Z.A.G/S&W

565 Fifth Avenue
New York, NY 10017
tel: (212) 508-8222
fax: (212) 508-8226
web: www.zag-sw.com

Boston
New York
Tel-Aviv
Washington, DC

Client Advisory

The Sarbanes-Oxley Act of 2002: Reforms in Corporate Governance, Accounting and Disclosure

On July 30, 2002, President George W. Bush signed the Sarbanes-Oxley Act of 2002 into law. This sweeping accounting and corporate governance reform legislation is in response to the various corporate and accounting scandals and frauds brought to light in recent months. Below is a summary of the major provisions of the Act which will have a significant effect on public companies and accounting firms. Some provisions will be effective immediately or in the near future, while others will be subject to enactment through Securities and Exchange Commission (the "SEC") rulemaking over the coming months. We encourage you to contact us to discuss the effective time for provisions of particular interest or concern.

Corporate Responsibility

Annual and Quarterly Report CEO and CFO Certifications. Under the Act, each periodic report containing financial statements filed with the SEC must "be accompanied by" a statement by the chief executive officer and chief financial officer. The statement must certify that the periodic report containing the financial statements fully complies with applicable securities law requirements and that information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer.

The SEC will also (within 30 days) require the principal executive officers and financial officers of all public companies to certify the accuracy of each quarterly and annual report filed with the SEC, including their financial statements. Chief executive officers and chief financial officers will have to certify that:

- the officer has reviewed the report;

- based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made not misleading;

- based on the officer's knowledge, the financial statements, and other financial information included in the report, fairly represent in all material respects the financial condition and results of operations of the issuer; and

- the officers are responsible for establishing and maintaining internal controls; they have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made know to such officers by others within those entities; they have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report; and they have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date;

- the officers have disclosed to the auditors and the audit committee any significant deficiencies in the internal controls as well as the existence of any fraud, whether material or not material, involving management or other employees with a significant role in the issuer's internal controls; and

- the signing officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

A knowing violation of this certification requirement may result in a fine up to $1,000,000 and/or up to 10 years in prison. Furthermore, a willful violation is punishable by a fine of up to $5,000,000 and/or 20 years in prison.

Forfeitures Due to Financial Statement Restatements. Following a restatement of an earnings report due to a material noncompliance with the securities laws, the chief executive officer and chief financial officer must forfeit to the issuer bonuses, other incentive-based compensation and profits on any stock sales realized in the twelve months after the filing of the original financial information that was restated.

Prohibition of Insider Trades During Blackout Periods. Directors and executive officers are prohibited from selling company stock during blackout periods when employees are barred from trading company stock held in individual retirement plans. Notice must be furnished to all participants to whom the blackout date applies at least 30 days in advance of the blackout period. Issuers (or shareholders acting on an issuer's behalf) may recover any profits from sales in violation of this provision.

Public Company Audit Committees Duties and Membership. The Act strengthens the role of audit committees and makes them responsible for the appointment, compensation, and oversight of the work of any accounting firm employed by that issuer. The Act also imposes the requirement that each member of the audit committee shall be independent, meaning, for purposes of the Act, that a member of the committee may not accept any consulting, advisory, or other compensatory fee from the issuer (other than routine director fees) and may not be an affiliated person of the issuer or any subsidiary. Note that the Act does not contain any exceptions as do NYSE and NASDAQ listing standards, other than on a case-by-case basis at the direction of the SEC. Issuers will also be required to disclose whether the audit committee has at least one member who is a "financial expert" (to be defined by the SEC).

Professional Conduct Rules for Attorneys. The SEC must issue rules setting forth the minimum standards of professional conduct for attorneys, including a rule mandating attorneys to report the securities law violations of management to the chief legal counsel or chief executive officer of the company. If the counsel or chief executive officer does not appropriately respond, the attorney must report the evidence to the audit committee of the board of directors.

Fair Fund for Investors. The Act creates a fund in which civil penalties levied by the SEC as a result of judicial or administrative actions are to be placed for the benefit of the victims of such violations.

Financial Disclosures

Enhanced Disclosures. Financial reports must reflect all material correcting adjustments that have been identified by an issuer's outside accounting firm. The SEC will issue rules pursuant to the Act requiring that each annual and quarterly financial report disclose all material off-balance sheet transactions with unconsolidated entities that may have a material current or future effect on the financial conditions of the company. Pro forma information will need to be reconciled to GAAP and not contain untrue statements of fact or omit material facts necessary to make the information not misleading.

Prompt Disclosure of Insider Transactions. Subject to the SEC clarifying exceptions and exemptions, insiders (directors, officers and greater than 10% stockholders) will need to report company stock trades within two business days following the day in which the transaction has been executed. This change to Section 16 shortens the deadline for filing most Form 4s from 10 days after the end of the month on which the transaction occurred. Within one year, all Section 16 reports must be filed electronically with the SEC and posted on the issuer's website.

Management Assessment of Internal Controls. Under the Act, the SEC will prescribe rules requiring issuers to state in their annual reports the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting and to make an assessment as to their effectiveness. Each accounting firm that prepares and issues an audit report must attest to the assessment made by the management of the issuer.

Ban on Loans to Executives. Executives cannot receive personal loans from the issuer that are unavailable to outsiders, with limited exceptions. This prohibition does *not* apply retroactively to loans currently outstanding so long as they are not materially modified or renewed.

Code of Ethics for Senior Financial Officers. The SEC must issue rules requiring issuers to disclose whether or not the issuer has adopted a code of ethics for senior financial officers. Waivers of the code of ethics would have to be disclosed by the issuer promptly on Form 8-K.

Enhanced Review of Periodic Disclosures. The SEC must review the Exchange Act filings of every public company at least once every three years.

Real Time Disclosures. Companies must disclose, on a "rapid and current basis," in plain English any material changes to their financial condition or operations. Rapid and current are not defined in the Act.

Auditor Independence

Most Non-Audit Services Now Prohibited. The Act provides that, beginning 180 days after the commencement of operations of the Public Company Accounting Oversight Board prescribed by the Act (the "Board"), it shall be unlawful for a registered public accounting firm to provide the following nine types of non-audit services to audit clients, many of which are already prohibited under current SEC rules:

- bookkeeping or other services related to the accounting records or financial statements of the issuer;
- financial information systems design and implementation consulting services;
- appraisal or valuation services, fairness options, or contribution-in-kind reports;
- actuarial services;
- internal audit services;
- any management or human resources function;
- broker, dealer, investment adviser, or investment banking services;
- legal services; and
- expert services unrelated to the auditing services.

The Board has the power to grant case-by-case exceptions to these prohibitions. Accounting firms may still provide services not explicitly listed, such as tax services.

Audit Committee Pre-Approval Required for Accounting Firm Services; Reports of Accounting Firms. The Act enhances oversight of outside auditors by requiring that all auditing and non-audit services be pre-approved by the audit committee (or a designated committee member(s)) of the issuer (with a de minimus exception). Firms may engage in non-audit services only if pre-approved by the audit committee. Any such services must be disclosed in the issuer's periodic SEC reports. Each accounting firm must now report to the audit committee all critical accounting policies and practices to be used and alternatives discussed with management, ramifications thereof, and other related information.

Audit Partner Rotation Required. Accounting firms must rotate the lead and reviewing partners from client assignments every five years.

Restrictions on Employment of Auditor Personnel. The Act establishes a one-year "cooling off" period before accounting firms' personnel can work for a public company audit client in certain senior management and financial positions.

Public Company Accounting Oversight Board

Establishment of Oversight Board. The Act creates a five-member Public Company Accounting Oversight Board which is independent of the accounting industry and has investigative and disciplinary power to establish and enforce standards on auditor independence, quality control, and ethics for the auditing of public companies. The SEC has oversight and enforcement authority over the Board. The Board will be funded through fees to be paid by issuers.

Registration of Accounting Firms. All public accounting firms that prepare audit reports for public companies must register with the Board and submit information regarding issuers for which the firm prepares audit reports, annual fees received from issuers for all services rendered, accountants associated with the firm, and disclosure of accounting disagreements between the issuer and the accounting firm in connection with an audit report prepared by the firm.

Inspections of Accounting Firms. The Board will conduct inspections annually with respect to accounting firms that regularly provide audit reports for more than 100 issuers and not less than once every three years with respect to firms that regularly provide audit reports for 100 or fewer issuers. Accounting firms, under standards to be adopted by the Board, will be required to maintain audit work papers for 7 years and to have second partner review of audit reports.

Corporate and Criminal Fraud Accountability

Document Destruction Penalties. Destroying, altering or fabricating records in federal investigations, or for any "scheme or artifice" to defraud shareholders will now be punishable by fine and/or up to 20 years in prison (increased from five years).

Securities Fraud Penalties. Persons who commit securities fraud shall be subject to fines and/or up to 25 years in prison.

Statute of Limitations for Securities Fraud Extended. The Act increases the statute of limitations for securities fraud lawsuits to two years after the discovery of the facts constituting the violation or five years after the violation.

Other Key Provisions

No Dischargeability of Certain Debts in Bankruptcy. Debts arising from penalties for securities fraud violations will no longer be dischargeable in bankruptcy proceedings.

Signing of Corporate Tax Returns. Under the Act, it is suggested, though not required, that a corporation's federal income tax return be signed by the CEO of the corporation.

Officer and Director Bars. The SEC will have the authority to bar an officer or director through an administrative proceeding (previously the SEC had to go to court) from serving as an officer or director of any public company if the SEC finds that person unfit to serve (the previous standard was "substantially unfit").

Temporary Freeze Authority. The Act permits a temporary freeze on extraordinary payments to employees of companies under investigation by the SEC.

Analyst Conflicts of Interest. In efforts to address conflicts of interest that can arise when securities analysts recommend equity securities, the Act imposes enhanced firewalls between securities research analysts and investment bankers.

Whistleblower Protection. The Act provides protection to employees of public companies that provide information or assistance in an official investigation relating to securities fraud.

Ongoing Studies. The Act also calls for a series of studies to be conducted to obtain more information regarding, among other things, auditor rotation, special purpose entities, credit agencies' roles, SEC enforcement, consolidation in the accounting industry, the role of investment banks in earnings manipulation, and sentencing guidelines.

Conclusion

The Sarbanes-Oxley Act of 2002 provides numerous changes to existing law which directly affect public companies and the accounting firms and practices. This advisory addresses the most critical elements of this new law. For a more comprehensive discussion of the topics covered in this advisory or for assistance in complying with any of the foregoing requirements, please contact the lawyer at ZAG/S&W LLP with whom you regularly consult, or the undersigned.

Kathleen P. Lundy
Howard E. Berkenblit
August 2002

© 2002 ZAG/S&W LLP

Because sound legal advice must necessarily take into account all relevant facts and developments in the law, the information you will find in this Advisory is not intended to constitute legal advice or a legal opinion as to any particular matter.