

July 16, 2002

SWEEPING ACCOUNTING REFORM AND CORPORATE GOVERNANCE BILL PASSED BY THE SENATE

To Our Clients and Friends:

On Monday, July 15 the U.S. Senate passed S. 2673 (substituted by the Senate for the text of H.R. 3763) sponsored by Senator Paul Sarbanes (D-MD) by a vote of 97-0.

If signed into law, the Sarbanes bill will significantly increase federal regulation of accounting and corporate governance, will create several new federal crimes and will significantly increase the penalties for certain existing federal crimes.

The bill will soon be sent to a Senate-House conference committee, where it will be reconciled with the accounting and corporate governance bill passed by the House in April, H.R. 3763 sponsored by Rep. Michael Oxley (R-OH).

The provisions of S. 2673, as passed by the Senate, are outlined below. The text of the bill is available at the Thomas website, <http://thomas.loc.gov/bss/d107query.html>.

A. Auditor and Accounting Related Provisions

1. Public Company Accounting Oversight Board. Auditors of public companies and companies offering securities in public offerings ("issuers") are regulated by a newly established "Public Company Accounting Oversight Board" ("Accounting Oversight Board"), a private regulatory entity subject to oversight by the Securities and Exchange Commission ("SEC"). The Accounting Oversight Board is authorized to:

- register and inspect auditors' operations with respect to public companies;
- establish rules governing auditing, quality control, ethics, independence, and other standards related to the preparation of audit reports;
- conduct investigations and disciplinary proceedings;
- impose sanctions on auditors;
- perform other duties necessary or appropriate to promote high professional standards, improve the quality of audit services, protect investors, and further the public interest;
- enforce compliance with the Act, the Accounting Oversight Board's rules, related provisions of the securities laws (and SEC rules), and professional standards; and
- set its budget and manage its operations and staff.

The Accounting Oversight Board is funded by fees assessed against issuers.

2. Audit Records Retention. Auditors are required to retain audit work papers and related documents for a period of up to 7 years. Knowing and willful violations of these requirements, as well as other records retention regulations to be established by the SEC, are subject to up to 5 years imprisonment. As a result of floor amendments, the bill currently contains two provisions addressing audit records retention that will need to be reconciled.

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3. Improper Influence on Audits. It is unlawful to "fraudulently influence" an auditor for the purpose of rendering an audit report materially misleading. The SEC is given sole civil enforcement authority to enforce this provision (*i.e.*, no private cause of action is authorized).

4. Auditor Independence.

- Non-Audit Services. Auditors may not provide the following nine types of non-audit services to audit clients:
 - 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 opinions, 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 service.

The Accounting Oversight Board is authorized to prohibit other non-audit services, and to grant exemptions from the services prohibited on a case-by-case basis.

- Audit Committee Pre-Approval of Audit and Non-audit Services. All audit and non-audit services must be pre-approved by the issuer's audit committee. Pre-approvals for audit-related services may be made in connection with approval of the audit engagement, rather than on a transaction-specific basis. An *de minimus* exception is provided for services that constitute less than 5% of the total revenues paid to the auditor for all services, and that were not recognized to be non-audit services at the time of engagement, if promptly brought to the audit committee's attention and approved prior to completion of the audit.
- Audit Partner Rotation. The lead audit partner and lead review partner must rotate every five years.
- Study on Auditor Rotation. The General Accounting Office (GAO) is required to conduct a study of the effects of mandatory auditor rotation.
- Restrictions on Employment of Auditor Personnel. Restrictions are imposed on the performance of audits by an auditor for issuers whose management was previously employed by the auditor.
- Auditor Communication With Audit Committee. Outside auditors must timely report to audit committees on a number of matters, including accounting disagreements with management.

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5. Accounting Standards. The Financial Accounting Standards Board ("FASB") (or another body recognized by the SEC to establish generally accepted accounting principles) must be supported by fees assessed against issuers, adopt procedures to ensure prompt consideration of changes in accounting principles, consider the need to keep standards current and the extent to which international convergence on accounting standards is necessary, and report annually to the SEC.

The SEC must conduct a study on the adoption in the U.S. of a "principles-based" accounting system.

6. Audit Committees.

The SEC is required to direct the national securities exchanges and national securities associations to require, through listing standards, that the audit committee of each listed company:

- be directly responsible for the appointment, compensation, and oversight of auditors;
- be composed solely of independent directors;
- have in place procedures for receiving accounting complaints and concerns; and
- have authority and appropriate funding to engage independent counsel and other outside advisors.

B. Corporate Accountability and Enforcement Related Provisions

1. Certification of Periodic Reports. In periodic reports containing financial statements filed with the SEC, the chairman of the board, CEO and CFO must certify to the appropriateness of financial statements and disclosures contained in such periodic reports and that those financial statements and disclosures fairly present the company's operations and financial condition. A reckless violation of this provision is punishable by a fine of up to \$500,000 and imprisonment of up to 5 years, and a willful violation is punishable by a fine of up to \$ 1 million and imprisonment of up to 10 years.

2. Officer and Director Bars. The SEC is given the authority to bar an individual who has violated the anti-fraud provisions of the federal securities laws from acting as an officer or director of a public company in administrative cease and desist proceedings if the person's conduct demonstrates unfitness to serve as an officer or director of a public company. The standard that governs imposition of officer and director bars is modified from "substantial unfitness" to "unfitness."

3. Disgorgement Related to Financial Statement Restatements. CEOs and CFOs must disgorge bonuses, other incentive-based compensation and profits on stock sales where there has been material noncompliance with reporting requirements and misconduct that requires a financial restatement.

4. Ban on Loans to Officers and Directors. Personal loans by an issuer to any officer or director of the issuer are prohibited, with an exception provided for certain loans made in the ordinary course of the issuer's consumer credit business that are of the same type and on no more favorable terms than those made available by the issuer to the general public.

5. Statute of Limitations for Securities Fraud. The statute of limitations is extended for private rights of action involving claims of fraud, deceit, manipulation or contrivance in contravention of a regulatory requirement under the securities laws, to the earlier of (i) 2 years after discovery of the facts constituting the violation or (ii) 5 years after such violation. This replaces current statutes of limitations of 1 year and 3 years, respectively.

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6. Whistleblower Protection. Public companies and their employees, contractors, subcontractors or other agents may not discriminate in the terms and conditions of employment with respect to employees who provide information or assist in investigations of securities law violations or who file, testify or participate in, or otherwise assist in proceedings involving alleged violations of the securities laws or SEC regulations or securities fraud.

7. Criminal Provisions

- Document Destruction. Persons who obstruct certain proceedings involving federal departments and agencies and bankruptcy cases by altering, concealing, falsifying or destroying documents and other tangible objects are subject to fines and /or imprisonment of up to 10 years. As a result of floor amendments, the bill currently contains two provisions addressing criminal penalties for document destruction that will need to be reconciled. Also, violations of the bill's audit records retention requirements are punishable by up to 5 years imprisonment.
- Securities Fraud. Persons who commit fraud in connection with public company securities are subject to fines and/or imprisonment of up to 10 years.
- Criminal Conspiracy. The federal conspiracy statute is amended to make conspiracy to commit any federal crime punishable to the same extent as the underlying offense, and to increase the maximum prison sentence for conspiracy to defraud the federal government or any federal agency to 10 years (from 5 years).
- Violations of Certification Requirement. A reckless violation of the bill's certification requirements is punishable by a fine of up to \$500,000 and imprisonment of up to 5 years. A willful violation is punishable by a fine of up to \$ 1 million and imprisonment of up to 10 years.
- Mail and wire fraud. The federal mail and wire statutes are amended to increase the maximum prison sentence to 10 years (from 5 years).
- Review of Federal sentencing guidelines. The United States Sentencing Commission is directed to review the Federal Sentencing Guidelines to ensure that offense levels and sentence enhancements are adequate with respect to obstruction of justice and extensive criminal fraud, fraud and other white collar crimes and securities and accounting fraud and related offenses. As a result of floor amendments, the bill currently contains three provisions addressing review of the Federal Sentencing Guidelines that will need to be reconciled.

8. Insider Trades During Pension Fund Blackout Periods. Insiders are prohibited from purchasing or selling equity securities during "blackout periods" during which employees are not allowed to trade in those securities under their company retirement plans.

9. Dischargeability of Debts in Bankruptcy. Debts arising from claims under federal and state securities laws and common law securities fraud are non-dischargeable in bankruptcy.

10. Temporary Freeze Authority for the SEC. The SEC may, during an investigation into securities law violations by a public company or an officer, director or other affiliate of a public company, seek a temporary order from a federal district court requiring the company to escrow "extraordinary payments" to such person for 45 – 90 days or, if such person is charged with a violation of the securities laws, the expiration of proceedings.

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C. Disclosure Requirements

1. Enhanced Disclosures in Periodic Reports. Additional disclosures are required in periodic reports, including:

- material correcting adjustments that have been identified by an issuer's outside auditor;
- material off-balance sheet transactions; and
- other relationships that may have a material impact on the issuer's financial condition and results of operations.

2. Expedited Disclosure of Insider Transactions. Directors, officers and greater than 10% equity holders must make expedited disclosure (to the SEC by the second day after the transaction) of issuer securities transactions. Effective one year after enactment, disclosures must be made to the SEC electronically and posted on the Internet by the SEC and by the issuer on its corporate website.

3. Management assessment of internal accounting controls. Management must present its assessment of internal accounting controls in each annual report filed with the SEC.

4. Codes of ethics for senior financial officers. The SEC must issue rules requiring issuers to disclose whether or not they have adopted and/or changed the code of ethics for senior financial officers.

5. Audit committee financial expert. The SEC must adopt rules to require an issuer to disclose whether its audit committee includes among its members at least one "financial expert."

D. Other Provisions.

1. Analyst Conflicts of Interest. The SEC (or, upon SEC authorization, the securities associations / exchanges) is required to adopt rules designed to:

- foster greater public confidence in securities research;
- protect the objectivity and independence of stock analysts;
- protect securities analysts from influence by investment banking staff;
- define periods during which broker-dealers participating in public offerings may not publish research or recommendations; and
- require analysts and broker-dealers to disclose potential conflicts of interest, including securities holdings, compensation from issuers and whether the analyst received compensation based on an affiliate's investment banking revenues.

2. SEC Appropriations. Section 35 of the Exchange Act is amended to authorize an appropriation of \$776,000,000 for the SEC for fiscal year 2003.

3. Appearance and Practice before the SEC. The SEC is authorized to censure or deny persons the privilege of appearing or practicing before it based on lack of requisite qualifications, unethical or improper professional conduct or violations of the securities laws.

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4. Professional Conduct Rules for Attorneys. The SEC is directed to establish minimum standards of professional conduct for attorneys practicing before the SEC in representation of public companies, including a requirement that attorneys report evidence of material violations of the securities laws, breaches of fiduciary duty and similar violations by public companies or their agents.

5. Penny Stock Bars. Federal courts are authorized to prohibit persons from participating in penny stock offerings.

6. Qualifications of Associated Persons of Brokers and Dealers. The SEC is authorized to bar from the securities industry persons who have been suspended or barred by a state securities, banking or insurance regulator because of fraudulent, manipulative or deceptive conduct.

7. Study of Credit Rating Agencies. The SEC is required to study the role and function of credit rating agencies in the operation of the securities markets.

8. Study Regarding Consolidation of Accounting Firms. The General Accounting Office (GAO) is required to conduct a study regarding the consolidation of the accounting industry.

9. CEO Signature on Tax Returns. The sense of the Senate is that the federal tax return of a corporation should be signed by the CEO of such corporation.

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