

# 14

## The Sarbanes-Oxley Act of 2002 \* Product Details

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## **§14.1 I. INTRODUCTION**

On July 30, 2002, the Sarbanes-Oxley Act of 2002 (Public Company Accounting Reform and Investor Protection Act) (the “Act”) (15 USC §§7201–7266) (Pub L 107-204, 116 Stat 745 (2002)) was signed into law. This Act, adopted in reaction to corporate accounting scandals involving some of the nation’s largest public companies, made sweeping changes in the law governing reporting companies and imposed significant new responsibilities on directors and officers of those companies.

This chapter discusses the principal provisions of the Act as they relate to officers and directors of reporting companies.

**NOTE™** The provisions of the Act generally do not apply to private companies. Many private companies nonetheless choose to implement selected provisions of the Act to prepare for a possible IPO, to position themselves to be acquired by a public company, to conform to the current “best practices” of corporate governance and ethical business behavior, or to satisfy the requirements of lenders or D&O insurers in these regards. See generally chap 15.

Where relevant, the following discussion includes cross-references to related discussions in chap 7. References to “Sections” mean sections of the Act.

## **§14.2      II. CERTIFICATION OF PERIODIC REPORTS**

The Sarbanes-Oxley Act of 2002 includes two separate requirements for certification of periodic reports filed with the Securities and Exchange Commission (SEC). See Sarbanes-Oxley Act §§302 and 906, discussed in §§14.3–14.4 respectively.

### **§14.3      A. Section 302 Certification**

Sarbanes-Oxley Act §302 (15 USC §7241) requires the chief executive and chief financial officers to certify their knowledge of the truth of each annual and quarterly report filed under §13(a) of the Exchange Act (15 USC §78m(a)) or §15(d) of the Exchange Act (15 USC §78o(d)). They must further certify the following:

- Their responsibility for designing, establishing, maintaining, and evaluating the effectiveness of internal controls; and
- Whether significant changes occurred in internal controls (or in other factors that could significantly affect internal controls) after the date of their evaluation, including any corrective actions relating to significant deficiencies and material weaknesses.

The SEC adopted Exchange Act Rule 13a-14(a) (17 CFR §240.13a-14(a)) and Exchange Act Rule 15d-14(a) (17 CFR §240.15d-14(a)) requiring “[e]ach principal executive and principal financial officer ... or persons performing similar functions,” of a reporting company to certify in each quarterly and annual report filed by the company under §13(a) or 15(d) of the Exchange Act that, among other things:

- He or she has reviewed the report;
- Based on his or her knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements, in light of the circumstances under which the statements were made, not misleading with respect to the period covered by the report; and
- Based on his or her knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition, results of operations, and cash flows of the company as of, and for, the periods presented in the report.

The specific language of this §302 certification is set forth in Item 601(b)(31) of SEC Regulation S-K, and cannot be varied by the certifying officers. The §302 certification also extends to the required management report on internal controls (Item 308 of SEC Regulation

S-K), discussed below. With respect to the company's annual report only (this certification does not apply to quarterly reports), the certifying officers must certify that they:

- Have evaluated the effectiveness of the company's disclosure controls;
- Have presented in the report their conclusions about the effectiveness of the disclosure controls and procedures as of the end of the period covered by the report based on that evaluation; and
- Have disclosed to the company's auditors and to the audit committee of the company's board of directors (or persons performing the equivalent function):
  - All significant deficiencies and material weaknesses (see 17 CFR §240.12b-2 (definition)) in the design or operation of internal controls that are reasonably likely to adversely affect the company's ability to record, process, summarize, and report financial data; and
  - Any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal control over financial reporting.

The §302 certification is not required for reports on Form 8-K, which are considered "current," not "periodic," reports.

The SEC has amended the exhibit requirements for periodic reports to provide that the §302 certification be filed as an exhibit to the quarterly or annual report. A separate certification must be provided for each certifying officer.

**NOTE™** Amendments to Form 10-Q and Form 10-K also must contain the §302 certification, but paragraph 3 of the §302 certification may be omitted unless the amendments contain new or amended financial statements. Also, no §906 certification, discussed in §14.4, is required for amendments unless they contain new or amended financial statements.

The §302 certification regarding fair presentation of financial statements "and other financial information" extends not only to financial statements (including footnotes), but also to management's discussion and analysis of financial condition and results of operations and any other financial information included in the report.

**NOTE™** The certification also is broader than a mere representation that the financial statements and other financial information conform to generally accepted accounting principles (GAAP),

some of which are highly technical and involve many subjective judgments. Rather, the certification is intended to provide assurance that, apart from compliance with GAAP, the financial information is a “fair presentation” of the company’s financial condition, results of operations, and cash flows.

Apart from the certification language itself, Rules 13a-14 and 15d-14 do not change the quarterly or annual reporting requirements. They also do not affect the specific types of information required to be disclosed in the quarterly or annual reports or expand the disclosures contained in such reports beyond what may be necessary to a fair presentation of the required information.

The §302 certification is to be made based on the knowledge of the certifying officer. Ignorance, however, will be no defense to a charge of falsely certifying a quarterly or annual report if the certifying officer should have known that the certification was false. An officer who makes a false certification under §302 could be subject to an SEC enforcement action for violating §13(a) or 15(d) of the Exchange Act and to potential actions by the SEC and private plaintiffs for violating §10(b) of the Exchange Act (15 USC §78j(b)) and Exchange Act Rule 10b-5 (17 CFR §240.10b-5).

**NOTE™** A reporting company’s principal executive and financial officers already are responsible as signatories to the company’s Exchange Act reports for the disclosures contained in the reports and can be liable for material misrepresentations or omissions in the reports. See §7.46. In this regard, therefore, the certification requirements were not necessarily meant as a significant departure from previous law.

An officer who “willfully” makes a false §302 certification may be liable for criminal violation of the Exchange Act. Section 1106 of the Sarbanes-Oxley Act increased the penalties for such violations to a maximum of up to 20 years imprisonment and fines of up to \$5,000,000.

**NOTE™** In March 2004, the SEC initiated a criminal complaint against Richard M. Scrushy, the founder and former Chief Executive Officer of HealthSouth Corporation, for, among other things, making false §302 certifications in connection with HealthSouth’s periodic SEC reports, thus making Mr. Scrushy the first individual to be indicted for alleged violations of the Act. In the first reported legal challenge to the Act, Mr. Scrushy’s attorneys asked the United States District Court in Birmingham, Alabama, to throw out the charges under the Act on the basis that the §302 requirements are unconstitutionally

vague. The court refused to do so, although Mr. Scrushy subsequently was acquitted of the charge by a jury.

#### **§14.4 B. Section 906 Certification**

Under §906 of the Sarbanes-Oxley Act of 2002 (15 USC §1830), each periodic report containing financial statements filed by a public company under §13(a) of the Exchange Act (15 USC §78m(a)) or §15(d) of the Exchange Act (15 USC §78o(d)) must be “accompanied by” a written statement of the company’s CEO and CFO certifying that (15 USC §1830(a)–(b)):

- The report fully complies with the requirements of §§13(a) and 15(d) of the Exchange Act; and
- The information contained in the report fairly presents, in all material respects, the financial conditions and results of operations of the company.

The §906 certification must be included as an exhibit to the report. Unlike, however, the §302 certification, which is filed as part of the report, the §906 certification is deemed to be “furnished” only, and so is not considered a part of the report for Exchange Act liability purposes and is not incorporated into any Securities Act filings that incorporate the report by reference. The §906 certification, like the §302 certification, is not required for current reports on Form 8-K.

Section 906 includes its own criminal provisions. Certifying officers who knowingly make false §906 certifications will be subject to fines of up to \$1,000,000 and imprisonment of up to ten years. “Willful” violators will be subject to fines of up to \$5,000,000 and 20 years’ imprisonment. 15 USC §1830(c).

**NOTE™** These penalties correspond to the increased penalties for criminal violations of the Exchange Act. The Department of Justice, and not the SEC, is responsible for enforcement of §906 of the Act. Apart from federal criminal action, it is unclear whether §906 increases the potential liability of certifying officers under the federal securities laws. In most if not all cases, actions by certifying officers that are determined to have violated §906 also would be likely to violate §302.

#### **§14.5 C. Backup Procedures**

Neither the Act nor the SEC implementing rules specify the procedures to be followed by officers in making their §302 or §906 certifications. Generally speaking, however, both §306 and §906 contemplate increased CEO and CFO involvement in all aspects of the

preparation of SEC reports and greater personal responsibility for the completeness and accuracy of such reports. When certifying periodic reports, CEOs and CFOs should consider, among other things, taking the following minimum steps:

- Carefully review the proposed periodic report, paying particular attention to the financial statements, notes to them, and related financial disclosures, including management's discussion and analysis. Require all members of management to do the same;
- Review the company's most recent Form 10-K and all subsequent filings (including any filings under the Securities Act of 1933) with the SEC to identify disclosure issues affecting these prior filings (and any SEC comments on the prior filings) that may be relevant to the periodic report and require all members of management to do the same;
- Make appropriate inquiries of members of management and of the company's independent auditors regarding the current state of the company's internal controls and reporting systems so as to identify any known or suspected deficiencies that could affect the accuracy or completeness of the information, *both financial and nonfinancial*, in the periodic report;
- Review with other members of management and the company's independent auditors the procedures undertaken for the preparation, review, and filing of the report, paying particular attention to any issues identified during the course of such procedures regarding, among other things, significant developments and trends in the company's business or industry;
- Review with members of management and the independent auditors the key accounting principles and significant management judgments reflected in the company's financial statements and the rationale for such principles and judgments, and consider the impact on the company's financial statements of adopting other appropriate accounting principles and of different judgments;
- Confirm with the manager and audit partner of the company's independent auditors that they are not aware of any possible material misrepresentations or omissions in the periodic report and are comfortable that the report presents fairly the financial condition, results of operations, and cash flows of the company even apart from its strict compliance with Generally Accepted Accounting Principles;
- Meet with the company's audit committee to resolve any disagreements regarding disclosures, review the officers'

certifications, and explain the due diligence undertaken to enable them to make the certification;

- Request the company's independent auditors and outside counsel to confirm that the periodic report complies on its face with the requirements of Form 10-Q, 10-QSB, 10-K, or 10-KSB, as the case may be, and applicable SEC rules and regulations;
- In the meetings and discussions outlined above, solicit suggestions for improving and clarifying the company's disclosures in its periodic reports; and
- In addition to other additions or changes to the periodic report necessitated by the foregoing due diligence, consider adding "risk factors" within the MD&A section of the report or elsewhere as appropriate.

**NOTE™** In its adopting release, the SEC recommended that reporting companies create a committee charged with responsibility for assessing the companies' disclosures in their periodic reports and determining the materiality of information. The SEC suggested that the principal accounting and legal officers and principal risk management officer might serve on the committee, which would report to the CEO, CFO, and other senior management. Whether or not a disclosure committee is formally established, as a practical matter CEOs and CFOs will have to work closely with other company officers and employees, including legal officers, to make sure that procedures and controls are in place to enable them to make the required certifications.

Whatever the procedures followed by officers in certifying a report under Sections 302 and 906 may be, they should be well documented.

**NOTE™** It is unclear to what extent certifying officers can rely on corresponding certifications or representations of other management personnel or employees regarding the accuracy and completeness of the reporting company's report. It is advisable, however, to obtain written certifications of representations from officers and other employees directly responsible for the information included in the report. These certifications and representations might serve to refute a charge that a false certification was "knowing" or "willful."

**§14.6 III. DISCLOSURE CONTROLS AND PROCEDURES AND MANAGEMENT'S REPORT ON INTERNAL CONTROLS OVER FINANCIAL REPORTING**

Sarbanes-Oxley Act §404 (15 USC §7262) and Exchange Act Rules 13a-15 and 15d-15 (17 CFR §240.13a-15; 17 CFR §240.15d-15) require all reporting companies to establish and maintain an “adequate internal control structure and procedures for financial reporting” or “disclosure controls and procedures.” As discussed in §14.3, the officer certifications under §302 of the Act (15 USC §7241) extend to these disclosure controls and procedures.

For purposes of the rules, “disclosure controls and procedures” mean controls and other procedures of a reporting company that are designed to ensure that *all* information required to be disclosed by the company in the reports filed or submitted by it under the Exchange Act is recorded, processed, summarized, and reported, within the time periods specified in the SEC’s rules and forms. See 17 CFR §§240.13a-15(e), 240.15d-15(e). The definition goes beyond “internal accounting controls” as previously specified in §13(b) of the Exchange Act (15 USC §78m(b)), which pertain strictly to financial reporting procedures. The definition, therefore, is intended to encompass procedures for ensuring that material nonfinancial information, as well as financial information, is disclosed as required in a reporting company’s quarterly and annual reports.

The SEC did not prescribe any particular controls or procedures, but expects each company to develop its own controls and procedures based on its own business and management needs.

Exchange Act Rules 13a-15 and 15d-15 also require the CEO and CFO of a public company to evaluate the effectiveness of their company’s internal controls over financial reporting, and Forms 10-Q, 10-QSB, 10-K, and 10-KSB have been amended to require disclosure of the conclusions reached by the CEO and CFO in their evaluations. Any significant changes in the controls and certain other matters also must be disclosed in these reports. Such controls and procedures should (17 CFR §240.15d-15(f)(1)-(3)):

- Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;
- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in

accordance with authorizations of management and directors of the issuer; and

- Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the issuer's assets that could have a material effect on the financial statements.

**NOTE™** Although many different methods for conducting an evaluation of the effectiveness of internal control over financial reporting exist to meet these requirements, an evaluation that is conducted in accordance with the interpretive guidance issued by the Commission in SEC Release No. 34-55929 is a prudent approach. 17 CFR §240.15d-15(c).

The SEC rules implementing §404 of the Act require a reporting company to include in each annual report on Form 10-K or 10-KSB a management report on internal controls containing the following information (see 15 USC §7262(a); 17 CFR §229.308(a)):

- A statement of management's responsibility for establishing and maintaining adequate control over financial reporting for the company;
- A statement identifying the framework used by management to evaluate the effectiveness of this internal control;
- Management's assessment of the effectiveness of this internal control as of the end of the company's most recent fiscal year; and
- A statement that the company's auditor has issued an attestation report on management's assessment.

The CEO's and CFO's report on internal controls also must state that the company's independent auditors have issued their own report attesting to management's evaluation of the effectiveness of the company's internal controls. 17 CFR §229.308(b).

Compliance with these internal control and audit attestation requirements generally became effective for fiscal years ending after November 14, 2004, for "accelerated filers" as defined in Exchange Act Rule 12b-2 (17 CFR §240.12b-2) (generally, companies with a "public float" in excess of \$75 million). Compliance with these requirements for all other public companies was repeatedly postponed by the SEC in the midst of complaints that the new requirements were unduly burdensome and costly to smaller public companies. Most recently, on December 15, 2006, the SEC extended the compliance date so that nonaccelerated filers must provide management's assessment regarding internal control over financial reporting in annual reports for fiscal years ending after December 14, 2007. The

SEC also extended the date by which nonaccelerated filers must begin to comply with the auditor attestation requirement; those filers must comply with this requirement for annual reports for fiscal years ending after December 14, 2008.

**NOTE™** The SEC announced recently that these compliance dates will not be extended.

The SEC also granted relief from the §404 (15 USC §7262) requirements for companies that are new to Exchange Act reporting. The rules provide all new public companies with a transition period that excuses them from having to comply with the §404 requirements in the first annual report they file after becoming an Exchange Act reporting company. The transition period applies to a company that has become public through an initial public offering (equity or debt) or a registered exchange offer or that otherwise has become subject to the Exchange Act reporting requirements. See SEC Concept Release No. 34-54122 (July 11, 2006), which can be viewed on the SEC's website at <http://www.sec.gov/rules/concept/2006/34-54122.pdf>.

This management report on internal controls has generated much consternation among reporting companies and their officers and directors, not only because of the increased administrative burdens it imposes on the companies and their officers and directors, but because of the substantial additional cost of obtaining the separate report of their auditors attesting to management's report. Senior SEC officials have predicted that, for many reporting companies, the requirements of §404 will be the most important requirements of the Act.

**NOTE™** On May 23, 2007, the SEC proposed interpretative guidance regarding management's duty to evaluate its internal control over financial reporting. The new standard is intended to be more flexible and less burdensome for companies. See <http://www.sec.gov/news/press/2007/2007-101.htm>. See also SEC Release Nos. 33-8762 and 34-54976 (Dec. 20, 2006), which can be viewed at the SEC's website: <http://www.sec.gov/rules/proposed/2006/33-8762.pdf>.

The Exchange Act requires that all reporting companies maintain internal "accounting" controls. Specifically, §13(b)(2)(B) (15 USC §78m(b)(2)(B)), enacted as part of the Foreign Corrupt Practices Act of 1977, provides that every reporting company must devise and maintain a system of "internal accounting controls" sufficient to provide "reasonable assurances" that:

- Transactions are executed in accordance with management's general or specific authorization;

- Transactions are recorded as necessary (1) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (2) to maintain accountability for assets;
- Access to assets is permitted only in accordance with management's general or specific authorization; and
- The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

Reporting companies also must maintain such internal controls with respect to their majority-owned subsidiaries.

Exchange Act §13(b)(7) (15 USC §78m(b)(7)) defines the term "reasonable assurance" to mean the "degree of assurance as would satisfy prudent officials in the conduct of their own affairs."

Section 404 of the Sarbanes-Oxley Act (15 USC §7262) complements Exchange Act §13(b)(2)(B) by requiring that management report on its company's internal controls over financial reporting and that the company's independent auditors attest to management's report. The Act also directs the Public Company Accounting Oversight Board (PCAOB) to adopt standards regarding the auditor's review and attestation regarding the company internal controls, which the PCAOB has done. As discussed above in §14.3, the Act requires the §302 certification that accompanies the company's periodic SEC filings to also address internal controls, including internal controls over financial reporting.

The PCAOB is required to adopt professional standards for auditors under Sarbanes-Oxley Act §404(b). Sarbanes-Oxley Act §103(a) (15 USC §7213(a)). Specifically, §103(a)(2)(A)(iii) directs the oversight board to "include in the auditing standards that it adopts" a requirement that registered public accounting firms describe in each audit report on the company's financial statements the scope of the auditor's testing of the internal control structure and procedures of the issuer required by §404(b), and present, *either in its audit report or in a separate report* (15 USC §7213(a)(2)(A)(iii)):

- The auditor's findings from such testing;
- An evaluation of whether such internal control structure and procedures meet the objectives of:
  - Maintaining records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the company; and
  - Providing reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in

accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and

- A description, at a minimum, of material weaknesses (see 17 CFR §240.12b-2 (definition)) in those internal controls, and of any material noncompliance found on the basis of such testing.

**PRACTICE TIP™** In effect, therefore, a reporting company's independent auditors must perform two audits—the traditional audit of the company's financial statements and a separate audit of the company's internal controls over financial reporting.

The SEC originally proposed to allow management complete discretion to design and implement its own internal controls over financial reporting. The final rule adopted by the SEC, however, requires that management's report be based on a "suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment."

In its adopting release, Securities Act Release No. 33-8238 (June 5, 2003), the SEC indicated that, although the company's independent auditor may assist management in documenting internal controls, "management must be actively involved in the process" and "management cannot delegate its responsibility to assess its internal controls over financial reporting to the auditor." The SEC's rules on auditor independence prohibit auditors from providing certain nonaudit services to their audit clients. These prohibited services include performing management functions for the client and internal control outsourcing. See §201(a)(5)–(6) of the Act (see 15 USC §78j-1(g), (h)) and Rule 2-01(c)(4)(v)–(vi) of Regulation S-X.

The SEC's rules do not specify how management should perform its internal control evaluation. However, Release No. 33-8238 makes the following points regarding evaluation methodology:

- In conducting an evaluation and developing its assessment of the effectiveness of internal control over financial reporting, a company must maintain evidential matter, including documentation, to provide reasonable support for management's assessment of the effectiveness of the company's internal control over financial reporting. Developing and maintaining such evidential matter is an inherent element of effective internal controls.
- The evidential matter should document both the design of internal controls and the testing processes. This evidential matter should

provide reasonable support for the evaluation of whether the control is designed to prevent or detect material misstatements or omissions; for the conclusion that the tests were appropriately planned and performed; and that the results of the tests were appropriately considered.

- The assessment of the effectiveness of internal control over financial reporting must be based on procedures sufficient both to evaluate design and to test operating effectiveness. Controls subject to assessment include, but are not limited to, controls over initiating, recording, processing, and reconciling account balances, classes of transactions, and disclosure and related assertions included in the financial statements; controls related to the initiation and processing of nonroutine and nonsystematic transactions; controls related to the selection and application of appropriate accounting policies; and controls related to the prevention, identification, and detection of fraud.

**NOTE™** The nature of a company's testing activities will largely depend on the circumstances of the company and the significance of the control. Although many different methods for conducting an evaluation of the effectiveness of internal control over financial reporting exist to meet these requirements, an evaluation that is conducted in accordance with the interpretive guidance issued by the SEC in Release No. 34-55929 is the prudent course. 17 CFR §240.13a-15(c).

The management of a company that was required to file or did file an annual report for the previous fiscal year must evaluate, with the participation of the principal executive and principal financial officers (or persons performing similar functions), the effectiveness of the issuer's internal control over financial reporting as of the end of each fiscal year. The framework on which management's evaluation of the issuer's internal control over financial reporting is based must be a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment. 17 CFR §240.13a-15(c). Management is similarly required to evaluate any change in the company's internal control over financial reporting that has materially affected (or is reasonably likely to affect) the internal control over financial reporting that occurred during each of the company's fiscal quarters. 17 CFR §240.13a-15(d); see 17 CFR §229.308(c).

Item 308(c) of SEC Regulation S-K requires disclosure in quarterly reports on Form 10-Q or Form 10-QSB of any change in internal control over financial reporting that occurred during a fiscal quarter

and that has materially affected, or is reasonably likely to affect materially, the company's internal control over financial reporting.

SEC Release No. 33-8238 also adopted amendments to Regulation S-X to implement the requirement in §404(b) of the Act that a reporting company's auditor attest to management's report on internal control. Amended Rule 2-02(f) of SEC Regulation S-X requires every registered public accounting firm that issues an audit report on a public company's financial statements to attest to, and report on, management's internal control assessment.

**NOTE™** The same audit firm must perform both audits.

The auditor must issue such an attestation report whenever management's internal control report is included in the company's annual report required by Exchange Act §13(a) or §15(d).

A discussion of the PCAOB's attestation standards applicable to auditors' reports on management's internal assessment is beyond the scope of this chapter.

#### **§14.7 IV. INTERFERENCE WITH AUDIT**

It is unlawful for any officer or director of a reporting company, or any person acting under his or her direction, in violation of rules adopted by the SEC, to coerce, manipulate, mislead, or fraudulently influence any independent accountant engaged in an audit of the company's financial statements for the purpose of making those financial statements materially misleading. Sarbanes-Oxley Act §303 (15 USC §7242(a)).

The SEC's rules implementing §303, Exchange Act Rule §13b2-2(b), prohibit a public company's officers and directors, and persons acting under their "direction," from subverting the responsibilities of the company's auditor to conduct a diligent audit and provide a true report of its findings. The rules set forth several examples of actions prohibited by §303, including the failure to report matters to the company's audit committee. In theory, at least, coercion or manipulation of an auditor violates the rule even if the effect on the auditor does not result in false or misleading financial statements by the company.

**NOTE™** Exchange Act Rule 13b2-2 (17 CFR §240.13b2-2), which predates the adoption of the Act, prohibits directors and officers of a reporting company from making false or misleading statements to an accountant in connection with an audit of the company's financial statements or the preparation of a document or report required to be filed with the SEC. See §7.79.

## **§14.8 V. REPAYMENT OF EQUITY-BASED BONUSES AND PROFITS**

As a further incentive to CEOs and CFOs to enhance the accuracy of their companies' public disclosures, CEOs and CFOs "shall reimburse" their companies all bonuses and other incentive-based or equity-based compensation received, and all "profits realized" from sales of company securities, during the 12-month period following the issuance or filing by their companies of financial statements that are subsequently restated because of material noncompliance by the companies, *as a result of misconduct*, with any financial reporting requirement under the securities laws. Sarbanes-Oxley Act §304 (15 USC §7243(a)).

Section 304 raises a number of significant interpretive questions, including the nature of the "misconduct" necessary to trigger a repayment obligation and how "profits realized" are to be calculated. The Act does not define "misconduct" or provide any guidance on how it is to be construed. (For example, does it matter if the misconduct was engaged in by persons other than the CEO or CFO?) On its face, §304 seems to provide for strict liability (similar to the short-swing trading prohibition under §16(b) of the Exchange Act (15 USC §78p(b)), discussed in §7.70) of the CEO and CFO, even if they were not guilty of the "misconduct" leading to the restatement, or even aware of it. On the other hand, §304 might be interpreted more narrowly, so as to require personal culpability on the part of the CEO or CFO involved. The resolution of this interpretive issue may determine whether or not §304 will prove to be a significant remedy in the enforcement of the federal securities laws. Whatever the ultimate resolution of this interpretive issue, presumably, "profits realized" for purposes of §304 will be broadly interpreted by the SEC as it is for purposes of §16(b)'s short-swing trading prohibition.

Assume, for example, that in 2000 a public company had granted its CEO 100,000 shares of restricted stock subject to vesting over a three-year period and that the market price of the stock at the time of grant was \$10 a share. Also assume that, by the end of 2003 when the shares become fully vested, the market price had reached \$30 a share, where it remained through March 2005, when the company filed its annual report on Form 10-K for 2004. Further assume that in December 2005 the CEO sold 50,000 of the previously restricted shares at the then-current market price of \$20 a share, thereby realizing a profit of at least \$10 a share, or \$500,000. Then, in March 2006, the company determines that it must restate its financial statements for 2004 (and 2005) due to improper accounting. If the restatement was due to "misconduct," it seems that the CEO would have to reimburse the company not less than \$500,000, representing

the difference between the sale price of the shares sold in 2005 and the market price of the shares at the time they were granted to the CEO. (Alternatively, perhaps the “profit realized” would be deemed to be the larger amount representing the difference between the sale price and the CEO’s tax basis in the shares, which presumably would be less than \$10 a share.) This would be the case even though the economic profits were earned over the three-year period 2000 through 2003, and none of the profits was attributable to an increase in the market price of the company’s stock following the publication of the false 2004 financials.

The Act grants the SEC the power to exempt individual CEOs and CFOs from these forfeiture provisions, but it is unclear whether the SEC can (or will choose to) do so by advance rule making, or only on a case-by-case basis in connection with enforcement actions under §304. 15 USC §7243(b). Unlike many of the Act’s directives, there is no deadline for SEC rule making under §304.

Another interpretive question unanswered by the Act is whether there is an implied private right of action for the issuer, or is the SEC the only party that can maintain an action under §304? As a practical matter, reasons why plaintiffs’ counsel might want to bring such a claim include the fact that derivative claims are generally not believed to be subject to the lead plaintiff/lead counsel and pleading requirements of the Private Securities Litigation Reform Act of 1995 (Pub L 104-67, 109 Stat 737). Thus, if one set of plaintiffs and their counsel are not selected as lead counsel for a federal securities claim (see §8.44B), a §304 derivative claim would give them an avenue to litigate on a separate “second front” against alleged wrongdoers in federal court. But under the Supreme Court’s approach in *Alexander v Sandoval* (2001) 532 US 275, 149 L Ed 2d 517, 121 S Ct 1511, a private right of action will be implied only when the statutory text and structure plainly “display an intent to create not just a private right but also a private remedy.” 532 US at 286, 149 L Ed 2d at 528. Here, the statutory text of §304 does not expressly create a private right of action. Nor does the statutory structure support implication of a private right. The Sarbanes-Oxley Act itself is plainly aimed at setting forth new standards for the SEC to police, and permitting the SEC to implement appropriate rules in furtherance of those standards. Furthermore, unlike §304, a parallel part of the Act, §306 (15 USC §7244), does expressly provide for a private right of action with respect to insider trades during blackout periods. See §14.11. Under the interpretative principle of “expressio unius est exclusio alterius” (the expression of one is the exclusion of the other), the fact that Congress chose to expressly state a private right of action for §306 but

did not provide such a right under §304 is telling. See also *Neer v Pelino* (ED Pa 2005) 389 F Supp 2d 648 (no private right of action).

Although public companies and derivative plaintiffs may not be permitted to seek disgorgement against a CEO or CFO under §304, a similar remedy remains available under common law causes of action for breach of fiduciary duty.

#### **§14.8A VI. NONDISCHARGEABILITY IN BANKRUPTCY**

Sarbanes-Oxley Act §803 amended §523(a) of the Bankruptcy Code (11 USC §523(a)) to except from discharge in bankruptcy liabilities arising from violation of federal or state securities laws. As a result, these liabilities, including new liabilities imposed under the Act on officers and directors of public companies, will not be dischargeable in a personal bankruptcy of an officer or director of a public company.

#### **§14.9 VII. PROHIBITION OF LOANS TO EXECUTIVE OFFICERS AND DIRECTORS**

One of the Sarbanes-Oxley Act's most controversial provisions is §402, which amended the Exchange Act to prohibit, with limited exceptions, personal loans by public companies to their directors and executive officers. See 15 USC §78m(k). As discussed below, §402, like §304 of the Act discussed above, poses a number of important interpretive questions that will require further Congressional action, judicial decisions, or perhaps SEC rule making, to resolve. In the meantime, reporting companies must be duly concerned with the broad potential reach of §402.

Section 402 (15 USC §78m(k)(1)) provides, in pertinent part, that it is unlawful for any reporting company

directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer.

**NOTE™** The terms “director” and “executive officer” are defined in Exchange Act §3(a)(7) (15 USC §78c(a)(7)) and Exchange Act Rule 3b-7 (17 CFR §240.3b-7), respectively. See §7.65.

This prohibition applies to extensions of credit by reporting companies and arrangements by reporting companies for the extension of credit that:

- Constitute a “personal loan” (which is not defined); and
- Are made after July 30, 2002.

Section 402 does not apply to loans made before July 31, 2002, as long as there is no “material modification” or renewal of the loans after that date.

**NOTE™** Any “material modification” to a loan to a director or executive officer, made before July 31, 2002, even one that benefits the reporting company, appears to be prohibited by §402.

#### **§14.9A A. Prohibited Transactions**

According to its plain meaning, Sarbanes-Oxley Act §402 seems to prohibit many transactions between public companies and their directors and executive officers that were considered routine before adoption of the Act, including:

- The company’s extension of loans to purchase company stock either directly from the company or in market transactions;
- The company’s acceptance of personal promissory notes in payment of the exercise price of company stock options or warrants, as well as so-called cashless exercises of stock options;
- The reporting company’s payment of withholding taxes due on an executive officer’s stock option exercise or other taxable event that is to be repaid later by way of a payroll deduction from salary or other amounts due to the executive officer;
- Loans made by the company, or arranged by the company with third party lenders, for the purchase of a residence in a new locale to which an executive officer is relocated, or to advance relocation expenses;
- Split-dollar life insurance policies (under which the premiums paid initially by the company are eventually reimbursed);
- Participant loans to executive officers under company-sponsored 401(k) plans; and
- Use of company credit cards for personal use.

**NOTE™** With cashless exercises of stock options, the company defers receipt of payment of the exercise price of the stock options until the director or executive officer (or broker acting on his or her behalf) pays the exercise price to the company from the proceeds from a concurrent sale of some or all of the option shares. (For state corporation law purposes, the director or executive officer

is “credited” with having paid for the option shares even before payment is received by the company.) Typically, this settlement period lasts only a few days. Section 402 does not distinguish, however, between long-term and short-term loans or between this and other types of “credit.”

**NOTE™** Split-dollar policies, so called because on paper the company and executive split the benefits, were a feature of executive compensation for nearly 40 years before the adoption of the Act. Typically, the company paid nearly 100 percent of the premiums, which appreciated tax-free within the insurance policy and over a decade or two become a significant amount of cash. When the executive retired, the corporation was repaid—without interest—from the cash buildup it had contributed in premiums. The policies were typically set up so that the remaining cash paid for premiums for the rest of the executive’s life, leaving the death benefit for his estate. Alternatively, after the corporation had been repaid, the executive could make regular tax-free withdrawals from the policy and spend the money during retirement, although the executive made sure to leave enough cash in the policy to continue paying premiums. If the policy lapsed, the loans became taxable. The prohibitions under §402 have all but eliminated the market for split-dollar policies.

It is possible that §402’s reach also extends to routine indemnification arrangements between a reporting company and its directors and executive officers, because these arrangements typically provide for the company’s advancement of defense costs. Section 402 might be deemed to prohibit a reporting company from making an advance of defense costs after July 31, 2002, under “grandfathered” indemnification arrangements when such advancement is permissive only and not mandatory.

The sparse legislative history, as well as subsequent public comments from members of Congress instrumental in the passage of the Act, suggest that the drafters of §402 meant what they wrote; that is, that the past practice of many public companies of extending or arranging loans in one form or other to their officers and directors would now be prohibited. This plain reading of §402 also is consistent with the political and regulatory climate that led to the enactment of the Act, in which business as usual would no longer be tolerated. Many corporate law practitioners, however, are not convinced that §402 is to be taken literally, and are troubled by the SEC’s refusal to offer any guidance on the many interpretive issues under §402, some of which are discussed below.

## **§14.9B B. Interpretive Questions**

The effect of §402 on contracts entered into between a reporting company and its directors or executive officers before July 31, 2002, that call for the company to make a personal loan after July 30, 2002, is unclear. Section 402's possible prohibition of such loans may raise due process and other constitutional issues.

It also is unclear under §402 whether a public company can provide personal loans to prospective directors or executive officers as a signing bonus before such persons are actually engaged by the company as a director or executive officer. At the time such loans are granted, the recipient is not an executive officer or director; however, it is conceivable that a court would interpret such a transaction as unlawful under §402 because the loan was made with the understanding and intent that the recipient would promptly become a director or executive officer. Under some circumstances, a court might determine that such loans are devices to evade §402.

Even if such loans were held to be lawful under §402, the issue arises whether the prohibition against material modifications would apply to these loans after the recipient becomes a director or executive officer. Section 402 prohibits material modifications of covered loans made before July 31, 2002. Strictly interpreted, signing loans would not be subject to §402's prohibition on material modifications because they would be executed after July 30, 2002. However, if the initial loan is lawful, a court nevertheless could determine that it would be covered by §402 after the director or executive officer joins the company, thus making any material modifications to the terms of the loan unlawful.

What if a company extended a personal loan to a director or executive officer before §402's effective date, and the director or executive officer subsequently resigned from such position and was instead engaged as a consultant? On one hand, one could argue that such a director or officer and the existing loan are no longer subject to the prohibitions of §402 because this person is no longer a "director," "executive officer," or "equivalent thereof." Assuming this is correct, one could further argue that the company could then materially modify, renew, or even forgive the loan in compliance with the Act, because §402 no longer applies by its terms. On the other hand, the phrase "personal loan to or for any director or executive officer" may refer to the point in time at which the loan is made. Assuming this interpretation is correct, whether the director or executive officer continues in the same capacity should not affect the analysis of whether the loan is subject to §402. Under this interpretation, a personal loan to a director or executive officer made before §402's

effective date will always be subject to the prohibition against material modifications and renewals of existing loans regardless of whether the director or executive officer remains a director or executive officer.

#### **§14.9C C. “Grandfather” Provision**

Section 402’s “grandfathering” of loans in existence on July 30, 2002, also raises some important interpretive questions. For example, companies often forgive all or a portion of their loans to directors and officers, or extend the repayment schedules of such loans. Presumably, unless the forgiveness or extension was specifically made part of the original terms of the loan, each of these actions would be considered a “material” modification and would no longer be permitted with respect to loans entered into before July 31, 2002. It may be the case, however, depending on the circumstances, that the forgiveness or extension of a loan made before July 31, 2002, would be implied by a past pattern or practice of the reporting company to forgive or extend similar loans.

A company that acquiesces in nonpayment by an officer or director may effectively have modified the original loan agreement requiring repayment by a certain date. Thus, allowing a significant variation in performance, or failing to exercise the company’s legal rights in regard to a grandfathered loan, may constitute a material modification of the loan in violation of the Act. To avoid the risk of violating §402, a company may have to proceed in a diligent and timely fashion to collect the money loaned.

However, according to some (but not all) commentators, forgiveness of a loan should not be prohibited by §402 because it involves no loan “modification.” Perhaps in reliance on this commentary, several public companies have forgiven prior loans to officers or directors since the adoption of the Act.

#### **§14.9D D. Substituted Payment**

Section 402 also raises the question of to what extent, if any, a company may accept substituted forms of repayment of existing loans to directors and executive officers. For example, may a company reduce the outstanding balance of, or forgive altogether, an existing personal loan to a director or executive officer in lieu of a cash bonus? Such an action may be permissible if justified based on the overall performance and compensation of the individual involved. Otherwise, it may appear that the company is materially modifying the loan terms by, in effect, forgiving or reducing the balance of a covered loan. Even assuming the action has independent significance, under a plain

reading of §402, a company still may be technically violating §402 by reducing the balance of an outstanding personal loan in this manner, unless such payment method is specifically contemplated by the terms of the loan.

Another common example of substituted payment is the surrender of company stock by the director or executive officer to pay back an existing personal loan. On one hand, the company is receiving equivalent value, and from an accounting perspective there is no significant difference for purposes of recording the payment on the company's balance sheet. However, accepting substituted payment with stock might be considered a "material modification" of the loan terms because stock, as compared to cash, is not a liquid asset to the company and presumably the use of stock benefits the director or officer involved by permitting him or her to avoid transaction costs that would be incurred in selling the stock in the market (assuming it can be sold publicly) and paying the proceeds to the company.

Alternatively, the reporting company could buy back the director's or executive officer's stock in a manner consistent with state corporation law and the director or executive officer could use the proceeds to immediately pay his or her obligations under a §402 covered loan. Because this manner of payment involves no modification of the loan, it should be permissible under §402.

It is unclear whether the SEC has rulemaking authority to resolve the many uncertainties surrounding the meaning and application of §402. To date, however, the SEC has been unwilling to provide advice regarding §402.

#### **§14.10 VIII. ACCELERATED REPORTING OF INSIDER TRADES**

Sarbanes-Oxley Act §403(a) amended §16(a) of the Exchange Act (15 USC §78p(a)) to require officers, directors, and 10-percent beneficial shareholders to report changes in beneficial ownership

before the end of the second business day following the day on which the subject transaction has been executed, or at such other time as the [SEC] shall establish, by rule, in any case in which the [SEC] determines that such 2-day period is not feasible.

15 USC §78p(a)(2)(C). See §7.63.

Additionally, the Act amended §16(a) to require electronic filing of beneficial ownership reports and website posting of such reports by both the SEC and the company itself, if the company maintains a website. 15 USC §78p(a)(4). The SEC adopted rules requiring §16(a) reports to be filed electronically beginning July 30, 2003, and

clarifying the Act's requirements for website posting of such reports. See §7.66.

**NOTE™** The requirement to post §16(a) reports on company websites and similar requirements regarding public dissemination of information reported to the SEC has caused some confusion regarding the maintenance of websites by reporting companies. Neither the SEC nor the stock exchanges, including NASDAQ, require a reporting company or listed company to maintain a website; if a reporting company otherwise maintains a website, however, it must post on its website §16(a) filings and other specified information as required by SEC rules and other applicable requirements. Website posting is one means, for example, of complying with SEC Regulation FD's requirement to report inadvertent selective disclosures of material nonpublic information. See §7.44A.

In general, all transactions by directors and officers in their company's securities must be reported before the end of the second *business* day following the transaction date. Transactions, such as many stock option grants, previously reportable on Form 5 at yearend also must now be reported on Form 4 within two business days. Filings submitted by direct transmission to the SEC on or before 10:00 p.m. Eastern time will be considered filed on that business day.

The two-business day filing period generally will begin running on the date of the transaction; however, the start of the period will be delayed for transactions under preplanned trading programs complying with Exchange Act Rule 10b5-1(c) (17 CFR §240.10b5-1(c)) and for discretionary transactions under employee benefit plans, in each case as long as the reporting person does not determine the date of the transactions. In these cases, the two-business day reporting period will commence instead on the day the reporting person receives notice of the transaction and in no event later than the third business day following the trade date.

The consequences of not filing a Form 4, or filing late, have not been changed by the Act or the SEC's implementing rules. See §7.67. Companies must disclose in their proxy statements or annual reports on Form 10-K the names of directors and officers who fail to comply with their Form 4 filing requirements, and the offending directors and officers will be subject to potential SEC enforcement action.

As a consequence of the accelerated reporting rules, companies have become more involved in assisting their directors and officers in filing §16(a) reports. Among other things, more than ever companies are requiring preclearance of trades by directors and officers to facilitate the timely filing of §16(a) reports.

## **§14.11 IX. INSIDER TRADING BLACKOUTS**

Sarbanes-Oxley Act §306 (15 USC §7244) makes it unlawful for directors and executive officers of a reporting company to purchase, sell, or otherwise acquire or transfer any equity security of the company during any “blackout period” with respect to that equity security if the director or executive officer acquired that equity security in connection with his or her service or employment as a director or executive officer. 15 USC §7244(a)(1). For purposes of §306, and subject to limited exceptions, a “blackout period” means a period of three or more consecutive business days during which a majority of the participants in the company’s “individual account” retirement plan or plans are required to hold their equity securities in the company. 15 USC §7244(a)(4).

The SEC has adopted rules to implement the ban under §306(a). Under the rules, the term “equity security” as used in §306(a) also includes options and other so-called derivative securities within the meaning of §16(a) of the Exchange Act. It also includes transactions in equity securities in which a director or executive officer has a “pecuniary interest” as defined in Exchange Act Rule 16a-1 (17 CFR §240.16a-1), thereby extending the ban to include trading by certain family members of a director or executive officer.

Any profit realized by a director or executive officer of the company from trading in violation of the blackout period trading restriction will be recoverable in an action by the company, or in a shareholder derivative action. 15 USC §7244(a)(2). This is a strict liability provision, and does not depend on any wrongful purpose or intent on the part of the director or executive officer in effecting the trade. The director or executive officer also would be subject to possible SEC enforcement action.

**NOTE™** It is not clear how “profit” is to be calculated for purposes of §306.

Section 306 of the Act also requires reporting companies to “timely” notify the SEC (and affected directors and executive officers) of these trading restrictions in “any case in which a director or executive officer is subject to the requirements of this subsection in connection with a blackout period.” 15 USC §7244(a)(6). Under the SEC’s rules implementing §306, the notice is to be given by means of a current report on Form 8-K.

## **§14.12 X. REQUIREMENTS PERTAINING TO AUDIT COMMITTEES**

The Sarbanes-Oxley Act of 2002 (Pub L 107-204, 116 Stat 745) (15 USC §§7201–7266) imposes qualification requirements and significant responsibilities on members of audit committees of the boards of directors of reporting companies and fundamentally alters the relationship among outside auditors, audit committees, and reporting companies. The Act’s requirements pertain to every committee (or equivalent body) of a board of directors established for the purpose of overseeing audits of the financial statements and the accounting and financial reporting processes of a reporting company. See §§14.13–14.14.

### **§14.13 A. Audit Committee Independence**

Subject to the SEC’s authority to create exceptions, under §301 of the Act a company may not have its securities listed on a national securities exchange or on NASDAQ unless each member of the audit committee is an “independent” director. 15 USC §78j-1(m). For purposes of the Act, “independent” means that a member of the audit committee cannot, other than in his or her capacity as a member of that committee, the board, or any other board committee (15 USC §78j-1(m)(3)(b); see 17 CFR §240.10A-3(b)(1)(ii), (e)):

- Directly or indirectly accept any consulting, advisory, or other compensatory fee from the company or any subsidiary; or
- Be an “affiliated person” of the company or any subsidiary.

Section 301 of the Act is not self-executing, and requires the SEC to promulgate implementing rules. Under rules adopted by the SEC, national securities exchanges, including NASDAQ, will be prohibited from listing any security of a company that is not in compliance with the following requirements:

- Initially, each member of the audit committee of the issuer must be independent according to the specified criteria in §10A(m) (15 USC §78j-1(m)(3));
- The audit committee must be directly responsible for the appointment, compensation, retention, and oversight of the work of any “registered public accounting firm” engaged for the purpose of preparing or issuing an audit report or performing other audit, review, or attest services for the issuer; and
- The registered public accounting firm must report directly to the audit committee.

The term “registered public accounting firm” refers to firms registered with the Public Company Accounting Oversight Board. 15 USC §7201(a)(5), (12).

The audit committee also must have the authority to engage independent counsel and other advisors, as it determines necessary to carry out its duties, and must be provided adequate funding from the company to carry out its responsibilities.

**NOTE™** Both the New York Stock Exchange (NYSE) and NASDAQ have adopted listing standards regarding the independence of audit committee members of listed companies consistent with the requirements of the Act and SEC rules. See NYSE Listed Company Manual §§303A.02–303A.07; NASDAQ Marketplace Rule 4350. A discussion of these listing standards, which are consistent with the requirements of the Act and the SEC’s rules, is beyond the scope of this chapter.

#### **§14.13A B. Audit Committee Approval of Accounting Services**

The SEC has adopted rules to strengthen its requirements regarding auditor independence. The rules apply to all engagements for audit, review, and attest services and nonaudit services. See 15 USC §78j-1(b)(3).

The rules prohibit a company’s registered public accounting firm that is performing an audit for the company from providing any of the following services to the company contemporaneously with the audit (15 USC §78j-1(g)):

- Bookkeeping or related accounting records/financial statements services;
- 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, dealer, investment adviser, or investment banking services; and
- Legal or expert services unrelated to the audit.

The rules also require that the audit committee approve, in advance, all permissible nonaudit services and all audit, review, or attest engagements required under the securities laws. Before the accountant

is engaged by the company or its subsidiaries, the engagement must be (15 USC §78j-1(h)-(i)):

- Approved by the company's audit committee; or
- Entered into under preapproval policies and procedures established by the audit committee.

**NOTE™** As explained in §14.6, nonaccelerated filers must begin to comply with the auditor's attestation requirement in their annual reports for fiscal years ending after December 14, 2008.

When services are provided under preapproved policies and procedures, such policies and procedures may not include delegation of the audit committee's responsibilities to management and the audit committee must nonetheless be informed of all such services.

The rules waive the advance approval requirements for permissible nonaudit services in circumstances when:

- All nonaudit services do not represent in the aggregate more than 5 percent of total revenues paid by the company to the auditor in the fiscal year when services are provided;
- Such services were not recognized as nonaudit services at the time of the engagement; and
- Such services are promptly brought to the attention of the audit committee and approved before the completion of the audit by the audit committee.

**NOTE™** Advance approval of nonaudit services is also important as a means to prevent engagements that would render the registered public accounting firm no longer independent, as discussed above.

The rules require that the registered public accounting firm report to the company's audit committee before the filing of the audit report with the SEC:

- All critical accounting policies and practices to be used in the company's financial statements;
- All alternative treatments under generally accepted accounting principles (GAAP) for policies and practices related to material items that have been discussed with management, including:
  - Ramifications of the use of such alternative disclosures and treatments; and
  - The treatment preferred by the accounting firm; and

- Other material written communications between the accounting firm and company management, such as any management letter or schedule of unadjusted differences.

Public companies currently must disclose under a separate heading in their annual reports on Form 10-K the professional fees paid for both audit and nonaudit services to their principal independent accountants for the most recent fiscal year. The SEC rules require such disclosures with respect to four categories: audit fees, audit-related fees, tax fees, and all other fees.

The SEC also has adopted two other rules relating to auditor independence. The first rule requires that the lead and concurring audit partners on an audit engagement must rotate after 5 years and, on rotation, be subject to a 5-year “time out” period during which they cannot serve as the lead or concurring partners in audit engagements for the company. The rotation rule also applies to audit partners on the audit engagement team who have responsibility for decisionmaking on significant auditing, accounting, and reporting matters that affect the company’s financial statements or who maintain regular contact with the company’s management and audit committee.

The second rule mandates that a registered public accounting firm cannot be independent with respect to a company if, within one year of that accounting firm’s provision of audit services to the company, a member of the audit engagement team becomes employed by the company in a financial reporting oversight role, including chief executive officer, controller, chief financial officer, or chief accounting officer.

As a consequence of the Act and the SEC’s implementing rules, audit committee members must assume the traditional responsibility of the company’s senior executive officers for dealing directly with their company’s outside auditors. In light of their new responsibilities, audit committee members may be subject to greater exposure to lawsuits and potential liability than other independent directors who are not members of the committee.

**NOTE™** In a case that should serve as a warning to directors, the SEC in April 2004 charged a former outside director and audit committee chairman of Chancellor Corporation with securities fraud solely on the basis that he failed to act in the face of warning signals regarding improper accounting practices at the company. According to the SEC, the outside director violated federal securities laws by “ignoring clear warning signs that financial improprieties were ongoing at the company and by failing to *ensure* that the company’s public filings were accurate.” (Emphasis added.) For further information, see SEC

Litigation Release No. 18104 (Apr. 24, 2003); SEC Accounting and Auditing Enforcement Release No. 1763 (Apr. 24, 2003).

Presumably, persons willing to serve on an audit committee at all will expect to be better compensated for the additional time requirements and risks associated with their service on the committee.

#### **§14.14 C. Disclosure of Financial Expertise**

Sarbanes-Oxley Act §407 (15 USC §7265) required the SEC to adopt rules requiring public companies to disclose in their annual reports on Form 10-K or 10-KSB whether (and, if not, why not) their audit committees include at least one member who is a financial expert.

An “audit committee financial expert” means a person who has all the following attributes (see 15 USC §7265(b); 17 CFR §229.407(d)(5)(ii)):

- An understanding of GAAP and financial statements;
- The ability to assess the general application of GAAP in connection with the accounting for estimates, accruals, and reserves;
- Experience in preparing, auditing, analyzing, or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by a company’s financial statements, or experience actively supervising one or more persons engaged in such activities;
- An understanding of internal controls and procedures for financial reporting; and
- An understanding of audit committee functions.

Under the SEC’s rules, a person must have acquired these necessary attributes by one or more of the following means (17 CFR §229.407(d)(5)(iii)):

- Education and experience as a principal financial officer, principal accounting officer, controller, public accountant, or auditor or experience in one or more positions that involve the performance of similar functions;
- Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor, or person performing similar functions;

- Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing, or evaluation of financial statements; or
- Other relevant experience.

Following the adoption of the Act, some commentators expressed their concern that the designated audit committee financial expert might be held to a higher degree of care or legal responsibility than other audit committee members and, as a result, that audit committee members might be unwilling to serve as the designated financial experts. To help alleviate this concern, the SEC's rules under §404 include a safe harbor to the effect that (17 CFR §229.407(d)(5)(iv)):

- An audit committee financial expert will not be deemed an "expert" for purposes of the heightened liability of "experts" under Section 11 of the Securities Act of 1933 or any other purpose, as a result of being designated or identified as an audit committee financial expert pursuant to the new disclosure item;
- The designation or identification of a person as an audit committee financial expert pursuant to the new disclosure item does not impose on such person any duties, obligations, or liability that are greater than the duties, obligations, and liability imposed on such a person as a member of the audit committee and board of directors in the absence of such designation or identification; and
- The designation or identification of a person as an audit committee financial expert pursuant to the new disclosure item does not affect the duties, obligations, or liability of any other member of the audit committee or board of directors.

#### **§14.15 D. Audit Committee Responsibilities [Deleted]**

Subjects formerly in this section are now covered elsewhere.

#### **§14.16 XI. FINANCIAL CODE OF ETHICS**

Sarbanes-Oxley Act §406 (15 USC §7264) requires the SEC to issue rules requiring reporting companies to disclose whether they have adopted a code of ethics for senior financial officers and, if not, to explain why. 15 USC §7264(a). The SEC recently adopted implementing rules that require a public company to disclose:

- In its Form 10-K whether (and, if not, why not) the company has adopted a written code of ethics for the company's principal executive officer and senior financial officers; and

- On Form 8-K (or, under some circumstances, on its website) any substantive changes to or waivers of its code of ethics (15 USC §7264(b)).

The SEC defines “code of ethics” as written standards that are reasonably designed to deter wrongdoing and to promote (15 USC §7264(c); 17 CFR §229.406(b)):

- Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
- Full, fair, accurate, timely, and understandable disclosure in reports and documents that a company files with, or submits to, the SEC and in other public communications made by the company;
- Compliance with applicable governmental laws, rules, and regulations;
- Prompt internal reporting of violations of the code of ethics to the individual(s) identified in the code; and
- Accountability for adherence to the code.

The SEC contemplates that most companies will adopt a code of ethics in response to the new disclosure requirements, and suggests that the code should include provisions regarding compliance procedures and disciplinary measures. The SEC does not require specific language, measures, or sanctions to be included in the code of ethics.

If adopted, the code of ethics must be made available to the public by one of the three following means (17 CFR §229.406(c)):

- Filing it with the SEC as an exhibit to Form 10-K;
- Posting it on the company’s website and disclosing, in the Form 10-K, the website address and the fact that the company has posted its code of ethics (see §14.10); or
- Undertaking in the Form 10-K to provide to any person without charge, on request, a copy of such code of ethics and explain the manner in which such request may be made.

If the company chooses to post its code of ethics information on its website, the code of ethics must remain on the website until the company chooses to make it available by one of the alternative methods above. 17 CFR §229.406, instructions to Sarbanes-Oxley Act §406.

## **§14.17 XII. “REAL-TIME” DISCLOSURES**

Sarbanes-Oxley Act §409 (15 USC §78m(l)) requires reporting companies to disclose on a “rapid and current basis” information regarding material changes in their financial condition or operations. The disclosures are to be in plain English, as the SEC determines is necessary or useful for the protection of investors. See also 17 CFR §229.307.

Responding to its mandate under §409, the SEC has amended Form 8-K to expand the matters required to be reported on a current basis, to include two items that previously were reported quarterly on Form 10-Q and eight new disclosure items. The two disclosure items moved from Form 10-Q to Form 8-K are:

- Unregistered sales of equities securities; and
- Material modifications to rights of security holders.

The eight new Form 8-K disclosure items are:

- Entry into a material agreement outside the ordinary course of business (Item 402(a) only);
- Termination of a material “non-ordinary course” agreement (Item 402(a) only);
- Creation of a material direct financial obligation or a material obligation under an off-balance sheet arrangement (Item 402(a) only);
- Events triggering acceleration or increase in a material direct obligation or a material obligation under an off-balance sheet arrangement (Item 402(a) only);
- Material costs associated with plans to exit from a line of business or dispose of a long-lived asset (Item 402(a) only);
- Material impairments (Item 402(a) only);
- Nonreliance on previously issued financial statements or a related audit report or completed interim review (Item 402(a) only); and
- Notice of delisting of securities from trading or failure to satisfy a continued listing rule or standard, or transfer of listing.

The SEC also expanded the required disclosures on Form 8-K regarding two disclosure items:

- Departure of directors or principal officers, or election of directors or appointment of principal officers (Item 502(e) only); and
- Amendments to the charter document or bylaws or a change in the fiscal year.

The deadline for filing Form 8-K has been accelerated to 4 business days from the previous 5-business day and 15-calendar day deadlines. The SEC sought to partially alleviate concerns about the accelerated filing deadline by creating a limited “safe harbor” for late filings with respect to certain new disclosure items noted by an asterisk above. Under amended Exchange Act Rule 13a-11(c) (17 CFR §240.13a-11(c)), a company will not be guilty of violating the reporting requirements under the Exchange Act solely by reason of a late filing with respect to any of these specified items, if the filing is made on or before the due date of the company’s next periodic (*i.e.*, Form 10-Q or Form 10-K) report. Late filings may, however, give rise to other liabilities under the federal securities laws.

The amended Form 8-K requirements have caused reporting companies to adopt appropriate changes to their internal controls to enable the new Form 8-K disclosures to be readily identified and made in a timely fashion.

#### **§14.18 XIII. DISCLOSURE OF OFF-BALANCE SHEET ARRANGEMENTS AND AGGREGATE CONTRACTUAL OBLIGATIONS**

Sarbanes-Oxley Act §401 (15 USC §7261(a)) requires the SEC to adopt rules regarding disclosure of off-balance sheet arrangements and certain contractual obligations in a separately captioned section of management’s discussion and analysis (the MD&A). See 15 USC §78m(j). The SEC has amended Item 303 of Regulation S-K (17 CFR §229.303) to implement the requirements of section 401.

An “off-balance sheet arrangement” is defined as any contractual arrangement to which an unconsolidated entity is a party, under which the company has (17 CFR §229.303(a)(4)(ii)):

- Any obligation under certain guarantee contracts;
- A retained or contingent interest in assets transferred to an unconsolidated entity or a similar arrangement that serves as credit, liquidity, or market risk support to that entity for such assets;
- Any obligation under certain derivative instruments; or
- Any obligation under a material variable interest held by the registrant in an unconsolidated entity that provides financing, liquidity, market risk, or credit risk support to the registrant, or engages in leasing, hedging, or research and development services with the registrant.

Off-balance sheet arrangements must be disclosed if they either have, or are reasonably likely to have, a current or future effect on the registrant's financial condition, changes in financial condition, revenues, expenses, results of operations, liquidity, capital expenditures, or capital resources that is material to investors. 17 CFR §229.303(a)(4)(i).

For all nonsmall business companies, the SEC also now requires under Item 3.03 of Regulation S-K disclosure in tabular format of the amounts of payments due under specified contractual obligations, aggregated by category of contractual obligation as of the date of the latest fiscal year-end balance sheet. This table may be in the same section of the MD&A that describes the off-balance sheet arrangements, or it may be in some other part of the MD&A that the reporting company deems appropriate.

#### **§14.19 XIV. USE OF NON-GAAP FINANCIAL INFORMATION**

The SEC has adopted Regulation G (17 CFR §§244.100–244.102) regarding the conditions for use of non-GAAP financial measures.

**NOTE™** “GAAP” stands for “Generally Accepted Accounting Principles,” a widely accepted set of rules, conventions, standards, and procedures for reporting financial information, as established by the former Financial Accounting Standards Board. 17 CFR §244.101(b).

Regulation G applies whenever a company publicly discloses or releases material information that includes non-GAAP financial measures, except for non-GAAP financial measures included in certain disclosure relating to a proposed business combination transaction.

A “non-GAAP financial measure” means a numerical measure of a company's historical or future financial performance, financial position, or cash flows that (17 CFR §244.101(a)(1)):

- Excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the most directly comparable measure calculated and presented in accordance with GAAP in the statement of income, balance sheet, or statement of cash flows (or equivalent statements) of the issuer; or
- Includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable measure so calculated and presented.

A “non-GAAP financial measure” does not include (17 CFR §244.101(a)(2)):

- Operating or statistical measures or ratios; or
- Statistical measures that are calculated using exclusively one or both of:
  - Financial measures calculated in accordance with GAAP; and
  - Operating measures or other measures that are not non-GAAP financial measures.

If a company makes a public disclosure of material information that includes a non-GAAP financial measure, the company must provide (17 CFR §244.100(a)):

- A presentation of the most directly comparable financial measure calculated and presented in accordance with GAAP; and
- A reconciliation (by schedule or other clearly understandable method) must be quantitative for historic measures and qualitative for prospective measures to the extent such information is available without unreasonable efforts. The reconciliation must be of the differences between the non-GAAP financial measure presented and the most directly comparable financial measure or measures calculated and presented in accordance with GAAP.

If a non-GAAP financial measure is released orally, telephonically, by webcast, by broadcast, or by similar means, the registrant may provide the comparable and reconciliation information by (17 CFR §244.100 (notes)):

- Posting that information on the registrant’s website; and
- Disclosing the location and availability of the required accompanying information during its presentation.

Regulation G also specifically prohibits the use of any non-GAAP financial measure that, taken together with the information accompanying that measure, contains an untrue statement of a material fact or omits to state a material fact necessary in order to make the presentation of the non-GAAP financial measure, in light of the circumstances under which it is presented, not misleading. 17 CFR §244.100(b).

**NOTE™** Materially false or misleading non-GAAP financial information generally also would violate §10(b) of the Exchange Act (15 USC §78j(b)) and Exchange Act Rule 10b-5 (17 CFR §240.10b-5), discussed in §14.3.

## **§14.20 XV. FURNISHING OF EARNINGS INFORMATION ON FORM 8-K**

SEC rules require public companies that provide earnings releases to furnish (not file) these releases to the SEC in an item to Form 8-K within four (4) business days after the earnings release. The issuance of a press release, webcast, or other broadcast, written or oral, containing earnings or material nonpublic information regarding earnings, will trigger this requirement.

Oral dissemination of earnings does not trigger the requirement to furnish an 8-K under the rules if:

- The oral disclosure occurs within 48 hours of an earnings release or announcement that is filed with the SEC on Form 8-K;
- The oral disclosure is made available to the public (*e.g.*, by conference call, webcast, etc.); or
- A press release precedes the disclosure, and such press release includes instructions for the public to access the information, including information posted on the company's website.

If non-GAAP financial information is disclosed, the information also should be posted on the company's website, along with comparable GAAP information and reconciliation required by Regulation G (see above).

## **§14.21 XVI. EXTENSION OF STATUTE OF LIMITATIONS**

Section 804 of the Act amends the Exchange Act to extend the limitations period for private plaintiffs to bring actions for alleged fraud, deceit, or manipulation in violation of the federal securities laws, including actions under Exchange Act Rule 10b-5 (17 CFR §240.10b-5), to whichever of the following occurs first (28 USC §1658(b)):

- Two years after discovery of the facts constituting the violation; or
- Five years after the violation.

The previous limitations period was one year from discovery or three years from the violation, whichever is earlier. It should be noted that the new, longer limitations period applies to private companies as well as public companies.

## **XVII. EMPLOYEE WHISTLEBLOWER RULES**

### **§14.22 A. Audit Committee Procedures**

Sarbanes-Oxley Act §301 (15 USC §78j-1(m)) directs the SEC to require by rule that national securities exchanges, including NASDAQ, prohibit the listing of the securities of any public company that does not satisfy certain audit committee requirements, including the requirement to “establish procedures” for (15 USC §78j-1(m)(4)):

- Receipt, retention, and treatment of complaints received by the company regarding accounting, internal accounting controls, or auditing matters; and
- Confidential anonymous submission by employees of concerns regarding questionable accounting or auditing matters.

Section 301 has spawned a cottage industry of third party providers offering public companies e-mail or telephone call-in services for the reporting and handling of employee complaints. Many public companies, including small companies, however, choose to handle such complaints internally.

### **§14.23 B. Whistleblower Protections**

Sarbanes-Oxley Act §806 (18 USC §1514A) prohibits public companies and their employees, contractors, and other agents from discriminating against company employees who blow the whistle on possible securities law violations. It also provides for an employee’s recovery of monetary damages if a company retaliates against the employee for reporting anything that the employee reasonably believed might be a violation of the federal securities laws or other federal law. The Department of Labor recently adopted rules implementing the provisions of §806.

The provisions of §806 are similar to existing California labor laws regarding employee whistleblower protections. Employers also have long been prohibited under federal and state statutes from retaliating against employees who report unlawful conduct or cooperate in governmental investigations of improper conduct.

### **§14.24 C. Criminal Actions**

Sarbanes-Oxley Act §1107 (18 USC §1513(e)) makes it a crime for anyone to “knowingly, with intent to retaliate,” take actions harmful to any person, including retaliation in connection with the person’s employment, in response to such person providing truthful information to law enforcement officials regarding a possible federal

offense. This potential criminal exposure of directors, officers, and employees of public companies is perhaps the most significant change effected by employee whistleblower protections.

#### **§14.25 XVIII. CALIFORNIA'S CORPORATE DISCLOSURE ACT**

Within 90 days after the articles of incorporation are filed, a domestic stock corporation must file a Statement of Information (Form SI-200C or Form SI-200N/C); see generally *Organizing Corporations in California* §§3.22–3.24D (3d ed Cal CEB 2001)). In the aftermath of Enron, WorldCom, and other corporate scandals, California adopted its own corporate disclosure rules for publicly traded companies. These rules require the filing of an additional Corporate Disclosure Statement (Form SI-PT), which is a supplement to the required Statement of Information. See *Organizing Corps* §§3.24C–3.24D.

The term “publicly traded corporation” for these purposes means a California or foreign corporation, as defined in Corp C §162 or §171, that is “an issuer as defined in Section 3 of the Securities Exchange Act of 1934, as amended [15 USC §78c], and has at least one class of securities listed or admitted for trading on a national securities exchange, on the National or Small-Cap Markets of the NASDAQ Stock Market, on the OTC-Bulletin Board, or on the electronic service operated by Pink Sheets, LLC.” Corp C §1502.1(b)(1).

The corporate disclosure statement must be filed annually, within 150 days after the end of the corporation’s fiscal year. The filing date coincides with the time for filing the corporation’s annual report on Form 10-K.

The Corporate Disclosure Statement contains the following information (Corp C §1502.1(a)(1)–(8)):

(1) The name of the independent auditor that prepared the most recent auditor’s report on the corporation’s annual financial statements.

(2) A description of other services, if any, performed for the corporation during its two most recent fiscal years and the period between the end of its most recent fiscal year and the date of the statement by the foregoing independent auditor, by its parent corporation, or by a subsidiary or corporate affiliate of the independent auditor or its parent corporation.

(3) The name of the independent auditor employed by the corporation on the date of the statement, if different from the independent auditor listed under item (1) above.

(4) The compensation for the most recent fiscal year of the corporation paid to each member of the board of directors and paid to each of the five most highly compensated executive officers of the corporation who are not members of the board of directors, including the number of any shares issued, options for shares granted, and similar equity-based compensation granted to each of those persons. If the chief executive officer is not among the five most highly compensated executive officers of the corporation, the compensation paid to the chief executive officer shall also be included.

(5) A description of any loan, including the amount and terms of the loan, made to any member of the board of directors by the corporation during the corporation's two most recent fiscal years at an interest rate lower than the interest rate available from unaffiliated commercial lenders generally to a similarly situated borrower.

(6) A statement indicating whether an order for relief has been entered in a bankruptcy case with respect to the corporation, its executive officers, or members of the board of directors of the corporation during the 10 years preceding the date of the statement.

(7) A statement indicating whether any member of the board of directors or executive officer of the corporation was convicted of fraud during the 10 years preceding the date of the statement, if the conviction has not been overturned or expunged.

(8) A description of any material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the corporation or any of its subsidiaries is a party or of which any of their property is the subject, as specified by Item 103 of Regulation S-K of the Securities Exchange Commission (12 CFR §229.103). A description of any material legal proceeding during which the corporation was found legally liable by entry of a final judgment or final order that was not overturned on appeal during the 5 years preceding the date of the statement.

For these purposes, "independent auditor" means an auditor that meets the requirements for auditor independence stated in 17 CFR §210.2-01. "Executive officer" means the chief executive officer, president, any vice president in charge of a principal business unit, division, or function, any other officer of the corporation who performs a policymaking function, or any other person who performs similar policymaking functions for the corporation. "Compensation" means all plan and nonplan compensation awarded to, earned by, or paid to the person for all services rendered in all capacities to the corporation and to its subsidiaries, as specified by Item 402 of Regulation S-K (17 CFR §229.402). "Loan" excludes an advance for expenses permitted under Corp C §315(d), the corporation's payment

of life insurance premiums permitted under Corp C §315(e), and an advance of expenses permitted under Corp C §317. Corp C §1502.1(b)(2)–(4).