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MEMORANDUM

August 5, 2002

TO: Our Corporate Clients

FROM: Graubard Miller

SUBJECT: New Corporate Governance Rules (The Sarbanes-Oxley Act of 2002)

General

On July 30, 2002, President Bush signed the Sarbanes-Oxley Act of 2002 into law. The Act will effect a significant overhaul in federal securities regulation. Some provisions of the Act are effective immediately. Others will be effective when the SEC adopts relevant rules within the Act's mandated time periods ranging from 30 days to one year.

Many companies will need to adopt changes to their existing corporate governance procedures and internal controls. The roles played by audit committees and senior management in the financial reporting process will change dramatically. The Act imposes broad responsibilities on CEOs and CFOs and subjects them to significant potential individual liability. It appears as though non-U.S. issuers that report under either Section 12 or Section 15(d) of the Securities Exchange Act of 1934 are subject to the provisions of the Act.

Key provisions of the Act are discussed below.

1. Increased obligations of CEOs and CFOs with respect to financial statements

- **General certification by CEOs and CFOs of financial information contained in any periodic or current report (e.g. 8-Ks, 10-Qs, 10-Ks and foreign issuer equivalents).** Section 906 of the Act provides that any periodic and current report containing financial information must be accompanied by a written statement signed by the CEO and the CFO certifying that:

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

- the information contained in the report fairly presents, in all material respects, the financial condition and operations of the issuer.

This provision is effective immediately and the certification described above must be contained in an issuer's next periodic report. This means that many of our calendar-year clients will need to include this certification in their 10-Q for the quarter ended June 30, 2002 (unless such report was filed with the SEC prior to July 30, 2002).

- **Additional certification by CEOs and CFOs.** In addition to the general certification requirement outlined above, Section 302 of the Act directs the SEC to adopt rules (no later than August 29, 2002) that will require CEOs and CFOs to provide additional certifications in all periodic and current reports. These additional certifications are:

  - that the CEO and CFO have each read the report;

  - that based on such officers' knowledge, the report does not contain any material misstatements or omissions;

  - that the CEO and CFO have designed internal controls to be effective and have evaluated the effectiveness of such controls within the last 90 days and that they have presented their conclusions about the effectiveness of the controls in the report;

  - that they have disclosed control deficiencies and any fraud by management or employees with a significant role in internal controls (regardless of materiality) to the auditors and the audit committee.

- **Civil and criminal penalties for false certification.** Any officer who makes a false certification may be subject to a fine of $1,000,000 and/or up to 10 years imprisonment if the violation was "knowing" and up to $5 million and imprisonment of up to 20 years if the violation was "willful."

- **Annual management report on internal controls.** Each annual report on Form 10-K must contain a statement of management's responsibility to establish and maintain adequate internal controls and procedures for financial reporting and a report evaluating the effectiveness of these controls and procedures ("Internal Controls Report"). This provision shall not be effective until the SEC sets rules. No deadline for the issuance of such rules is mandated under the Act.

- **Potential recourse against the compensation of CEOs/CFOs.** Section 304 of the Act provides that, effective immediately, if an issuer's financial statements must be restated as a result of misconduct that leads to material noncompliance with any financial reporting requirement, the issuer's CEO and CFO shall disgorge any bonuses paid to them and all profits made from their stock sales during the year following the original financial statements. There is no provision requiring that the CEO or CFO have any culpability in the misconduct. In fact, the Act does not specify whose misconduct will be relevant or the level of misconduct (e.g., negligent, knowing or willful) required for imposition of this penalty. The SEC has been given authority to exempt any person from application of this provision as it deems advisable.

2. <u>Issuers have heightened disclosure obligations</u>

- **Financial statements must reflect auditors' material adjustments.** The Act will require that each financial report containing financial statements required to be prepared under GAAP or reconciled to GAAP "shall reflect all material correcting adjustments that have been identified by a registered public accounting firm in accordance with [GAAP] and the rules and regulations of the [SEC]." Further guidance is expected with respect to whether this provision will require (i) the financial statements to actually be modified (even if the issuer disagrees with such modification) or (ii) the issuer to simply make a separate disclosure regarding the adjustments. This provisions will not be effective until the completion of the Auditor Registration Process described later in this memorandum in Item 4.

- **Accelerated reporting of insider trades.** Effective August 29, 2002, insiders (*i.e.,* directors, officers and 10% holders) stock transactions must be reported on Form 4 two business days from the date of the transaction. Not later than July 30, 2003, (i) insiders will be required to file all Forms 4 electronically; (ii) if the issuer maintains a web site, such issuer will be required to post a copy of the filing on such site by the end of the business day following such electronic filing; and (iii) the SEC will be required to make the filing available on its site within the same time frame.

- **Real-time current disclosure by public companies.** Section 409 of the Act will require issuers to disclose "on a rapid and current basis" additional information about their financial condition or operations as the SEC may determine is necessary or useful to investors or in the public interest. The effectiveness of this provision is subject to the SEC adopting rules and guidelines. No deadline for the adoption of such rules or guidelines has yet been set.

- **Additional disclosures required in periodic reports.** The Act directs the SEC to adopt rules (effective not later than January 26, 2003) that require the following disclosures:

  - **Off-balance sheet transactions.** All annual and quarterly reports will be required to disclose all material off-balance sheet transactions, arrangements and obligations (including contingent obligations).

  - **Pro forma financial information.** Pro forma financial information included in a periodic report filed with the SEC, or in a press release or other public disclosure, will be required to be presented in a manner that is not misleading and must be reconciled with the company's financial condition and results of operations under GAAP.

- **Code of ethics.** Each public company will be required to disclose in its periodic reports (e.g. 10-Ks or 10-Qs or foreign issuer equivalent) whether or not it has adopted a code of ethics for senior financial officers (CFO and principal accounting officer or controller) and whether its audit committee has at least one member who is a "financial expert." If such a code has not been adopted and/or the audit committee does not have at least one such expert, the issuer is required to explain why. An issuer also will be required to immediately disclose any change in or waiver of its code of ethics in a Current Report on Form 8-K. These provisions will not be effective until the SEC has adopted rules. The Act requires the SEC to adopt such rules not later than January 26, 2003.

- **Regular SEC review of disclosures.** Effective immediately, the SEC will review disclosures made by issuers on a regular basis and at least once every three years. The SEC will review certain issues more frequently based on factors such as whether an issuer has restated its financials, has a volatile stock price, has a large market capitalization or is an emerging company with a high P/E ratio.

3. Insider Transaction Prohibitions

- **General prohibition on insider loans.** Effective immediately, loans to directors and executive officers are prohibited under almost all circumstances. Specifically, Section 402 provides that, effective immediately, no company may make, extend, modify or renew any personal loan to executive officers or directors. There are limited exceptions for loans made in the ordinary course of the Company's business.

- **Prohibition on insider trades during retirement plan blackout periods.** Effective January 26, 2003, Section 306 of the Act will prohibit direct or indirect purchases, sales and transfers by insiders of issuer equity securities (obtained by them as compensation for services to the issuer) during any blackout period

imposed under such issuer's 401(k) or other profit sharing or retirement plans. A "blackout period" would be deemed to exist any time when the issuer or plan fiduciary suspends the ability of at least 50% of the plan participants from buying or selling the issuer's securities. Any profits realized by an officer or director in violation of this provision, regardless of that person's intent, may be recovered by the company, including through a shareholder derivative suit. It is expected that the SEC will issue clarifying rules, including exemptions for "purchases or sales made pursuant to an advance election," such as under Rule 10b5-1.

4. <u>New rules governing auditors</u>

- **Auditors must report on management assessment of internal controls.** The company's public accountants must report on and attest to the assessment made by the company's management in its Internal Control Report. This provision shall not be effective until the SEC sets rules. No deadline for the issuance of such rules is mandated under the Act.

- **Registration of auditors**. The Act established the Public Company Accounting Oversight Board. This Board will consist of five full-time members and will be operational within 270 days of the Act's adoption. Within 180 days thereafter, auditing firms must register with the Board by submitting a detailed application in which they consent to cooperate with investigations (the "Auditor Registration Process"). The Board, subject to SEC oversight and approval, will set auditing and professional standards, some of which are prescribed by the Act. The Board will inspect auditing firms. Large auditing firms will be inspected annually. Inspection reports will be made publicly available, subject to certain confidentiality provisions.

- **Auditor independence.** Following the Auditor Registration Process, accounting firms will no longer be allowed to provide most non-audit services to public companies they are auditing. Tax services and some other non-audit services may be provided if preapproved by the audit committee. Most other non-audit services, however, are absolutely prohibited.

- **Discussions between auditors and audit committees.** Following the Auditor Registration Process, auditors must discuss certain matters with the audit committee, including (a) critical accounting policies and (b) alternative accounting treatment of financial information that has been discussed with management, the ramifications of the alternative treatment and the treatment preferred by the auditors.

- **Auditor conflict of interest rules.** Following the Auditor Registration Process, an accounting firm may not perform audit services for an issuer whose CEO,

CFO, controller or chief accounting officer participated in the audit of the issuer on behalf of the accounting firm during the previous year.

- **Audit partner rotation.** Following the Auditor Registration Process, Section 203 of the Act will prohibit registered public accounting firms from providing audit services for a company if either the lead audit partner or the reviewing audit partner has been performing audit services for that issuer in each of the previous five years. Effectively, this will require a new lead partner and a new reviewing partner at least once every five years.

5. <u>Increased role and obligations of audit committees</u>

- **Many changes in role and function to be effected by listing standards.** Section 301 of the Act directs the SEC to adopt rules, effective no later than April 26, 2003, that direct the national securities exchanges and Nasdaq to effect certain listing standards (similar, in part, to recent proposals by such exchanges) that impose the following requirements on audit committees' functions and role:

  - **Independence.** The audit committee must be composed entirely of independent directors. To be "independent" under the Act, the audit committee member may not accept any consulting, advisory or compensatory fee from the company, except in his or her capacity as a board or board committee member. No audit committee member may own or control 5% or more of the voting securities of the company or be an officer, partner or employee of the company.

  - **Authority to engage advisors.** The audit committee must have the authority, and any funding it finds appropriate, to engage the outside auditing firm, independent counsel and other advisers as it determines necessary to carry out its duties.

  - **Employee complaint procedures.** Audit committees must establish procedures for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters, and for the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters.

- **Financial expertise of audit committee.** Section 407 of the Act directs the SEC to adopt rules no later than January 26, 2003, requiring disclosure in companies' periodic reports whether or not (and if not, why not) at least one member of the audit committee is a "financial expert" as the SEC may define such term.

- **Auditor reports directly to audit committees.** Following the Auditor Registration Process of Section 204 of the Act will require registered public accounting firms to make timely reports to the audit committee of:

  - all critical accounting policies and practices to be used;

  - all alternative treatments of financial information within GAAP that have been discussed with management, ramifications of the use of such alternatives, and the treatment preferred by the accounting firm; and

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

6. Penalties and other obligations

- **Criminal Penalties.** The Act creates several new crimes for securities violations, effective immediately, for (a) destroying, altering or falsifying records with the intent to impede or influence any federal investigation or bankruptcy proceeding, (b) knowing and willful failure by an accountant to maintain all audit or workpapers for five years after the end of the fiscal period in which the audit or review was conducted; and (c) knowingly executing a scheme to defraud investors in connection with any security.

- **Civil Liabilities.** The Act makes the following changes to civil liabilities, effective immediately, (a) amends the bankruptcy code to prevent the use of bankruptcy to avoid liability incurred due to federal or state securities laws violations; (b) extends the statute of limitations for investors to file a civil action for securities fraud to two years after discovery of the facts but no more than five years after the actual occurrence of the fraud from one year and three years, respectively; and (c) provides protection to whistle-blowing employees, agents and contractors who lawfully provide information or otherwise assist investigations.

- **Attorney Obligation to Report Violations.** Attorneys representing public companies will be required to report evidence of a material violation of the securities laws or breach of fiduciary duty by a company (or its agent) to the company's general counsel or CEO and, if no appropriate response is made, to the company's audit committee, independent directors or board of directors. This provision will not be effective until the SEC issues rules. The SEC is required to issue such rules not later than January 26, 2003.

Additional Information

If you have any questions, please call Brian Ross at (212) 818-8610. It is expected that additional guidance and clarification with respect to the Act will be forthcoming from the SEC shortly. We intend to provide updates to this memorandum as warranted at our website www.graubard.com. When visiting our website for updates, please review the section entitled "Articles."