during the period when the reports are being presented; (v) have evaluated the effectiveness of the internal controls within the 90 days prior to the report; (vi) have stated their conclusions about the effectiveness of the internal controls; (v) the certifying officers have reported to the issuer's auditors and to the audit committee of the issuer all material deficiencies in the design or operation of the internal controls and/or any fraud; and (vi) the certifying officers have disclosed whether any changes to the internal controls have recently been made that could affect the integrity of future financial reports of the issuer.

Rulemaking Status – The final rule was issued on August 29, 2002.

Summary – The final rule tracks the statutory provisions of Section 302 closely, albeit with one significant exception – the final rule substitutes a new term "disclosure controls and procedures" for the statute's "internal controls." The final rule also sheds some further light

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[4] The final rules provide an exception for *de minimus* and inadvertent violations of the requirement that the audit committee approve. In particular, pre-approval is not required for "(1) all [non-audit] services that do not aggregate more than five percent of total revenues paid by the audit client to its accountant in a particular year; (2) [the non-audit services] were not recognized as non-audit services at the time of the engagement; and (3) are promptly brought to the attention of the audit committee and are approved by the audit committee prior to the completion of the audit." 17 CFR § 210.2-01(c)(7)(i)(c).

on the meaning of the Act's requirement that the CEO and CFO certify that the financial statements "fairly present" the financial results of the issuer.

- "*Disclosure Controls and Procedures" –* The final release explains that the Commission has developed a new concept to effectuate the intent of Congress in enacting Section 302. The new concept, "disclosure controls and procedures" encompasses a broader range of controls and procedures than the more conventional concept of "internal controls," already a part of the "books and records" provisions of Section 13 the Exchange Act and incorporated in Section 302 and Section 404 of the SOA. "Internal controls" refers generally to an issuer's control of its assets and its financial reporting. Release No. 33-8124 at 7-8. The new concept of "disclosure controls and procedures" includes a broader range controls and procedures than "internal controls," addressing the quality and timeliness of the issuer's disclosure of *both* material non-financial and financial, information. Release No. 33-8124 at 8.

- *"Fairly Presents" –* The release accompanying the final rule clarifies that "the certification statement regarding fair presentation of financial statements and other financial information is not limited to a representation that the financial statements and other financial information have been presented in accordance with generally accepted accounting principles and is not otherwise limited by reference to generally accepted accounting principles." Release No. 33-8124 at 8; U.S. v. Simon, 425 F.2d 796, 806 (2d Cir. 1969)(Friendly, J.)(Holding that expert evidence of compliance with GAAP is not sufficient to avoid criminal conviction for securities fraud and that expert testimony regarding GAAP is not dispositive on whether financial statements provided "fair presentation" of financial results of issuer).[5] Rather, "fair presentation" is understood by the Commission to mean that "the financial information disclosed in a report, viewed in its entirety, meets a standard of overall material accuracy and completeness that is broader than financial reporting requirements under generally accepted accounting principles."[6] Id.

Effective Time -- The new rule became effective on August 29, 2002.

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[5] Judge Friendly stated, for example, that "[w]e think the [district court] judge was right in refusing to make the accountants' testimony so nearly a complete defense. The critical test according to the charge was the same as that which the accountants testified was critical. We do not think the jury was also required to accept the accountants' evaluation whether a given fact was material to overall fair presentation, at least not when the accountants' testimony was not based on specific rules or prohibitions to which they could point, but only on the need for the auditor to make an honest judgment and their conclusion that nothing in the financial statements themselves negated the conclusion that an honest judgment had been made." Simon, 425 F.2d at 806.

[6] The Commission explained, in the final release, that a "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." Release No. 33-8124 at 7.

Section 303(a) – Improper Influence on Conduct of Audits

SOA -- The Act provides that it "shall be unlawful . . . for any officer or director of an issuer to take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of the issuer for the purpose of rendering such financial statements materially misleading." The Act directs the Commission to issue proposed rules within 90 days of enactment and to issue final rules or regulations not later than 270 days after the date of enactment.

Rulemaking Status -- The proposing release was issued on October 18, 2002. The comment period ended on November 25, 2002. No final rule has yet been issued.

Summary -- The proposed rule provides, in relevant part, that:

> [N]o officer or director of an issuer, or any other person acting under the direction thereof, shall directly or indirectly take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified public accountant engaged in the performance of an audit or review of the financial statements of that issuer that are required to be filed with the Commission if that person knew or was unreasonable in not knowing that such action could, if successful, result in rendering such financial statements materially misleading.

Release 34-46685 at 21. The proposing release specifically identifies certain types of activities that may potentially violate the prohibition in the Act, including, directly or indirectly: (i) offering or paying bribes or other financial incentives, including offering future employment or contracts for non-audit services; (ii) providing an auditor with inaccurate or misleading legal analysis; (iii) threatening to cancel or canceling existing non-audit or audit engagements if the auditor objects to the issuer's accounting; (iv) seeking to have a partner removed from the audit engagement because the partner objects to the issuer's accounting, (v) blackmailing; and (vi) making physical threats. Id. at 6.

Section 306(a) – Insider Trades During Pension Fund Blackout Periods

SOA – Section 306(a) of the Act prohibits any director or executive officer of an issuer to purchase, sell or otherwise acquire or transfer, directly or indirectly, any shares of the issuer during any pension plan blackout period with respect to such equity security, if the director or executive officer acquired the equity security in connection with his or her service or employment as a director or executive officer. Section 306(a) also requires the issuers to notify directors and executive officers and the Commission of a blackout period that could affect them.

Rulemaking Status – The SEC proposed so-called Regulation BTR on November 6, 2002. The comment period ended December 16, 2002. On January 22, 2003, the SEC issued the final Regulation BTR.

Summary – Regulation BTR (for "Blackout Trading Restrictions") generally restricts trading by executive officers and directors in the issuer's equities during pension fund blackout periods. Regulation BTR is intended to "facilitate compliance with the will of Congress . . . and to eliminate the inequities that may result when pension plan participants and beneficiaries are temporarily prevented from engaging in equity securities transactions through their plan accounts." Release No. 34-47225 at 1. Regulation BTR is explicitly patterned on the trading restrictions and grounds for liability established by Section 16 of the Exchange Act and the regulations promulgated pursuant to Section 16. Like the Section 16 regime, the specifics of Regulation BTR are complex. Briefly the key features are as follows:

- *General Restriction* – Reg BTR makes it unlawful for any director or executive officer of an issuer (including a foreign private issuer) of any equity security[7] (other than an exempt security), directly or indirectly, to purchase, sell or otherwise acquire or transfer any equity security of the issuer (other than an exempt security) during any blackout period with respect to such equity security, if such director or executive officer acquires or previously acquired such equity security in connection with his or her service or employment as a director or executive officer.

  - *"Acquired in Connection with Service or Employment"* – Reg BTR includes a detailed definition of what it means for an equity security to be acquired in connection with service or employment as a director or executive officer.[8] Critically, however, Reg BTR adopts a rebuttable presumption that any securities of the issuer acquired, sold or transferred during a blackout period were "acquired in connection with service as a director or executive officer." 17 CFR § 245.100(a). It is then up to the director or officer to establish, as a defense, that the securities were acquired other than in connection with the director or officer's service to the issuer. Id.

  - *Blackout Period* – Reg BTR defines "blackout period" to mean any period of three consecutive business days during which the ability of not fewer than 50% of the participants or beneficiaries to transact in

[7] "Equity security" under Reg BTR includes any equity security or derivative security relating to an issuer, whether or not issued by that issuer. Derivative security has the same meaning as in Exchange Act Rule 16a(1)-c and the release accompanying the final rule provides that the term "derivative security" is to be interpreted in a manner that is consistent with how the term is interpreted under Section 16.

[8] Reg BTR provides, for example, that an equity security is acquired in connection with service or employment as a director or executive officer where: (i) acquired at a time when the officer or director was a participant in a plan relating to options, warrants or rights, pension, retirement or deferred compensation or bonus, incentive or profit-sharing (whether or not set forth in any formal plan document), including a compensatory plan, contract, authorization or arrangement with a parent, subsidiary or affiliate; (ii) the equity security was acquired as a direct or indirect inducement to service or employment as a director or executive officer; and (iii) where the equity security was received as a result of a business combination in respect of an equity security of an entity involved in the business combination that he or she had acquired in connection with service or employment as a director or executive officer of that entity.

the Plan is temporarily suspended by the issuer or a fiduciary.[9] 17 CFR § 245.100(b).

- *Notice to Officers/Directors and the Commission* – Reg BTR includes a detailed procedure for providing notice to the issuer's officers and directors as follows:

  - New Rule 104 provides that the content of the notice specify (i) the length of the blackout period – using either the actual or expected beginning and ending dates of the blackout period, or the calendar week or weeks during which the blackout period is expected to begin and end; (ii) the reason or reasons for the blackout period; (iii) the transactions restricted during the blackout period and the class of equity securities subject to the blackout period; and (iv) a contact person for questions concerning the blackout period;[10]

  - The Commission has attempted to coordinate the required timing of the notice under Reg BTR with the required notice to pension plan participants under Department of Labor ("DOL") regulations; accordingly, the required notice to directors and executive officers is considered timely if it is issued not later than five business days after the issuer receives notice from the pension plan administrator required by DOL rules;[11] and

  - Rule 104 requires that the issuer also provide public disclosure of an impending blackout period by filing a Form 8-K with the Commission; as a general matter, the Form 8-K must be filed with the Commission within five business days of receipt by the issuer of

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[9] The release accompanying the final rule notes that the Commission "remains concerned that the problems [Sarbanes-Oxley] is intended to address may not be limited to blackout periods that last longer than three consecutive business days . . . We will continue to consider whether these issues, to attempt to ascertain whether blackout periods of three business days or less are or may become a concern and to talk to the Department of Labor about possible solutions." Release No. 34-47225 at 13.

[10] The option either to notice the specific expected begin/end dates or to notice the week(s) during which the begin/end dates are expected to occur is intended to deal with the uncertainty involved in managing the timing and length of the blackout period. Reg BTR requires, however, that when the notice specifies only the week(s) during which the blackout period is expected to occur, directors and officers be provided access to real time information during the noticed week(s) regarding the actual beginning date and ending date as they occur. 17 CFR § 245. 104(b)(1)(iv). Where the notice specifies the anticipated beginning and ending dates, it must be updated with a subsequent notice if, in the event, the actual begin and end dates differ from the notice begin and end dates as previously noticed. The updated notice is required to be provided as soon as reasonably practicable. Release No. 34-47225 at 24.

[11] The final release specifically notes that, "an issuer's failure to provide notice [to its directors or executive officers] will not preclude a Commission enforcement action for a violation of Section 306(a)(1) of the Act or a private action to recover profits under Section 306(a)(2)." The failure to provide notice may also lead to an enforcement action against the issuer, "whether or not a director or executive officer subsequently violates the Section 306(a) trading prohibition." Release No. 34-47225 at 23.

the notice from the plan administrator as required under DOL regulations.

17 CFR § 245.104.

- *Exempt Transactions* – Reg BTR specifies several transactions that are exempted from the blackout trading restrictions. These exempt transactions include: (i) acquisitions of equity securities under dividend or interest reinvestment plans; (ii) purchases or sales of equity securities pursuant to a trading arrangement that satisfies the affirmative defense conditions of Exchange Act Rule 10b5-1(c);[12] (iii) increases or decreases in the number of equity securities held as a result of a stock split or stock dividend applying equally to all equity securities of that class; (iv) acquisitions or dispositions of equity securities pursuant to a domestic relations order; (v) the exercise of a derivative security without any influence from the director or officer as to the exercise or conversion of the derivative. 17 CFR § 245.102; see also Release No. 34-47225 at 11.

- *Private Right of Action* – When a director or officer of the issuer violates Section 306(a), the Act permits either the issuer or a security holder of the issuer on the issuer's behalf, to bring an action to recover the profit gained by the officer or director.[13] The release accompanying Reg BTR likens the actions to a private right of action under Section 16(b). In determining damages in such an action, the final release directs courts to focus on the "gain realized or loss avoided" during the blackout period. 17 CFR § 245.103; see also Release No. 34-47225 at 21. Accordingly, (i) for transactions involving a security that is listed and traded on a national exchange, the measure of damages in a private action "may be measured by comparing the difference between the amount paid or received for the equity security on the date of the transaction during the blackout period and the average market price of the equity security calculated over the first three trading days after the ending date of the blackout period; (ii) for transactions not described in the forgoing subparagraph, "profit (including any loss avoided) may be measured in a manner that is consistent with the objective of identifying the amount of any gain realized or loss avoided by a director or executive officer as a result of a violation of Reg BTR. 17 CFR §245.103(c)(1)-(2).

Effective Time – The restrictions on trading during pension fund blackout periods is effective January 26, 2003. Issuers must comply with the requirement to disclose blackout

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[12] The release accompanying Reg BTR clarifies that transactions pursuant to a trading arrangement that satisfies the conditions of 10b5-1(c) are exempt from Reg BTR as long as the as the trading plan is not entered into or modified during a blackout period or at a time when the director or officer is aware of the approximate beginning or ending of the blackout period. Release No. 34-47225 at 10.

[13] A violation of Section 306(a) of the Act is a violation of the Exchange Act and, as such, "subject to all resulting sanctions, including Commission enforcement action." Release No. 34-47225 at 20.

periods publicly on Form 8-K beginning March 31, 2003 and may provide the required disclosure before then on Form 10-Q or 10-QSB.

Section 307 – Rules of Professional Responsibility for Attorneys

SOA – Section 307 provides that within 180 days of enactment, the Commission must issue rules "setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers." SOA § 307. The statute further provides that the rule must include a requirement that attorneys report "evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof," to either the chief legal counsel or the chief executive officer of the company and, in the event the CLO or CEO does not "appropriately respond to the evidence," then, to the audit committee or other committee of independent directors. SOA § 307(1) and (2).

Rulemaking Status – The SEC issued proposed rules on November 21, 2002. The comment period ended December 18, 2002. On January 23, 2003, the SEC issued the final rule. The SEC has, however, issued a further proposed rule pursuant to Section 307 regarding whether or not attorneys practicing before the Commission should be required to effect a "noisy withdrawal" (and notify the Commission) under certain circumstances.

Summary – The Final rule implements the "up the ladder" reporting requirement called for by Sarbanes-Oxley and, in addition, provides an alternative method of reporting evidence to a "qualified legal compliance committee." The Final rule also includes a safe-harbor from civil liability.

- *Reporting Procedure* -- The final rule requires an attorney who appears and practices before the Commission[14] to report "evidence of" a material violation of the securities laws or a material breach of fiduciary duties. The report of such evidence must be made in one of the following two ways:

    - *"Up the Ladder" Reporting* – The final rule requires attorneys who learn of evidence of a material violation of the securities laws or material breach of fiduciary duty to report the evidence to the Chief Legal Officer (CLO) or the Chief Executive Officer (CEO) of the company. If the reporting attorney does not receive an "appropriate response" within a reasonable time from the CLO or the CEO, then the reporting attorney is obligated to report the evidence to the audit committee or, if the issuer does not have an audit committee, then to "another committee of independent directors," or, if the issuer does not have another committee of independent directors, then, the

[14] The concept of "appearing and practicing before the Commission" is quite broad in scope. The final rule provides that "appearing and practicing before the Commission" includes: (i) communicating in any way with the Commission; (ii) "providing advice" of any kind concerning the securities laws in the context of preparing a document for filing with the Commission; and (iii) advising any issuer as to whether a statement should be included in a filing with the Commission. Release No. 33-8185 at 3.

report must be made to the full board of directors. 17 CFR § 205.3(b); see also Release No. 33-8185 at 6-17.

- *Report to a Qualified Legal Compliance Committee* – As an alternative to the "up the ladder" reporting procedure, the rule allows issuers to establish a "qualified legal compliance committee" (QLCC) which would become responsible for receiving and investigating evidence of a material violation of the securities laws or material breach of fiduciary duty. 17 CFR § 205.3. The QLCC would also be responsible for determining whether the issuer has made an appropriate response to the reported evidence of a violation. 17 CFR § 205.3(c); see also Release No. 33-8185 at 17-20. Under the proposed rule, attorneys who do not receive an appropriate response within an appropriate period of time would have been required to report the evidence directly to the SEC. Under such a rule, the existence of a QLCC was a significant factor because the proposed rule had provided that the attorney may discharge its obligation to assess whether an appropriate response has been made by simply reporting the evidence to a QLCC. The reporting attorney would thereupon no longer be responsible for determining whether the issuer has made an "appropriate response" to the evidence and potentially reporting the matter to the Commission. As the rule presently stands, reporting to the QLCC removes some of the burden from the reporting attorney with regard to the investigated and reporting obligations of the rule.[15]

➢ *No Paper-Trail Requirement* – The final rule has dropped the requirement in the proposed rule that an "attorney reporting evidence of a material violation shall take steps reasonable under the circumstances to document the report and the response thereto and shall retain such documentation for a reasonable time." See Release No. 33-8185 at 22. Many commentators noted that this requirement could give rise, to a conflict of interest between attorney and client. Id. at 23.

➢ *Noisy Withdrawal* – The SEC has deferred a decision on the most controversial element of the proposed rule. The proposed rule had included a requirement that an outside attorney effect a "noisy withdrawal" from representing an issuer if the attorney: (i) has reported a material violation of the securities laws or a material breach of fiduciary duty to the CEO or CLO and to the audit committee, other committee of majority outside directors or the full board; (ii) has not received an "appropriate response" in a reasonable

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[15] The final rule also provides that an attorney engaged by the QLCC to investigate evidence of a possible material violation "shall not have any obligation to report evidence of a material violation under [the final rule]." 17 CFR §205.3(b)(7). An attorney retained by the issuer and reporting to the CLO, in comparison, is relieved of his or her obligation to report "up the ladder" only where the investigating attorney and the CLO reasonably believe that no material violation has occurred or where the CLO reports the possible material violation "up the ladder." 17 CFR §205.3(b)(6)(B).

time; and (iii) "a material violation is ongoing or is about to occur and is likely to result in substantial injury to the financial interest or property of the issuer or of investors." Release No. 33-8105 at 70. The attorney would also be required, within one business day, to inform the Commission that the attorney has withdrawn for "professional considerations." Id.

- *Rulemaking Status* – The SEC has voted to extend for 60 days (to February 24, 2003) the comment period on the proposed "noisy withdrawal" requirement. Release No. 33-8186. The SEC has also proposed an alternative to the "noisy withdrawal" requirement, as originally proposed, whereby, upon reporting evidence of a material violation "up the ladder" (rather than to a QLCC), and having not received an appropriate and timely response, if the violation "is ongoing or about to occur and is likely to cause substantial injury to the financial interest or property of the issuer or of investors," the attorney would be required to notify the issuer that the attorney has not received an appropriate and timely response to the evidence of the material violation and that the attorney is, therefore, withdrawing from the representation. Upon receiving such notice from counsel, the issuer, rather than the attorney, would be required to disclose this development by filing the information on a Form 8-K. Id. at 10-13.

- *Permissive Disclosure of Confidences* – The final rule permits, but does not require, counsel to an issuer to disclose confidential information to the Commission to the extent the attorney reasonably believes disclosure necessary to (i) prevent a material violation that is likely to cause substantial financial injury; (ii) prevent the issuer from suborning perjury or from violating the false statement section of the criminal code (18 USC § 1001) in a Commission investigation or administrative proceeding; or (iii) to rectify the consequences of a material violation by the issuer that caused or may cause substantial injury.

- *No Private Right of Action* – The final rule promulgated pursuant to Section 307 includes an important safe-harbor against personal liability for non-compliant attorneys. Section 307 threatened to expand significantly the grounds for liability against attorneys so as to include all shareholders suffering losses as a result of securities fraud or a breach of fiduciary duty; indeed, Section 307 threatened to permit a cause of action against attorneys advising corporate issuers where the corporate issuer's directors (and possibly officers) could be exculpated from liability. Compare Del. Gen. Corp. L. § 102(b)(7) with SOA § 307. The Commission has largely removed this risk by providing in the final rule that "the rules do not create a private cause of action and that authority to enforce compliance with the rules is vested exclusively with the Commission."

Effective Time – The new Part 205 takes effect 180 days after publication in the *Federal Register*.

Section 401 – Disclosures in Periodic Reports

Section 401(a) – Disclosure of Off-Balance Sheet Transactions

SOA – Section 401(a) of Sarbanes-Oxley requires the Commission to issue final rules providing that each quarterly and annual report shall disclose all material off-balance sheet transactions, arrangements, obligations (including contingent obligations) and other relationships of the issuer with unconsolidated entities or other persons that may have a material effect on the financial condition of the issuer.

Rulemaking Status – The SEC issued the proposed rule on November 4, 2002. The comment period ended December 9, 2002. On January 27, 2003, the SEC issued the final rule pursuant to Section 401(a).

Summary – The final rules require each registrant to include in their MD&A disclosure[16] a separate, titled section concerning the registrant's "off-balance sheet arrangements." Generally, the new rules "clarify disclosures that registrants must make with regard to off-balance sheet arrangements, require registrants to set apart disclosure relating to off-balance sheet arrangements in a designated section of MD&A and (except in the case of small business issuers) require tabular disclosure of aggregate contractual obligations." Release No. 33-8182 at 4.

- *Off-balance Sheet Arrangements* – The final rules define off-balance sheet arrangements to include any contractual arrangement to which an unconsolidated entity[17] is a party, under which the registrant has: (i) any obligation under certain guarantee contracts;[18] (ii) an interest retained by the

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16 The Commission has consistently stressed the importance of MD&A to the overall quality of disclosure. The final release is no exception: "The Commission has long recognized the need for a narrative explanation of financial statements and accompanying footnotes and has developed MD&A over the years to fulfill this need. The disclosure in MD&A is of paramount importance in increasing the transparency of a company's financial performance and providing investors with the disclosure necessary to evaluate a company and make informed investment decisions." Release No. 33-8182 at 3.

17 Consolidation depends principally on the level of control held over the entity in question. Under current rules, control of greater than 50% of the voting securities of an entity gives rise to a presumption in favor of consolidation. See SFAS 94 (1986). Special purpose entities presumptively should be consolidated if unaffiliated entities have invested less than 3% of the entity's total capital. See EITF 90-15 (Describing the 3% requirement but noting that "the SEC staff believes that a greater investment may be necessary depending on the facts and circumstances, including the credit risk associated with the lessee and the market risk factors associated with the leased property."); see also Excerpts from Speeches by the Staff of the Office of the Chief Accountant Through December 6, 2001 (Washington, DC: Securities and Exchange Commission 2001). In addition, FASB is currently considering increasing the minimum requirement for unaffiliated capital contributions from the current 3% to 10%. See Release No. 33-8144, n.37 (citing FASB Exposure Draft, Proposed Interpretation, Consolidation of Certain Special-Purpose Entities (June 2002).

18 The release accompanying the final rule defines "guarantee" by reference to FASB Interpretation No. 45. Such guarantees include (i) contracts that contingently require the guarantor to make payments to the guaranteed party based on changes in the "underlying;" (ii) contracts that contingently require the guarantor to make payments to the guaranteed party based on another entity's failure to perform under an obligating agreement; (iii) indemnification agreements; and (iv) indirect guarantees of indebtedness whereby one entity is

registrant in assets transferred to an unconsolidated entity as credit support for that entity;[19] (iii) any obligation under certain derivative contracts; (iv) any obligation, including a contingent obligation, arising out of a material variable interest,[20] held by the registrant in an unconsolidated entity, where such entity provides financial, liquidity, market risk or credit risk support to, or engages in leasing or hedging with, the registrant. 17 CFR § 228.303(c)(3).

- *Disclosure Threshold* – The proposed rules had established a low threshold for the disclosure of off-balance sheet transactions. Specifically, the proposed rule would have required disclosure of all "off-balance sheet arrangements" unless "the likelihood of either the occurrence of an event implicating an off-balance sheet arrangement, or the materiality of its effect, is remote." Release No. 33-8182 at 7. The final rule has retreated from this standard and, instead, requires disclosure of off-balance sheet arrangements that "have or are reasonably likely to have, a current or future effect on the issuer's financial condition . . . that is material to investors." 17 CFR § 228.303(a)(1); Release No. 33-8182 at 7.[21]

- *Required Table of Contractual Commitments* – The final rules require issuers to disclose in tabular form the amounts of payments due, aggregated by category of contractual obligation, for specified time periods, with regard to the following categories of commitments: (i) long-term debt; (ii) capital lease obligations; (iii) operating leases; (iv) purchase obligations; and (v) other long-term liabilities. Small business issuers[22] are not required to make such disclosures in tabular form.

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obligated to transfer funds to another entity such that the funds thereupon become available to the second party's creditors. Release No. 33-8182 at 12.

[19] This refers to a form of credit support whereby the issuer would retain an interest in the collateral securing obligations of the unconsolidated entity. For example, an entity transferring accounts receivable to an unconsolidated entity may retain an ownership interest in the last-dollar receivables such that, if a percentage of the pledged receivables are not ultimately collectable, the guarantor bears the costs of such losses. See Release No. 33-8182 at 13.

[20] The release accompanying the final rule notes that "variable interest" is defined as a "contractual, ownership, or other pecuniary interest in an entity that changes with the entity's net asset value." Release No. 33-8182 at 13 (citing FASB Interpretation 46).

[21] In assessing whether an "off-balance sheet obligation" is reasonably likely to have a material effect on an issuer's financial condition, the release accompanying the final rule directs management to proceed as follows: First, identify all off-balance sheet arrangements. Second, assess the likelihood of the occurrence of any known trend, demand, commitment, event or uncertainty that could affect an off-balance sheet arrangement. If management cannot determine that any such occurrence is not "reasonably likely," then management is directed to assess the significance of the impact of any such occurrence assuming it comes to fruition. Release No. 33-8182 at 14.

[22] Defined as any entity that: (i) has revenues of less than $25,000,000; (ii) is a U.S. or Canadian issuer; (iii) is not an investment company; and (iv) if the entity is a majority-owned subsidiary, its parent also separately qualifies as a small business issuer. Release No. 33-8182 at n. 115 (citing 17 CFR 228.10).

- *Safe-Harbor for Forward Looking Statements* – To resolve any ambiguity as to whether the PSLRA's statutory safe-harbor for forward-looking statements would apply to the MD&A disclosure of off-balance sheet arrangements, the final rule specifies that, except for historical facts, certain of the disclosures concerning off-balance sheet arrangements would be deemed to be "forward looking statements" within the meaning of the PSLRA. 17 CFR § 229.303(c).[23]

Effective Time – Registrants must comply with the final rules' off-balance sheet arrangements disclosure requirements in registration statements, annual reports and proxy statements that are required to include financial statements and that are filed by June 15, 2003. The final rules require issuers to include the tabular report of contractual commitments in registration statements, annual reports and proxy statements that are required to include financial statements and that are filed on or after December 31, 2003.

Section 401(b) – Use of *Pro Forma* Figures

SOA – Section 401 of Sarbanes-Oxley directs the Commission to adopt rules which provide that *pro forma* financial information[24] included in any disclosure shall be prepared in such a way that: (i) the *pro forma* financial information does not contain any material untrue statement of fact or omission; and (ii) the *pro forma* financial information is reconciled with the financial results of the issuer as calculated in accordance with GAAP.

Rulemaking Status – The SEC proposed Regulation G on November 5, 2002. The comment period ended December 13, 2002. On January 22, 2003, the SEC issued the Final rule.

Summary – Regulation G applies whenever an issuer publicly discloses or releases material information that includes a non-GAAP measure of financial results.

- *Non-GAAP Financial Measures* – The final rule defines a "non-GAAP financial measure" as "a numerical measure of a registrant's historical or future financial performance, financial position or cash flows that excludes amounts . . . that are included in the most directly comparable measure calculated and presented in accordance with GAAP . . . or includes amounts

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[23] The final rules provides specifically that the statutory safe harbor applies to disclosure of: (i) "management's analysis of the material effects [of the off-balance sheet arrangement(s)] on the registrant's financial conditions, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures and capital resources; (ii) any "known event, demand, commitment, trend or uncertainty," that would lead to "an off-balance sheet arrangement that materially benefits the registrant" from being materially reduced or terminated. See 17 CFR § 229.303(c).

[24] "*Pro forma* financial information" refers to financial results that are prepared and presented for analytic purposes in a way that does not comply with GAAP. One such *pro forma* measure is operating earnings. The term "operating earnings" typically refers to earnings adjusted to remove non-recurring gains or, more often, charges. See, e.g. Jonathan Weil, "What's the P/E Ratio? Well, Depends on What is Meant by Earnings. Terms Like 'Operating,' 'Core,' 'Pro Forma' Catch Fire, Leave Investors Muddled: Earnings Before Bad Stuff," Wall Street Journal, A1 (August 21, 2001).

. . . that are excluded from the most directly comparable measure" under GAAP. 17 CFR § 244.101(a)(1); see also Release No. 33-8176 at 8-9. A widely used example of such non-GAAP financial measures is EBITDA, which is often intended to substitute for GAAP earnings.[25] Release No. 33-8176 at 11. "Non-GAAP financial measures," within the scope of Regulation G, do not include financial measures that do not have an analogous GAAP measure and do not include ratios and other statistical measures that are calculated in accordance with GAAP. 17 CFR § 244.101(a)(2).[26]

- Foreign Private Issuers – Regulation G applies to many foreign private issuers.[27] However, with respect to certain foreign private issuers whose primary financial statements are prepared in accordance with non-GAAP standards, those issuers must conduct reconciliations between any reported financial results that are not prepared in accordance with the non-GAAP standard, on the one hand, and the appropriate non-GAAP standard, on the other hand. 17 CFR § 244.101(b).

- Pro Forma Merger Calculations – The final rules provide an exception for non-GAAP financial measures contained in disclosures relating to business combinations. 17 CFR § 229.10(e)(6).

➢ *General Anti-fraud Provision* – Reg G provides generally that an issuer shall not make public a non-GAAP financial measure that, taken together with the information accompanying that measure, contains an untrue statement of material fact or omits to state a material fact.[28] 17 CFR § 244.100(b).

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[25] Relying on EBITDA, rather than GAAP earnings or net income, for a particular reporting period may be economically inappropriate. See e.g., Benjamin Graham and David Dodd, Security Analysis p. 387 (New York: McGraw Hill 1932)("The argument is often made that depreciation charges may properly be ignored because they are mere bookkeeping entries and do not represent a real outlay of cash. This is a highly inaccurate statement of the case. Depreciation is not a mere bookkeeping conception because, for the most part, it registers an actual diminution of capital values, for which adequate provision must be made if creditors or owners are to avoid deceiving themselves. Moreover, in the majority of cases, the depreciation charges are consumed or offset over a period of time by even larger cash expenditures made for replacements or extensions.")

[26] One area of disclosure that may be within the scope of Reg G is certain complicated business segment disclosures. The Commission has lately been pushing for more fulsome business segment disclosure. In some cases, however, in order to provide quality disclosure of complicated business segments, the financial disclosures must be made through non-GAAP financial measures.

[27] See 17 CFR § 230.405 (defining "foreign private issuer").

[28] The outstanding example of a *pro forma* disclosure that the Commission regarded as materially misleading involved calculating "operating" or "core" earnings by excluding a "non-recurring charge" while including a non-recurring gain without disclosing that fact in the earnings release. See, e.g., In the Matter of Trump Hotels & Casino, Inc., Release No. 34-45287 (Jan. 16, 2002). Along similar lines the Association of Investment Management Research, in a comment letter to the Commission, cautioned that *pro forma* disclosures could be misleading if the method used to prepare the *pro forma* numbers changes from reporting period to reporting period. See Release No. 33-8176 at n.23.

- *Reconciliation Requirement* – Regulation G provides further that when an issuer discloses material financial information that includes a non-GAAP financial measure, the issuer is required to provide the following information as part of the release or disclosure containing the non-GAAP measure: (1) a presentation of the most-directly comparable financial measure calculated and presented in accordance with GAAP; and (2) a quantitative reconciliation of the differences between the *pro forma* number and the most directly comparable GAAP financial measure. 17 CFR § 244.100(a); see also Release No. 33-8176 at 12-13.[29]

    - "Most Directly Comparable Financial Measure" – Key to Regulation G is the concept of the "most directly comparable financial measure." Yet, the final rule and the release do not define or attempt to define the term.[30] This is an important oversight. It may be unclear what is the "most directly comparable financial measure." What, for example, is "most directly comparable" to EBITDA? Net income or cash flow from operations?

- *Submission of Earnings Announcements on Form 8-K* – Reg G further requires issuers "to furnish to the Commission a Form 8-K within five business days of any public announcement or release disclosing material non-public information regarding a registrant's results of operations or financial condition for an annual or quarterly fiscal period that has ended." Form 8-K, Item 12; see also Release No. 8176 at 21.[31] Reg G, as proposed, would

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[29] If the *pro forma* information is provided orally, then the issuer may provide the reconciliation information by both (i) posting the information on the issuer's web site; and (ii) disclosing the location and availability of the required accompanying information during the oral presentation. Id. at 13. If the *pro forma* information is forward-looking, the issuer must prepare a schedule or other presentation detailing the differences between the forward looking *pro forma* information and the most directly comparable GAAP measure. Id.

[30] The release accompanying the final rule states the following in this regard:

> Examples of financial measures calculated and presented in accordance with GAAP would include, but not be limited to, earnings or cash flows as reported in the GAAP financial statements. We believe that it is most appropriate to provide registrants with the flexibility to best make the determination as to which is the "most directly comparable financial measure calculated and presented in accordance with GAAP." We, therefore, do not believe that it is appropriate to provide a specific definition of that term. As general guidance, however, we note that our staff has been, and continues to be, of the view that (1) non-GAAP financial measures that measure cash or "funds" generated from operations (liquidity) should be balanced with disclosure of amounts from the statement of cash flows (cash flows from operating, investing and financing activities); and (2) non-GAAP financial measures that depict performance should be balanced with net income, or income from continuing operations, taken from the statement of operations.
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> Release No. 33-8176 at n. 26.

[31] The requirement applies to each piece of financial information and not each disclosure of specific financial information so that a separate 8-K filing is not necessary for each announcement or release. A partial exception involves oral presentations of financial results. A separate 8-K is not necessary after an oral presentation of financial results provided that the oral presentation is preceded within previous 48 hours by a release or announcement that triggers the filing requirement and that (i) the presentation is broadly accessible; (ii) the financial information and Reg G reconciliations are provided on the issuer's web site; and (iii) the presentation was widely announced.

have required the 8-K to be "filed" with the Commission. The final Reg G requires only that earnings and other financial information be "furnished to the Commission" on Form 8-K and not technically "filed" with the Commission.[32] Id.

- *No Effect on Antifraud Liability* – The Final rule explicitly provides that the compliance or non-compliance with Reg G shall not affect, one way or the other, any person's liability under Section 10(b) of the Exchange Act or Rule 10b-5. 17 CFR § 244.102.

Effective Time – Reg G will apply to all subject disclosures made as of March 28, 2003.

Section 403 – Disclosure of Transactions Involving Management and Principal Stockholders

SOA – Section 403 of the Act amends Section 16 of the Exchange Act to require Forms 3, 4, and 5 to be filed under Section 16 on an accelerated basis. Section 16, as amended by Sarbanes-Oxley, provides that upon becoming a 10% beneficial owner, director or officer of an issuer, the requisite filing must made within 10 days thereafter, and then, upon any purchase or sale of the securities of the issuer or execution of any securities-based swap agreement, the requisite filings must be made before the end of the second business day following the transaction. The Act also requires that, within one year of enactment (July 30, 2003), Forms 3, 4 and 5 must be filed electronically.

Accelerated Filing of Forms 4 and 5

Rulemaking Status – The final rule was issued on August 27, 2002.

Summary – The final rule amends Rule 16a-3 and Rule 16a-6 and Forms 3, 4 and 5 under the Exchange Act. Previously, Section 16(a) had permitted changes in ownership of an issuer's securities by officers, directors or 10% shareholders to be disclosed within 10 days after the end of the month in which the trade took place. Section 403(a) and the final rules now require such changes in ownership to be disclosed on Form 4 within 2 business days of the trade.

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[32] The distinction between information furnished to the Commission and information filed with the Commission is generally and briefly as follows:

- Information "furnished to the Commission" is not subject to Section 18 of the Exchange Act;
- Information "furnished to the Commission" is not thereby incorporated by reference into a registration statement, proxy statement or other report unless specifically so incorporated; and
- Information that is "furnished to the Commission" is not subject to the requirements of Item 10 of Reg S-K or Item 10 of Reg S-B.

See Release 33-8176 at 23-24.

Transactions Exempt from T+2 Requirement – The final rules provide that the following two categories of transactions not subject to the 2 day reporting requirement: (i) trades made pursuant to a 10b5-1 trading plan where the reporting person does not select the date of the transaction; and (ii) discretionary trades made pursuant to an employee benefit plan where the reporting person does not select the date of execution. Instead these trades must be reported on Form 4 by the end of the second day following either (i) the date that notice of the trade is provided to the reporting person or (ii) the third day following the date that the trade has taken place.

Transactions Between Officers/Directors and Issuer – Under the final rule, transactions between an officer or director and the issuer (such as options exercises), previously reportable on Form 5 by the end of the year, now must be reported on Form 4 by the end of the second business day following the trade.

Electronic Filing of Forms 3, 4 and 5 – Proposed Rule

Rulemaking Status – The proposed rule was released December 20, 2002. Comments must be submitted on or before February 10, 2003. No final rule has yet been released.

Summary – The proposed rule would amend Regulation S-T, Rule 16a-3(k) and Forms 3, 4 and 5 to require the electronic filing of Section 16 forms on EDGAR by July 30, 2003 and also require the electronic posting of Forms 3, 4 and 5 on issuer websites. With regard to the latter disclosure, the proposed rule would require issuers to post all Form 3, 4, and 5 filings by the end of the day of filing with the Commission. An issuer could meet this requirement by providing access to a third-party website displaying the filed forms. Access to the forms on a third party site must, among other things, be free of charge to any investor and must be direct from the issuer's website.[33]

Effective Date – The accelerated filing requirements became effective on August 29, 2002. No effective date has been set by the Commission with respect to the electronic reporting requirements. However, the Act requires compliance by July 30, 2003 and the Commission has urged compliance pending release of the final rules.

Section 406 – Code of Ethics for Senior Financial Officers

SOA – Sarbanes-Oxley Section 406 requires the Commission to issue rules requiring each issuer to disclose whether it has adopted a code of ethics for its senior financial officers, including its chief executive officer and controller (or individuals performing similar functions). SOA at § 406(a). The Act also requires that the SEC amend its disclosure regime to require that issuers promptly disclose on form 8-K or via the Internet any change in or waiver of the code of ethics. SOA at § 406(b).

[33] The Proposed Rule would permit the issuer to link to a list of the filings are the actual filings themselves but not, for example, to the home page of the third-party if the person wishing to access the information must then conduct a search or navigate the third-party site in order to access the filings. Release No. 33-8170 at 4.

Rulemaking Status – On October 22, 2002, the SEC issued the proposed addition of Parts 228, 229 and 249 to chapter 17 of the Code of Federal Regulations.[34] The comment period ended November 29, 2002 and the final rule was issued on January 23, 2003.[35]

Summary – The Final rule requires each issuer to disclose whether or not it has adopted a code of ethics for senior financial officers, including the issuer's chief financial officer and controller. In a departure from the requirements of the Act, the final rule also requires each issuer to disclose whether it has adopted a code of ethics that applies to the issuer's chief executive officer as well as the chief financial officer. 17 CFR § 229.406(a); see also Release No. 34-47235.

- *Code of Ethics* – Each code of ethics must be reasonably designed to deter wrongdoing and to promote: (i) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships; (ii) full, fair, accurate, timely and understandable disclosure; (iii) compliance with applicable governmental laws, rules and regulations; (iv) the prompt internal reporting to an appropriate person or persons identified in the code of ethics of violations of the code; and (v) accountability for adherence to the code. The non-specific nature of these requirements was evidently deliberate. In the issuing release, the Commission specifically noted, for example, that "[w]e continue to believe that ethics codes do, and should, vary from company to company and that decisions as to the specific provisions of the code, compliance procedures and disciplinary measures for ethical breaches are best left to the company." 17 CFR § 229.406(b); Release No. 34-47235 at 33.

- *Required Public Disclosure of Code* – The final rule requires companies to disclose their code(s) of ethics applicable to senior financial officers and to the chief executive officer. The Commission has provided issuers with different options for disclosing the contents of their code(s) of ethics. An issuer may file its code of ethics as an exhibit to its annual report. Alternatively, an issuer may post its code of ethics on its website and disclose in the annual report that it has done so. Thirdly, an issuer may commit in its annual report to provide free of charge printed copies of its code of ethics to anyone requesting a copy. 17 CFR § 229.406(c); see also Release No. 34-47235 at 34.

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[34] The proposing release included proposed rules to implement Section 404 of SOA. The proposed rule would have required management to attest in each quarterly and annual report stating: (i) that management is responsible for establishing and maintaining adequate internal controls and procedures for financial reporting for the company, (ii) management's conclusions concerning the effectiveness of the company's "internal controls and procedures" as of the end of the company's most recent fiscal year; and (iii) that the company's registered public accounting firm "has attested to, and reported on, management's evaluation of the company's internal controls and procedures." Release No. 33-8138 at 1. The final release, however, did not include a rule implementing Section 404. The Commission has, instead, deferred rulemaking pursuant to Section 404 until a later date. See Release No. 34-4725 at 9.

[35] The Commission has set forth similar requirements, implementing Section 406 of SOA, applicable to registered investment companies in a separate release. See Release No. IC-25914.

- *Disclosure of Changes/Waivers of Code* – The final rule adds an item to list of events triggering an obligation to make prompt disclosure on Form 8-K. The new Item 12, requires disclosure of: (i) any amendments to the issuer's code of ethics that applies to a senior financial officer or to the chief executive officer; and (ii) any waiver, including an implicit waiver, from any provision of the code of ethics. 17 CFR § 229.406(d). "Waiver" is defined as "the approval by the company of a material departure from a provision of the code of ethics." Release No. 34-47235 at 37. "Implicit waiver" is defined as the issuer's failure to "take any action within a reasonable period of time regarding a material departure from a provision of the code of ethics that has been made known to an executive officer." Id. As an alternative to filing this information on a Form 8-K, an issuer may disclose amendments to or waivers from the code of ethics on its website.

Effective Time – Companies must comply with the code of ethics disclosure and amendment/waiver disclosure requirements in their annual reports for fiscal years ending on or after July 15, 2003.

Section 407 – Disclosure of Audit Committee Financial Expert

SOA – Section 407 of Sarbanes-Oxley requires the Commission to issue rules requiring each issuer to disclose whether or not at least one member of its audit committee is a "financial expert" as defined by the Commission. SOA at § 407(a). The Act further directs the Commission, in fashioning a definition of "financial expert" to consider whether, through education or experience, a person has knowledge of GAAP, experience in preparing financial statements and experience with accounting for estimates, accruals or reserves. Id. at 407(b).

Rulemaking Status – On October 22, 2002, the SEC issued the proposed addition of Parts 228, 229 and 249 to chapter 17 of the Code of Federal Regulations. The comment period ended November 29, 2002 and the final rule was released on January 23, 2003.[36]

Summary – The rule requires each issuer to disclose whether it has at least one financial expert serving on its audit committee. In response to numerous comments, the Commission has departed from the term "financial expert" in the final rule and has adopted the term "audit committee financial expert" instead. Compare SOA at § 407(a) with Release No. 33-8177 at 6. The change in terminology is meant to reflect the emphasis in Sarbanes-Oxley on accounting/auditing matters and not on matters of valuation, capital structure, financial risk management and other strictly financial matters. Release No. 33-8177 at 6. The final rule includes specific a definition of "audit committee financial expert."

- *Audit Committee Financial Expert* – The final rule provides that anyone designated as an Audit Committee Financial Expert must have the following

[36] The Commission has set forth similar requirements, implementing Section 407 of SOA, applicable to registered investment companies in a separate release. See Release No. IC-25914.

attributes: (i) an understanding of GAAP;[37] (ii) the ability to assess the general application of GAAP in connection with the accounting for estimates, accruals and reserves;[38] (iii) experience preparing, auditing, analyzing or evaluating financial statements or experience in supervising persons engaged in these activities;[39] (iv) an understanding of internal controls and procedures for financial reporting; and (v) an understanding or audit committee functions. Release No. 33-8177 at 15.

- *Disclosure Requirement* – The final rule requires issuers to disclose either that (i) it has at least one Audit Committee Financial Expert serving on its audit committee; or (ii) it does not have an Audit Committee Financial Expert serving on its audit committee. If the issuer does not have an expert serving on its audit committee, it must explain why it does not. Release No. 33-8177 at 8. If the issuer discloses that it has an at least one expert serving on its audit committee, it must disclose the expert's name. This disclosure must be made in the issuer's annual report or in its annual proxy statement provided the latter is filed within 120 days after the end of the fiscal year. Id. at 29.

- *Safe Harbor* – Many of the comments submitted in response to the proposed rule regarding "financial experts" focused on the risk that such a financial expert might be exposed to an increased risk of liability as a result of their designated expertise. 17 CFR § 229.401(h)(4). For example, under Section 11 of the Securities Act, outside directors of an issuer ordinarily are not subject to liability for so-called "expertised" portions of a registration statement, including the issuer's audited financial statements.[40] One question is whether the "financial expert" on the audit committee may, by virtue of the designation, become liable for expertised as well as non-expertised portions of a registration statement in a Section 11 action or, similarly, whether the financial expert must meet a higher standard to establish a due diligence defense under Section 11. Another question is whether such an

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[37] The release accompanying the final rule provides that an Audit Committee Financial Expert must have "experience with financial statements that present accounting issues that are 'generally comparable' to those raised by the registrant's financial statements." Release 33-8177 at 20.

[38] The release accompanying the final rule clarifies that the expertise in accruals, estimates and reserves need be only of a general nature and need not be in the specific industry in which the issuer operates. Release No. 33-8177 at 18.

[39] The release clarifies that an Audit Committee Financial Expert need not have experience auditing companies or preparing audited financial statements. The Commission has broadened the requirement of Section 407 to include within the definition of Audit Committee Financial Expert "persons with experience performing extensive financial statement analysis of evaluation." Release No. 33-8177 at 19.

[40] Section 11 of the Securities Act provides for near strict liability of officers and directors of an issuer for misrepresentations contained in a registration statement subject to a defense of due diligence. See 15 USC § 77k (a)-(b). With respect to "expertised" portions of a registration statement, they are entitled to rely on the experts that prepared those portions of the registration statement provided that reliance is reasonable. See Id. at § 77k(b)(3)(A)-(B).

expert has heightened fiduciary duties under state corporation law[41] or is more likely, a practical matter, to be shown to have acted with *scienter* or actionable recklessness under Section 10(b) of the Exchange Act and Rule 10b-5. The Commission has attempted to address these concerns by providing a limited safe-harbor for all Audit Committee Financial Experts. In particular, the limited safe harbor clarifies that:

- A person who is determined to be an "audit committee financial expert" will not be deemed an "expert" for any purpose, including without limitation for purposes of liability under Section 11 of the Securities Act 17 CFR § 229.401 (h)(4)(i). In particular, the safe harbor provides that any portion of a registration statement reviewed by an Audit Committee Financial Expert is not thereby "expertised." Id.

- The final rule provides further that designation of a person as an Audit Committee Financial Expert does not impose any duties, obligations or liability that are greater than the duties, obligations and liability imposed on such person as a member of the audit committee and the board of directors;[42] and

- The designation of a person as an Audit Committee Financial Expert does not affect the duties of other members of the audit committee or of the board of directors.

17 CFR § 229.401(h)(4); Release No. 33-8177 at 27.

- *Selection of Audit Committee Financial Expert* – the final rule provides that the issuer's board of directors is responsible for determining whether an individual qualifies as an Audit Committee Financial Expert within the meaning of the final rule. 17 CFR § 229.401(h).

Effective Date – Companies, other than small business, must comply with the Audit Committee Financial Expert disclosure requirements promulgated pursuant to Section 407 in their annual reports for fiscal years ending on or after July 15, 2003. Small business issuers must comply with the disclosure requirements in their annual reports for fiscal years ending on or after December 15, 2003.[43]

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[41] In this regard, the release accompanying the final rule summarily states that "whether a person is, or is not, an audit committee financial expert does not alter his or her duties, obligations or liabilities. We believe this should be the case under federal and state law." Release No. 33-8177 at 28.

[42] Again, although the final rule provides that an "expert" designation does not impose any "additional duties, obligations and liability," an increased risk appears to the remain, at least as a practical matter, with regard to whether the designation of a person as an Audit Committee Financial Expert will thereby provide additional grounds for a strong inference of fraudulent intent or actionable recklessness in actions brought against the director under section 10(b) of the Exchange Act and Rule 10b-5.

[43] Comments to the proposed rule expressed concern that small businesses would have a more difficult time complying with the requirements of the final rule and would need additional time to enlist an Audit Committee

Section 802 – Preservation of Audit Records

SOA – Section 802 of the Act directs the Commission to adopt regulations regarding the retention of relevant audit and accounting records, such as work papers and documents that form the basis of an audit or review or documents that are created, sent, or received in connection with an audit or review and contain conclusions, opinions, analyses, or financial data relating to such an audit or review.

Rulemaking Status – The SEC proposed on November 21, 2002. The comment period ended December 27, 2002. On January 24, 2003, the SEC issued the final rule.

Summary – The final rule requires that an auditor retain for a period of seven years records relevant to the audit or review and that meet two criteria: (i) the materials are created, sent or received in connection with the audit or review; and (ii) the materials contain conclusions, opinions, analyses, or financial data related to the audit or review. Release No. 33-8180 at 4-5. The release clarifies that materials relating to an audit shall be retained "whether they support the auditor's final conclusions regarding the audit or review, or contain information or data, relating to a significant matter, that is inconsistent with the auditor's final conclusions regarding that matter or the audit or review. See Release No. 33-8180 at 33 (17 C.F.R. § 210.2-06(c)).

Effective Time – Auditors must comply with the record retention requirements for audits and reviews completed on or after October 31, 2003.

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The rules promulgated pursuant to the Act attempt to effect a dramatic change in corporate governance and disclosure practices. As the Commission notes in one final release: "The Sarbanes-Oxley Act clearly was intended to enhance corporate responsibility by effecting significant change; its purpose was not to perpetuate the status quo." Release No. 33-8177. While it remains a question how significantly the Act and the rules promulgated pursuant to the act will enhance corporate responsibility, there is no question that the new governance and disclosure regime will have lasting effect on corporate America for years to come.

Financial Expert. The Commission extended the time for compliance by small business issuers in view of this stated concern. Release No. 33-8177 at 18.