

## THE SARBANES – OXLEY ACT of 2002 Redefining Corporate Integrity, Governance and Disclosure

August 2002

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002, arguably the most significant legislation affecting the business of public companies since the Securities Act of 1934. The following is a very brief summary of certain provisions of the Act. A more detailed summary can be found on the homepage of our website - [www.wallerlaw.com](http://www.wallerlaw.com).

### Corporate Responsibility

- The Commission must adopt rules within 30 days which require the CEO and CFO of each SEC reporting company to certify (a) that based on the officers' knowledge, each periodic report does not contain materially false statements or omissions and the financial statements are a fair representation of the financial condition of the company, and (b) as to the adequacy of, and any deficiencies in, the internal financial controls. A similar though less detailed statement is required on all future filings, including second quarter 10-Qs for all reporting companies, effective immediately.
- If a company restates financial information as a result of material noncompliance with any financial reporting requirement, the CEO and CFO must reimburse the company for any bonuses or incentive pay received during the 12 month period following the publication of the information along with any profits from stock sales during the period.
- Directors and officers are prohibited from trading employer securities during any blackout period of a 401(k) or retirement plan that prevents plan participants from directing trades in an employer stock fund of the plan.
- Effective immediately, personal loans from a company to any executive officer or director are prohibited, with some exceptions.

### Increased Disclosure

Pursuant to the increased disclosure requirements, companies must:

- include in annual and quarterly reports disclosures regarding all material off-balance sheet transactions;
- present pro forma financial information in a manner that reconciles with generally accepted accounting principles (GAAP);
- report changes in ownership of securities held beneficially by directors and executive officers within two business days of the execution of the transaction;
- include in annual reports an internal control report containing an assessment of the effectiveness of such controls, as well as an attestation to the assessment from the auditing firm;
- disclose whether they have codes of ethics for senior financial officers and, if not, the reasons they do not. Any changes or waivers to a company's code of ethics require disclosure; and
- disclose to the public "on a rapid and current basis" material changes in their financial condition or operations in "plain English."

In addition to these increased disclosure requirements, the Commission must review the reports of each reporting company no less than once every three years.

### Audit Committees

- A fully independent audit committee must be responsible for the appointment, compensation and oversight of the auditing firm. The audit committee must establish procedures for receiving and maintaining complaints regarding accounting controls. Audit committees must be able to engage independent counsel and advisors.



- A company must disclose in periodic reports whether the audit committee contains at least one person who is a financial expert, such as a former auditor, controller or CFO.

#### **New Crimes and Increased Criminal Penalties**

- Knowingly tampering with or falsifying documents with the intent to obstruct or influence an investigation can result in fines, imprisonment for up to 20 years or both.
- Accountants who knowingly and willfully fail to maintain workpapers for five years may be fined, imprisoned for up to 10 years or both.
- Certifying a report knowing that it does not comply with law can result in fines up to \$1,000,000, imprisonment for up to 10 years or both. Doing so willfully can result in a fine of up to \$5,000,000, imprisonment for up to 20 years or both.
- Knowingly taking action against someone for providing truthful information relating to a covered offense can result in fines, imprisonment for up to 10 years or both.
- Conspiring or attempting to violate any of the new laws, whether successful or not, results in the same penalties as those prescribed for the offense.
- The maximum sentence for securities fraud has been increased to 25 years, the maximum sentences for mail fraud and wire fraud have been increased to 20 years and the maximum sentence for defrauding a pension fund has been increased to 10 years.

#### **New Civil Cause of Action and Increased Enforcement Powers**

- A whistleblower who prevails in an action alleging retaliation by an employer for his cooperation in either a potential securities fraud investigation or a securities fraud action brought by the SEC may be reinstated and recover back pay with interest and special damages.
- The SEC may obtain a temporary restraining order that prohibits a company from making extraordinary payments to insiders during the pendency of an investigation.
- The SEC may bar individuals from serving as officers or directors of a public company as a result of violations of the securities law that render them unfit for those positions.
- The Act adds to the SEC's enforcement powers by lengthening the statute of limitations for private securities fraud claims to the earlier of two years after the discovery of the facts constituting the violation or five years after the occurrence of the violation, and by limiting the use of bankruptcy to avoid liability for securities fraud.

#### **Auditor Independence**

- All audit and non-audit services (with some exceptions) must be pre-approved by the audit committee of the company, and such approval must be disclosed to investors.
- Audit partners must be rotated every five fiscal years.
- Auditing firms must report to audit committees recommended alternative accounting treatments that have been discussed with management.
- Auditing firms cannot provide audit services to a company if a former employee of the auditing firm who participated in an audit of the company within the past year now serves as CEO or CFO for the company or holds a similar position.

#### **The Public Company Accounting Oversight Board**

The Act establishes a Public Company Accounting Oversight Board under the aegis of the Commission. The Board will register public accounting firms, establish audit preparation standards, regularly inspect registered accounting firms and investigate and discipline individuals or entities who violate its rules. The Board will be composed of five members appointed by the Commission, two of whom must be, or must have been, CPAs. The other three members must not have worked as accountants.



## Securities Analysts

The Act includes measures:

- preventing conflicts of interest between securities analysts and investment banking activities regarding approval of research reports;
- prohibiting broker-dealers from retaliating against analysts for negative research reports; and
- requiring disclosures of investments by a broker-dealer or securities analyst in a company that is the subject of a report regardless of whether the company has compensated the broker-dealer or analyst, the company is a client of the broker-dealer, or the analyst received compensation based upon investment banking revenues.

If you have any questions about this new Act, please contact [Chase Cole](#) or [Marlee Mitchell](#) at (615) 244-6380.

***The opinions expressed in this bulletin are intended for general guidance only. They are not intended as recommendations for specific situations. As always, readers should consult a qualified attorney for specific legal guidance.***

***Certification as a specialist in securities law is currently not available in Tennessee.***