LIVING WITH THE REFORM: THE IMPACT OF THE SARBANES-OXLEY ACT OF 2002

As President Bush signed the Sarbanes-Oxley Act of 2002 into law, it marked the most sweeping revision of the federal securities laws since their New Deal era roots. The statute can be accessed at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_cong_bills&docid=f:h3763enr.txt.pdf.

The Act is a unique product of a “perfect storm” generated through a series of high profile financial reporting debacles involving prominent companies, an erosion in market confidence and extreme market volatility. The Act is a vast patchwork quilt of reforms that aim at (a) creating an independent regulatory structure for the accounting industry, (b) higher standards for corporate governance, (c) increased independence of securities analysts, (d) improved transparency of financial reporting and (e) a panoply of new civil and criminal remedies for violations of the federal securities laws.

The Act adds to the charged atmosphere in which public company managers and their boards must operate. Given its quick passage, the Act leads to a number of practical considerations in the near term.

1. The Act will place a premium on a good working relationship between public companies and their auditors. A number of reforms clearly are intended to strengthen the hand of auditors in dealing with their clients. The Act directs the SEC to adopt rules making it unlawful to “fraudulently influence, coerce, manipulate or mislead” independent auditors. Section 13 of the Securities Exchange Act is amended to require that financial statements reflect “all material correcting adjustments” identified by independent auditors in accordance with GAAP and SEC rules. Auditors will perform their duties with the added risk of enforcement action by a new oversight board.

The passage of the Act should cause public company managers to revisit and explore ways to improve their working relationship with their independent auditors. Like any other advisory relationship, this one can be made more effective through more advance planning and creating a review process that allows for more informal discussion of accounting treatments well before a reporting deadline. Accounting is not science but the art of applying principles to the results of a unique organization. Since, going forward, the relationship will be subject to a greater level of regulatory micromanagement, this is apt time to ensure that there is an active informal discussion between two sides.
2. **Audit committees will need enhanced support from public company management.** Under the Act, the audit committee continues as the pack mule of corporate governance. The statute layers additional burdens on the backs of directors who, by definition, extend part-time service to issuers. For example, the Act requires the Audit Committee’s approval, in advance, of non-audit services provided by the issuer’s independent auditor. Similarly, the Act requires independent auditors to report to audit committees on, among other things, all alternative treatments of financial information within GAAP that were discussed with management, the ramifications of the use of alternative approaches and the treatment preferred by the independent auditor.

Audit committee members are acutely aware of intense scrutiny and criticism, always with the benefit of perfect hindsight, that falls on the directors of troubled companies. While directors have finite time they can direct to their roles, they will look to management for insight about the judgments and processes that lead to the issuer’s financial results. The Act specifically provides that audit committees can retain advisers, including counsel. The multiple roles assigned by the Act to audit committees will increase substantially the time that advisers, internal and external, must devote to the audit committee’s processes.

3. **Companies should revisit their compliance procedures, particularly as they relate to financial reporting issues.** In-house counsel at public companies should ask themselves a simple question: “If a randomly-selected employee in our company had a concern about the company’s revenue recognition practices, who would that employee contact?” If the answer would not be immediately apparent, issuers should revisit the way their compliance procedures are structured and disseminated.

The Act fosters such introspection. The statute requires issuers to disseminate a code of ethics to financial reporting personnel. The Act also imposes on audit committees to establish procedures to address, on a confidential basis, employee complaints regarding questionable accounting practices. And, for good measure, the Act creates a private right of action for “whistleblowers” who face retaliation for raising such issues. While not every employee complaint will be as prescient as Enron’s Sherron Watkins, issuers will want to bolster systems that identify and resolve such issues before they are referred to an external source.

4. **An issuer’s General Counsel should extend an “open door” policy to all counsel acting for the company.** The Act requires the SEC to adopt rules mandating that any lawyer acting for the company to report, to the General Counsel or the CEO, any material violation of securities law or fiduciary duty by the company or any of its personnel. If appropriate remedial action is not taken, the Act requires counsel to report the information to the issuer’s audit committee or committee of independent directors. It would appear that failure to make the required report could lead to a proceeding under SEC Rule 102(e) aimed at barring the attorney from practicing before the SEC.

From the perspective of corporate counsel, it is hard to imagine a circumstance in which the chief legal officer would not want to be apprised of a potentially material defalcation. While the process of preparing these rules goes through intensive debates, a General Counsel could simply signal to lawyers serving the company that this communication is expected, regardless of the form of the SEC’s rules.
5. **Companies will have to adjust securities trading policies.** The Act amends Section 16(a) of the Exchange Act to effectively require that directors, executive officers and ten percent shareholders disclose transactions involving equity securities on SEC Form 4 before the end of the second business day following the day on which the transaction occurred. This is a significant acceleration of the reporting cycle. For the majority of issuers that assist directors and executive officers in preparing their filings, this will require an adjustment of the company’s procedures. Those procedures should also be adjusted to forbid, as the Act does, trading the company’s securities while employee benefit plans have restricted transactions for most participants. Since the text of the statute acknowledges that a two-day reporting cycle may be impractical, issuers should position their directors and key officers with systems that reflect a good faith effort to meet the new filing deadline.

6. **CEO/CFO certifications will become a fixture of the reporting process.** The Act requires that each quarterly and annual report be accompanied by a certification from the issuer’s principal executive officer and principal financial officer. The certification would affirm that these senior officers have (a) reviewed the report, (b) that it contains no material misstatements, (c) that any significant deficiencies in internal controls have been disclosed to the company’s independent auditors and the audit committee. The certification is broader than the certification mandated by the SEC for CEOs and CFOs of 947 domestic issuers due by mid-August.

For all issuers – including the 947 subject to the SEC’s June order – the current exercise provides lessons in implementing this requirement. The practical issues include (a) the need to develop a record substantiating the basis on which the certification was made, (b) coordinating to ensure Audit Committee review of the process, (c) and the SEC staff’s guidance yesterday that the certifications should be considered material, nonpublic information (and suggesting disclosure on a Form 8-K of the certification before it is available on the SEC’s website).

7. **The Act will spur pending SEC and SRO regulatory reforms.** The Act requires rulemaking to address corporate governance reforms that, to a great extent, are addressed in reports compiled by the principal exchanges. The Act also requires SEC rulemaking to foster real-time disclosure of material changes in an issuer’s operations or financial results. The Commission proposed, on June 17, 2002, an expansion of events giving rise to a Form 8-K filing requirement. The Act will spawn a bevy of SEC rulemaking and should add fuel to initiatives not directly addressed in the statute. The Act also calls for the preparation of nine separate studies addressing various aspects of the securities markets. These studies, all of which must be completed within a year, also may shape the regulatory agenda.

With only three dissenting votes from over 500 legislators, it is hard to overstate the legislative rush to spur aggressive civil and criminal enforcement of the securities laws. The SEC’s budget will increase dramatically as will its panoply of civil remedies. The Act requires review of public company periodic reports on a three-year cycle. Significant new criminal penalties and a Justice Department task force devoted to these issues can only lead to an increased use of criminal inquiries.

With the Act, one cost of being a public company – periodic reporting – will increase and continue to increase over the coming months and years. For public companies that cover a wide spectrum, the immediate and long-term challenge will lie in adjusting their systems, staffing and cultures to the rigors of this environment.
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