On July 30, 2002, President George W. Bush signed the Sarbanes-Oxley Act of 2002 (the “Act”) into law, describing it as “the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt.” The Act was adopted in an effort to restore investor confidence, which had been rocked by a year of corporate scandals. This article will outline the most significant provisions of the Act, which can be divided into three broad categories:

1. Provisions affecting the conduct and regulation of auditors;
2. Provisions affecting internal corporate governance, including enhanced penalties for corporate misconduct; and

Auditors
The Public Company Accounting Oversight Board
The centerpiece of the Act is the creation of the Public Company Accounting Oversight Board (the PCAOB or the Board), an independent non-profit corporation charged with overseeing the accounting industry. The PCAOB was created in reaction to growing skepticism regarding the ability of the accounting profession to police itself in the wake of well-publicized accounting scandals at Enron, Global Crossing and WorldCom, among others.

The PCAOB is comprised of five members who are “prominent individuals of integrity and reputation who have demonstrated a commitment to the interests of investors and the public.” Board members are selected by the Securities and Exchange Commission (SEC), in consultation with the treasury secretary and the chairman of the Federal Reserve Board. To ensure the Board’s independence from the accounting industry, the Act requires that three of the five board members must be individuals who are not and never have been certified public accountants (CPAs). In addition, the Chair, if a CPA, may not have practiced for the five years preceding his or her appointment.

The PCAOB is charged with the registration of (Continued on page 19)
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all public accounting firms that prepare or issue audit reports for public companies or participate in the preparation or issuance of such reports (any such firm to be referred to as a “registered firm”).

In addition, the PCAOB is charged with establishing auditing and related attestation standards, quality control standards and ethics standards for registered firms in preparing and issuing audit reports. The Act directs the PCAOB to adopt rules that require each registered firm to maintain audit workpapers for a minimum of seven years, to provide for a concurrent partner review of each audit report, and to provide an attestation as to the audited client’s internal controls.

The PCAOB must also conduct regular inspections of registered firms to assess their compliance with the Act and SEC rules governing the conduct of audits. Each firm that audits more than 100 public companies is subject to an annual inspection. Firms that audit less than 100 issuers must be inspected every three years. The Board is also charged with investigating and disciplining registered firms and their “associated persons.”

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Auditor Independence

In addition to establishing the PCAOB, the Act imposes auditor independence requirements that generally seek to sever the close ties that frequently existed between a company’s auditor and its corporate management. Section 201 prohibits registered firms from providing certain non-audit services to audit clients. Proscribed services include bookkeeping, financial information systems design and implementation, appraisal and valuation services, actuarial services and internal audit services. In addition, all audit and non-audit services must be pre-approved by the audit committee of the board of directors. The Act also requires the mandatory rotation of the lead audit partner for each issuer at least once every five years, and closes the so-called “revolving door” between accounting firms and their clients by prohibiting a registered firm from auditing a client if any of the client’s senior financial officers worked for the audit firm and on the client account during the year preceding the audit.

Corporate Governance

Certification Requirements

In an effort to provide for greater accountability for CEOs and CFOs, the Act requires that these officers personally certify to the accuracy and reliability of the annual and quarterly financial reports filed with the SEC. The Act contains two independent certification requirements, set forth in Sections 302 and 906. These certification requirements overlap, but must be complied with separately in all public company periodic reports.

Section 302

Section 302 directed the SEC to adopt rules requiring that the CEO and CFO of every public company certify to the accuracy of each annual and quarterly report filed with the SEC. In response, the SEC adopted new Exchange Act Rules 13a-14 and 15d-14. These rules provide the specific certification that must be included in each quarterly report on Form 10-Q and each annual report on Form 10-K filed with the SEC. Under the rules, CEOs and CFOs must certify the following:

- that they have read the report;
- that, to their knowledge, the report does not contain anything misstated or omitted; and
- that the financial statements and other information in the report fairly present the financial condition, results of operations and cash flows of the company.

“Knowing” violations are punishable by fines of up to $1,000,000 and imprisonment for up to 10 years.

Section 906

In addition to Section 302’s certification requirements, Section 906 requires that each periodic report containing financial statements be accompanied by a written statement by the CEO and CFO certifying that “the report fully complies with the requirements of [the Exchange Act] and that the information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer.” Section 906 imposes criminal penalties for false certifications under its provisions. “Knowing” violations are punishable by fines of up to $1,000,000 and imprisonment for up to 10 years. “Willful” violators of Sections 906 are subject to fines of up to $5,000,000 and imprisonment for up to 20 years.

Disclosure Controls and Procedures

In response to Section 302, the SEC also adopted requirements regarding the maintenance of disclosure controls and procedures. Disclosure controls and procedures are to be designed to ensure that information required to be disclosed to the SEC is recorded, processed, summarized, and reported within the time frame specified by SEC rules and forms. The
concept embodies not only “internal controls” designed to elicit required financial information but also includes procedures and controls designed to elicit the broader non-financial information required by periodic reports. The SEC rules require companies to adopt and maintain disclosure controls and procedures, to perform a periodic review and evaluation of such controls and procedures, and to certify to their effectiveness in each periodic report. New Rules 13a-15 and 15d-15 require an evaluation of disclosure controls and procedures within the 90-day period prior to the filing of each periodic report. New Item 307 of Regulation S-K requires disclosure of the results of such review in each periodic report.

Insider transactions are now required to be reported no later than two business days after the date of the transaction.

Audit Committees
The Act includes a number of provisions aimed at corporate directors who serve, or wish to serve, on their board’s audit committee, including provisions specifying the composition, qualifications, responsibility and authority of the audit committee of the board of directors.

Audit Committee Authority
Section 301 directs the SEC to adopt rules requiring the stock exchanges and Nasdaq to deny the listing of the securities of any issuer that does not comply with its provisions.15 It requires that each member of the audit committee be “independent” of management. To be considered independent, an audit committee member may not accept any consulting, advisory, or other compensatory fee other than director or committee fees, or be an “affiliated person” of the issuer or any of its subsidiaries.

In addition, Section 301 reallocates many key responsibilities from corporate management to the audit committee. Under the Act, the audit committee is now directly responsible for appointing, determining the compensation, and overseeing the work of the company’s audit firm, and the auditors must report directly to the audit committee. The audit committee has the authority to hire independent advisers (such as lawyers and accountants) and companies must provide the committee with appropriate funding to fulfill its duties. Finally, the Act requires the audit committee to establish a reporting system for the receipt of confidential, anonymous reports from employees concerning questionable accounting or auditing matters.

Audit Committee Financial Expert
Section 407 directed the SEC to adopt rules requiring each public company to disclose whether its audit committee has at least one member who is a “financial expert.” The SEC adopted rules implementing Section 407 in January 2003.16 The rules require each issuer to disclose in its annual report whether it has an audit committee financial expert serving on its audit committee. If it does have an expert, it must disclose the expert’s name and whether the expert is “independent” of management. If it does not have an expert, it must disclose the reasons why. Unlike Section 301, Section 407 is a disclosure rule, not an affirmative requirement. An issuer that lacks an audit financial committee expert may simply disclose such fact. To be sure, many issuers will be reluctant to make such disclosure and instead will seek to recruit an audit committee financial expert to join the board.

Executive Compensation
A number of the Act’s provisions address perceived excesses in executive compensation. For example, Section 402 of the Act imposes an outright ban on personal loans to directors and executive officers. Section 304 contains a compensation forfeiture provision which requires that if a company is required to restate its financial reports as a result of “misconduct,” the CEO and CFO must forfeit any bonus or other incentive- or equity-based compensation and profits realized from the sale of company stock during the 12-month period immediately following the filing of the inaccurate report. Section 306 makes it unlawful for any director or executive officer to trade in company stock, if the stock was received as compensation, during any “blackout period” imposed on any of the company’s employee stock plans.17 Any profits earned from such prohibited transactions are subject to disgorgement to the company.

Finally, Section 403 requires that directors and officers disclose transactions in their corporation’s stock on a more timely basis. Insider transactions are now required to be reported no later than two business days after the date of the transaction. These requirements are significantly more restrictive than prior rules which allowed most transactions to be reported up to one month and 10 days after the transaction, and permitted the delayed reporting for more than one year for many insider transactions.

Civil and Criminal Penalties
The Act includes a number of provisions that penalize certain conduct by corporate executives.

Civil Remedies
Section 305 lowers the standard required to bar an individual from future service as an officer or director of a public company from “substantial unfitness” to “unfitness.” In addition, Section 1105 gives the SEC the authority to impose a bar on officer or director service based on the same “unfitness” standard in a cease and desist proceeding. Section 804 extends the statute of limitations for civil actions for securities fraud to two years from discovery of the fraud (from one year), and no more than five years
from violation (from three years). In addition, the Bankruptcy Act was amended to prevent the discharge of indebtedness incurred in judgments or settlements of securities law violations.21

Criminal Penalties
The Act creates a number of new substantive crimes with significant penalties and increases the maximum penalties for a number of existing crimes. Section 1102 makes it a crime to “corruptly” alter, destroy, mutilate or conceal a document in an official proceeding, or to obstruct, influence or impede an official proceeding. Similarly, Section 802 makes it a crime to “knowingly” alter, destroy, mutilate, conceal or falsify records in connection with a federal investigation or bankruptcy proceeding. It is also a crime for anyone to violate the Act’s requirements that auditors retain their work papers for five years,22 to improperly influence audits,23 or to retaliate against whistleblowers.24 Finally, the Act creates a new crime of securities fraud, the essential elements of which substantially overlap with existing criminal liability under Rule 10b-5.25

The Act also increases criminal penalties for securities fraud and other white-collar crime. The maximum sentence for mail fraud and wire fraud is increased from five years to 20 years.26 The maximum sentence for Exchange Act violations is increased from ten to 20 years, and maximum fines are increased from $1 million to $5 million for individuals (and from $2.5 million to $25 million for corporations or other entities).27 Furthermore, in a number of separate provisions, Congress instructed the U.S. Sentencing Commission to reconsider its sentencing recommendations for white-collar crime.28

Attorneys
Section 307 of the Act requires the SEC to adopt rules “setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission,” including rules requiring attorneys to report evidence of material violations of securities law “up the ladder” to the chief legal officer (“CLO”) or the CEO. If the CLO or CEO fails to respond appropriately to such evidence, SEC rules must require the attorney to report such evidence to the audit committee or the full board of directors. The SEC adopted rules implementing Section 307 in January 2003.29 The SEC rules require the “up-the-ladder” reporting set forth in Section 307, but refrained from adopting a controversial “noisy withdrawal” proposal which would have required attorneys who become aware of a client’s violation of law to blow the whistle on their client. Instead, the SEC tabled the noisy withdrawal proposal for further comment and consideration.

Conclusion
On the whole, the Act represents a significant reform of rules regulating the conduct of public company officers and directors and their auditors and attorneys. Many of the Act’s provisions codify widely recognized voluntary “best practice” standards or legislatively mandate reforms initiated by the SEC and stock exchanges. In this respect, the Act may be viewed merely as a small step in the right direction. Alternatively, however, the Act may be viewed as an attempt to create a wholesale restructuring of the relationship between management and its purported monitors: directors, auditors and attorneys. Whether the Act will succeed in this endeavor remains to be seen. In any case, the broad sweep of the Act’s reforms and its mandated changes to standard corporate practices ensure a multitude of challenges for attorneys seeking to guide their clients in this evolving regulatory environment.

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Endnotes
4. Id. § 101(e).
5. Id.
6. Id. § 102.
7. Id. § 103.
8. Id.
9. Id. §104.
10. Id. § 105.
11. Id. § 202.
12. Id. § 203.
13. Id. § 206.
18. The Act § 803
19. Id. § 802.
20. Id. § 303(a).
21. Id. § 1107.
22. Id. § 807
23. Id. § 903.
24. Id. § 1106.
25. Id. §§ 805, 905 & 1104.