ROPES & GRAY

CLIENT ALERT

July 29, 2002

CORPORATE ACCOUNTABILITY, FRAUD AND GOVERNANCE ACT

Last week Congress passed the Sarbanes-Oxley Act of 2002, which the President is expected to sign into law imminently. The Act imposes on public companies, their boards and management, new obligations regarding corporate reporting, governance and responsibility and creates a Public Accounting Oversight Board to oversee public accountants and the audit of public companies. Many provisions of the Act will go into effect immediately upon the signing of the Act by the President. The effectiveness of other provisions will depend upon rulemaking by the SEC during a period of up to one year.

CORPORATE RESPONSIBILITY AND GOVERNANCE PROVISIONS

CEO/CFO Certification

The Act directs the SEC to enact rules effective within 30 days of enactment of the Act requiring a public company's principal executive officer and principal financial officer to certify in each annual or quarterly report:

1) that he has reviewed the report;

2) that, based on his 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, in light of the circumstances under which such statements were made, not misleading;

3) that, based on his knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the company as of, and for, the periods presented in the report; and

4) as to certain matters about the company's internal controls (including certification of responsibility for establishing and maintaining internal

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controls, disclosure to auditors and audit committee of significant deficiencies and material weaknesses in internal controls and any fraud involving management or employees with a significant role in the company's internal controls, evaluation of effectiveness of internal controls and disclosure in the report of changes in internal controls).

Principal executive officers and principal financial officers who knowingly or willfully certify false or non-compliant company financial reports would face prison terms of 10 to 20 years and fines of $1 million to $5 million, respectively.

CEO/CFO Disgorgement
Effective immediately, if a company is required to restate its financial statements due to material noncompliance with reporting requirements under the securities laws resulting from misconduct, then the company's chief executive officer and chief financial officer each must reimburse the company for any bonus or incentive compensation and any profits on sales of the company's securities in the twelve months prior to the disclosure of the restatement.

Officer and Director Bars
Under certain circumstances and based on violations of certain securities laws, effective immediately, the SEC may now prohibit a person from serving as a director or officer if he demonstrates "unfitness" to serve, a more stringent standard than the prior standard of "substantial unfitness."

Blackout Periods
Effective 180 days after enactment of the Act, the Act makes it unlawful for any director or executive officer of a public company to engage in any transaction in equity securities of such company during pension fund (e.g., 401(k) plans) blackout periods. The company (or a shareholder on behalf of the company) may recover any profits on a sale or purchase of the company's equity securities by a director or officer in violation of this provision.

Counsel's Reporting Obligations
The Act directs the SEC to issue professional conduct rules for corporate attorneys representing a public company within 180 days of enactment of the Act, including a rule requiring such an attorney to report to a company's CEO or chief legal counsel evidence of any material violation of securities laws or breach of fiduciary duty by the company or an employee, and if the CEO or legal counsel fails to respond, report the same to the audit committee or the board. These rules ostensibly will apply to both internal and external counsel of a public company.

Prohibition on Personal Loans
Effective immediately, the Act proscribes public companies from directly or indirectly extending credit or making loans (with certain very limited exceptions for companies in the business of lending) to their directors or officers; however, any pre-existing loans to directors and officers may be maintained as long as there are no material modifications to the terms of such loans and no renewal occurs.

ENHANCED DISCLOSURE PROVISIONS

Additional Disclosure in Periodic Reports
Effective immediately, the Act requires that companies augment their financial statement reporting by reflecting all material correcting adjustments that have been identified by their auditors in accordance with GAAP.

The Act directs the SEC to adopt final rules within 180 days of the enactment of the Act that would require companies to disclose in each 10-Q and 10-K all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities or other persons that may have a material current or future effects on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources or significant components of revenues or expenses.

The Act also directs the SEC to adopt final rules within 180 days of the enactment of the Act that would require companies to present any pro forma financial information included in any report filed with the SEC or in any public disclosure (e.g. a press release) in such a fashion that i) does not contain an untrue statement of a material fact or omit to state a material fact necessary in order to make the pro forma financial information, in light of the circumstances under which it is presented, not misleading, and ii) reconciles the pro forma financial information with the financial condition and results of operations of the issuer under generally accepted accounting principles.

Beneficial Ownership Reporting
Effective 30 days after the enactment of the Act, the Act accelerates the deadline for reporting of transactions in a public company's equity securities by directors, officers and greater than 10% shareholders. A change in ownership by any such person must be reported by the end of the second business day following the date of the transaction. The Act provides for enhanced public accessibility to transaction statements by requiring that within one year of the enactment of the Act, such statements be filed electronically and the SEC and the issuer of the security to which the statement relates post such statement on their respective websites.

Internal Control Report
The Act directs the SEC to adopt rules requiring companies to include in their annual reports an internal control report.

Code of Ethics for Senior Financial Officers
The Act directs the SEC to adopt final rules within 180 days of the date of enactment of the Act requiring public companies to disclose in periodic reports whether they have adopted a code of ethics for senior financial officers, and if they have not, why not. Any changes to or waivers of the code of ethics would have to be disclosed in a current report on Form 8-K.

SEC Review
The SEC is charged with the duty, under the Act, to make a systematic and regular review of the disclosures of each issuer at least once every three years.

Real Time Issuer Disclosures
The Act requires a public company to disclose on a rapid and current basis material changes in operations or financial condition of the company. It is expected that the SEC will determine by rule the additional information to be disclosed and deadlines for such disclosure.

Absence of Option Reporting
Conspicuously absent from the Act is a provision requiring companies to report employee stock options as a business expense on their balance sheets. Some companies have declared that they plan to expense options (e.g., Coca Cola Co., Washington Post Co., Bank One Corp.), notwithstanding the lack of an affirmative requirement to do so at this time.

AUDIT COMMITTEE AND ACCOUNTING INDUSTRY PROVISIONS

Audit Committee
The Act imposes new standards on audit committees of public companies by directly requiring audit committees to satisfy standards articulated in the Act, effective immediately, and by directing the SEC to adopt a rule within 270 days of the enactment of the Act ordering national securities exchanges and associations to prohibit listing of securities of issuers not in compliance with those standards.

The new standards most prominently include maintaining an audit committee comprised solely of independent directors, where to be "independent" a director:

> i) may not accept any consulting, advisory or compensatory fee from the company (other than for service in his capacity as a director), and
>
> ii) may not be an affiliated person of the company or any of its subsidiaries.

Note that under this new independence definition a director owning a controlling stock interest in a company is disqualified from serving on the company's audit committee, as likely is also the case with officers or directors of controlling shareholders. The new independence definition renders obsolete the exception under special limited circumstances that an audit committee may have one non-independent member under the NASDAQ Marketplace Rules and the Rules of the New York Stock Exchange, which some companies have come to rely upon. The Act does, however, authorize the SEC to grant discretionary exemptions from the independence requirements.

Also under the new standards and effective immediately, an audit committee must establish procedures for processing and responding to complaints received by the company related to accounting matters and must be vested with the authority (and resources) to engage independent counsel and advisers. Finally, the Act explicitly

charges the audit committee with the responsibility of engaging, compensating and overseeing the work of the company's outside auditor, effective immediately.

Within 180 days of the enactment of the Act, the SEC must issue final rules requiring companies to disclose whether any member of their audit committee qualifies as a "financial expert." The Act directs the SEC to consider in defining the term "financial expert" whether a person through experience or education understands GAAP and financial statements, has experience in the preparation or audit of financial statements and the application of GAAP, has experience with internal accounting controls and understands audit committee functions.

Oversight

The Act provides for the establishment of a five member Public Company Accounting Oversight Board, charged with the duties of registering and inspecting public accounting firms, enforcing compliance with the Act and establishing standards regarding the preparation of audit reports for companies, including auditing, quality control and ethics standards. Unless registered with the Board within 180 days after the establishment of the Board, it will be illegal for an accounting firm to audit public companies. The primary source of funding for the Board will be annual accounting support fees levied against public companies.

Auditor Relationship with Public Companies

The Act adds to the reports to be delivered to a company's audit committee under the 1934 Act by requiring that the auditor report to the audit committee information regarding critical accounting policies and practices to be used, alternative treatments of financial information within GAAP relevant to the company's audit and material written communications between the auditor and management of the company.

The Act also impacts the composition of the team performing an audit by requiring accounting firms to rotate the lead audit partner and the reviewing audit partner on an audit for a public company every five years.

Also an accounting firm will be disqualified from auditing a public company if during the one year period preceding the most recently commenced audit the CEO, CFO, chief accounting officer, controller or a person serving in a similar capacity was employed by such firm and participated in an audit of the issuer.

The Act prohibits accounting firms from providing the following non-audit related services to a company to which it provides audit services:

1) bookkeeping or similar services;

2) financial information systems design and implementation;

3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports;

4) actuarial services;

5) internal audit outsourcing services;

6) management or human resource functions;

7) broker or dealer, investment adviser, or investment banking services;

8) legal services and expert services unrelated to the audit; and

9) any other Board-determined impermissible service.

Further, the provision of all audit related services (including comfort letters) and any non-audit services that are not prohibited (e.g., tax services) by a registered accounting firm must be approved in advance by a company's audit committee.

ANALYST INDEPENDENCE PROVISIONS

The Act charges the SEC with the duty to create, within one year, new rules to prevent conflicts of interest for securities analysts and to ensure the objectivity and independence of securities analysts.

ENHANCED PENALTY PROVISIONS AND PROTECTIONS FOR WHISTLEBLOWERS

The Act creates new crimes and new penalties for corporate fraud and, notably, provides for imprisonment for up to 20 years for knowingly concealing, destroying or altering documents sought in certain federal investigations. The Act also provides for increased sentences for mail and wire fraud and permits temporary freezes on payments to employees of companies being investigated by the SEC. Additionally, the Act extends the statute of limitations for private securities fraud claims from the earlier of one year after the discovery of the facts constituting the violation or three years after such violation to the earlier of two years after the discovery of the facts constituting the violation or five years after such violation. The Act also gives federal protection to employees of public companies who act as whistle-blowers.

If you have questions regarding this memo or the Sarbanes-Oxley Act of 2002, please call David Fine, Christopher Klem, Keith Higgins, Laurie Churchill or your regular Ropes & Gray contact.