

AN OVERVIEW OF SARBANES-OXLEY

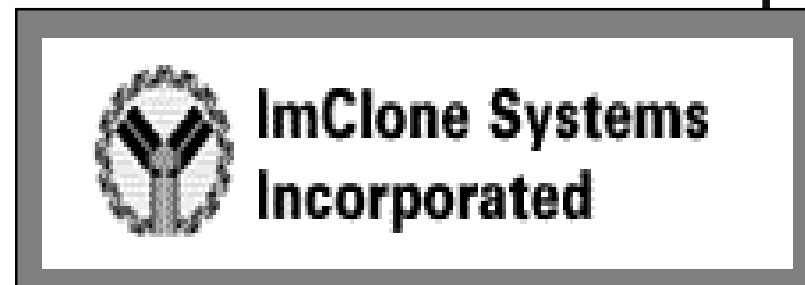
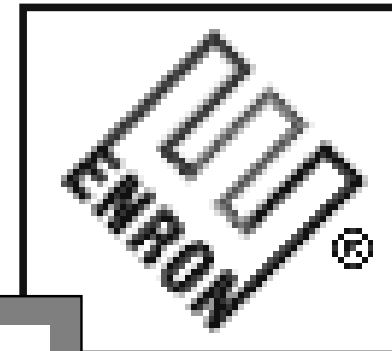
Bryce D. Linsenmayer

ACCA South/Central Texas Chapter

February 5, 2003

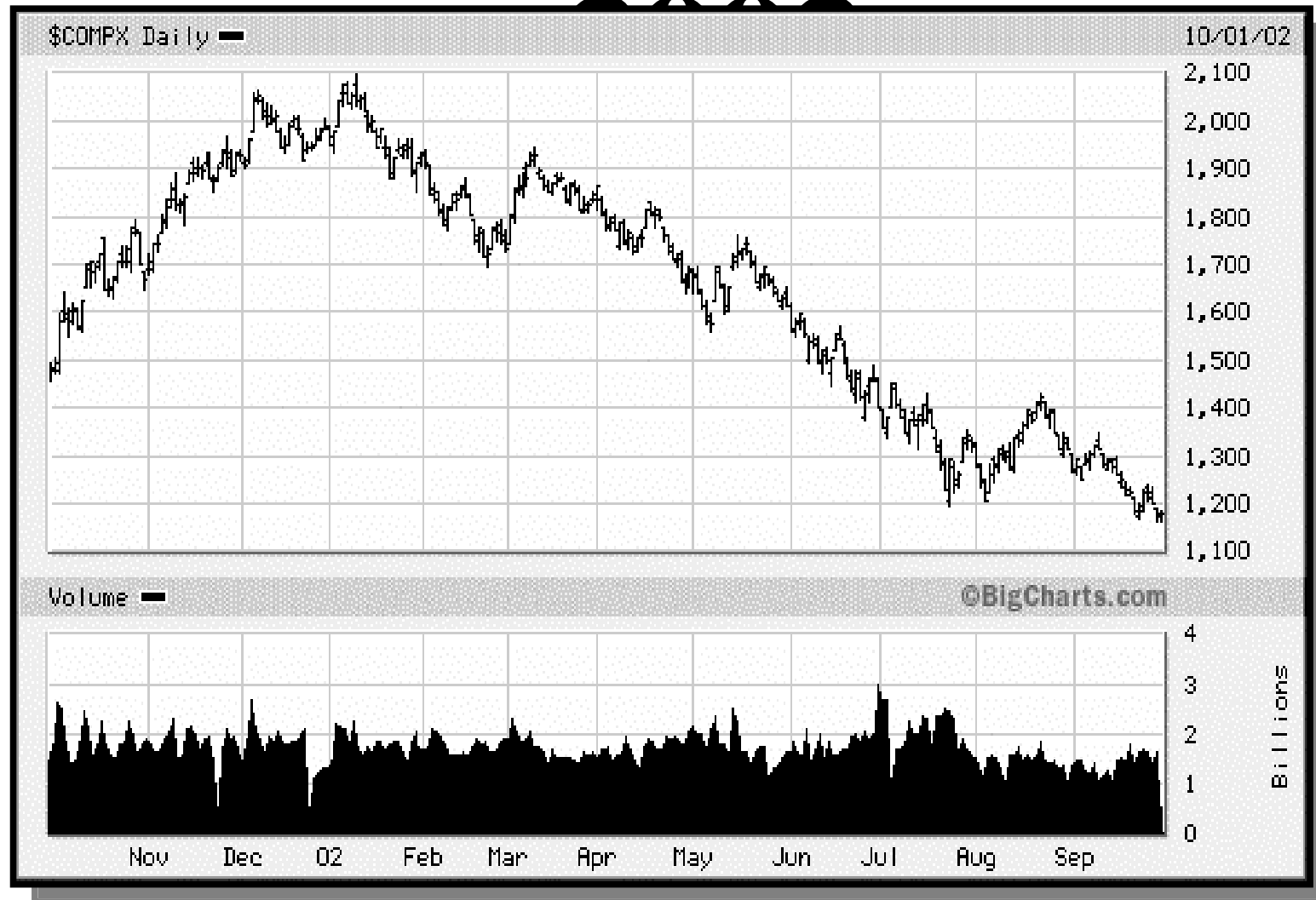
haynes **boone**
Are you changing?

The Party is Over



NASDAQ/Dow

October 2001 to October



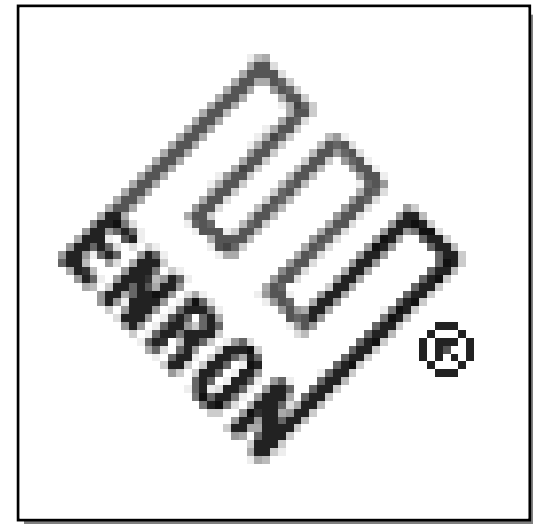


“The Enron fiasco is the best thing that has happened to plaintiffs and plaintiffs’ lawyers in recent history.”

– Lisa Blue; Baron & Budd, Dallas

“People already believe that big corporations are bad and not to be trusted...Enron just validates that belief.”

– Marc Whitehead;
Sonnenschein Nath &
Rosenthal, Chicago.

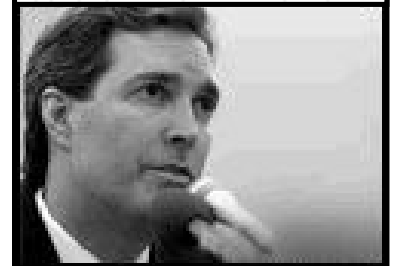
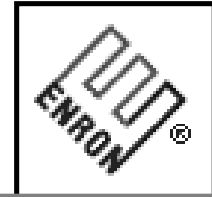
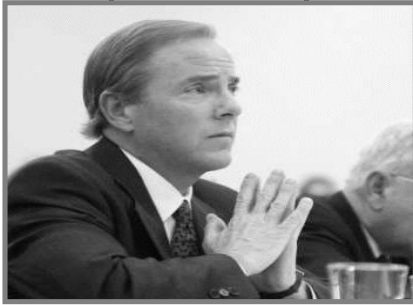
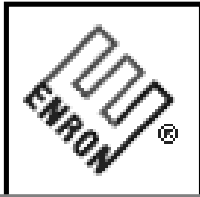


Public in a punishing mood



“One of the many ways to get back the [public] trust is to see people in handcuffs....”

--Jane Boyle, U.S. Attorney Dallas, Texas



A crisis of public trust



And this means ...

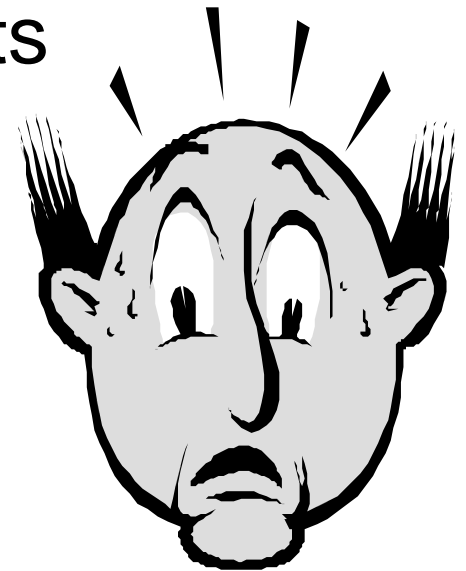
➤ Sarbanes-Oxley Act of 2002

- Rushed legislation to secure public trust
- Sweeping reforms on corporate governance, accounting and disclosure rules
- Enhanced enforcement, punishment and liability with criminal penalties



Hair Raising Provisions

- CEO and CFO certifications
- Expanded role of audit committee
- Corporate governance requirements
- Demand for financial transparency
- Accelerated, real time disclosure
- Employee whistleblower protection
- Attorney whistleblowers



Certification Requirements

- Requires CEOs and CFOs to certify in periodic reports (with civil and/or criminal penalties) that:
 - Report complies fully with statutory requirements
 - Information fairly represents, in all material respects, financial condition and results of operations
 - Report does not contain any untrue statement or material omission to make report misleading



Certification Requirements (cont.)

- CEOs and CFOs must certify in periodic reports (with civil and/or criminal penalties) as to disclosure controls and procedures that:
 - CEO/CFO is responsible for and has designed, established and maintained disclosure controls and procedures
 - CEO/CFO has evaluated the effectiveness of disclosure controls and procedures within 90 days of the report filing date
 - Report contains a discussion of the evaluation of effectiveness of disclosure controls and procedures

Certification Requirements

(cont.)

- CEOs and CFOs must certify in periodic reports (with civil and/or criminal penalties) as to internal controls and procedures that:
 - Deficiencies and material weaknesses in internal control have been disclosed to the Audit Committee and auditors, as well as any fraud (whether or not material) involving anyone with a significant role in internal control
 - Significant changes in internal control affecting controls for periods beyond review have been reported in the certification, including any corrective actions with regard to significant deficiencies and material weaknesses

Audit Committees

- All “independent” members
 - “Independent” means that the Audit Committee member may not accept any consulting, advisory or other compensatory fee from the Company except in his or her capacity as a member of the Committee or as a member of the Board

Audit Committees (cont.)

- Designated “financial expert”
 - Five Attributes
 - Experience preparing, auditing, analyzing or evaluating financial statements that present a level of complexity of accounting issues that can reasonably be expected to be raised by Company’s financial statements
 - Understanding of GAAP and financial statements
 - Ability to assess the general application of GAAP in connection with the accounting for estimates, accruals and reserves
 - Understanding of internal controls and procedures for financial reporting
 - Understanding of audit committee functions

Audit Committees (cont.)

- Direct oversight of outside auditors
 - Audit Committee must be directly responsible for the appointment, compensation and oversight of work by the auditor engaged by the Company
 - Auditor must report directly to the Audit Committee
- Drastic changes in relationship with outside auditors
 - Prohibition on certain non-audit services
 - Pre-approval by audit committee of the non-prohibited services
 - Audit partner rotation every five years

Corporate Governance

- Requires adoption and disclosure of:
 - Code of Ethics for CEO and senior financial officers to promote:
 - Honest and ethical conduct
 - Full, fair, accurate and timely disclosure
 - Compliance with law
 - Avoidance of conflicts of interest
 - Prompt internal reporting of violations of code

Corporate Governance

(cont.)

- Requires adoption and disclosure of:
 - Internal control report
 - Management's assessment of the effectiveness of the Company's internal control structure for achieving the following objectives:
 - Reliability of financial reporting
 - Effectiveness and efficiency of operations
 - Compliance with applicable laws and regulations
 - Attestation report from the Company's auditor

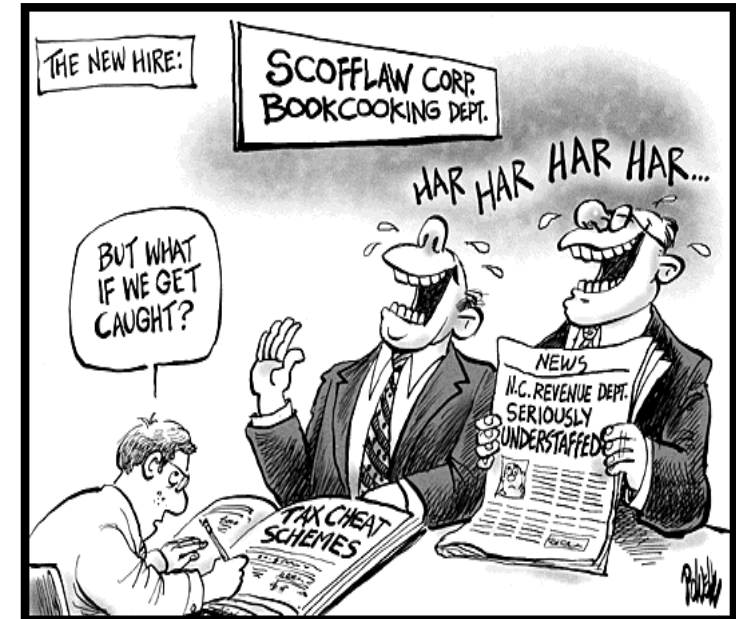
Corporate Governance (cont.)

- NYSE proposed rules require adoption of Code of Business Conduct and Ethics for all officers, directors and employees
 - Any waiver of the Code for a director or executive officer may be made only by the Board or a Board Committee and must be disclosed to the stockholders
 - Code must address a number of topics:
 - Conflicts of interest
 - Confidentiality
 - Corporate opportunities and fair dealing
 - Compliance with laws
 - Protection and proper use of Company assets
 - Encouraging the reporting of any illegal or unethical behavior

Financial Transparency

➤ Pro forma financial information disclosure

- Must not contain any untrue statement of material fact or omit to state a material fact
- Pro forma information must be reconciled with results of operations under GAAP
- Enhanced disclosure where non-GAAP measures used
- Statute provides basis for stockholder claims



Financial Transparency (cont.)

➤ Off-balance sheet transactions

- Required to disclose material off-balance sheet transactions
- Must contain comprehensive explanation of off-balance sheet arrangements
 - Nature and business purpose of arrangement
 - Importance of arrangement for liquidity, capital resources, market risk or other benefits
 - Financial impact and exposure to risk
 - Known events, trends or uncertainties that implicate ability to benefit from arrangement

Real Time Disclosure

- Expedited 10-K and 10-Q filings for some companies
- “Rapid and current” disclosure of material changes in the financial condition or operations of the Company

Real Time Disclosure (cont.)

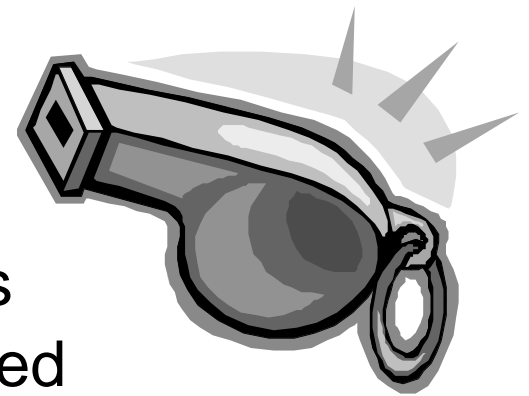
- More required Form 8-K disclosure items
 - Entry into material agreements not made in the ordinary course of business
 - Termination of a material agreement not made in the ordinary course of business
 - Termination or reduction of a business relationship with a significant customer
 - Creation of a direct or contingent financial obligation that is material to the Company
 - Appointment or departure of a director, CEO, CFO or COO
 - Conclusion or notice that security holders no longer should rely on the Company's previously issued financial statements or a related audit report

Real Time Disclosure (cont.)

- More required Form 8-K disclosure items (cont.)
 - Events triggering a direct or contingent material financial obligation
 - Exit activities including material write-offs and restructuring charges
 - Material impairments
 - A change in a rating agency decision, issuance of a credit watch or change in the Company's outlook
 - Change in exchange listing, delisting or notice of exchange standard non-compliance
 - Any material limitation, restriction or prohibition, including the beginning and end of lock-out periods, regarding the Company's employee benefit, retirement and stock ownership plans

Employee Whistleblower Protection

- Statute provides protection for employees who report violations or potential violations:
 - No retaliation
 - Establishes cause of action for employees
 - who believe their rights have been violated
 - Company must adopt procedures
 - so employees can report violations
 - anonymously and confidentially



Employee Whistleblower Protection (cont.)

- Covers employees who:
 - Report
 - Cause information to be reported
 - Assist in an investigation
- Covers conduct that the employee reasonably believes violates securities laws, SEC rules or other federal laws relating to fraud against stockholders

Employee Whistleblower Protection (cont.)

- Prohibited retaliation includes:
 - Discharge
 - Demotion
 - Suspension
 - Threats
 - Harassment
 - Any other form of discrimination in terms or conditions of employment

Employee Whistleblower Protection (cont.)

- Potential remedies to employee
 - Reinstatement
 - Backpay with interest
 - Special damages caused by retaliation
 - Litigation costs
 - Expert witness fees
 - Witness fees
 - Reasonable attorneys' fees

Attorney Whistleblowers

- Current rule: Attorney is permitted (but not required) to disclose client's confidential information under very limited circumstances
- New rule: SEC mandates "inferential disclosure" if an attorney (in-house or outside counsel) becomes aware of material violation of SEC's laws
 - No attorney discretion
 - Not a violation of client confidentiality rules
 - Requirement that attorney report the violation "up the ladder"



Attorney Whistleblowers (cont.)

- Aware of a violation
 - Level of care required of an attorney is controversial, especially given the tendency to evaluate conduct in hindsight
 - Proposed SEC rule contained a subjective and an objective test
 - Final rule significantly modified the proposal
 - New standard is that the attorney becomes aware of “credible evidence, on the basis of which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur”

Attorney Whistleblowers (cont.)

- Material Violation
 - SOX uses phrase “material violation of securities laws, fiduciary duty or similar violation”
 - Fiduciary duty not typically a federal concern
 - “Similar violation” provides considerable uncertainty

Attorney Whistleblowers (cont.)

- Up-the-Ladder
 - Report first to the Company's chief legal officer or CEO
 - Appropriate response:
 - No material violation
 - Appropriate remedial measures
 - Colorable defense
 - If no appropriate response, report to the Board or a committee of the Board

Attorney Whistleblowers (cont.)

- Resignation
 - Proposed SEC rule required a “noisy withdrawal”
 - Final rule left this open for an additional 60 days of comment
 - Alternative proposal requires a withdrawal, and places the obligation on the Company to file a Form 8-K
 - Under the alternative proposal:
 - The level of knowledge the attorney must have is higher
 - The Company is not required to file a Form 8-K if certain criteria are met

The Results

- CEOs and CFOs are more involved in drafting reports and evaluating internal controls
- More difficult to defend statements like “Could I have known everything going on in the Company?”
– Jeff Skilling, Enron
- Corporate mismanagement is now a U.S. securities law violation
- Financial statements turned into false certification claims
- Litigation minefield