SARBANES-OXLEY: THE NEW CORPORATE STANDARDS

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On July 30, 2002, President George Bush signed the Sarbanes-Oxley Act of 2002 ("Act")[1] to address the weaknesses affecting the capital market and the breakdown of the auditor, corporate-financial, and broker-dealer responsibilities. In the months leading to the Act, there were numerous companies restating their financial statements and involved in corporate scandal. These companies included large, well-established organizations including Enron, Arthur Andersen, K-Mart, Qwest, Grover Crossing, WorldCom, Adelphia, Xerox, Dynergy, CMS Energy, El Paso, Halliburton, Reliant, Merck, Mirant, AOL Time Warner, Duke Energy, and Bristol-Meyers. These are only a few of the large public companies involved in the recent scandals, and there will likely be more to follow.

The Act has been called the federalization of the accounting industry. The Act's principal reforms include the following: (1) establishing an independent accounting oversight board; (2) enacting auditor independence provisions that restrict the non-audit services that accountants may provide to their audit client; (3) enacting standards regarding corporate governance and responsibility; (4) expanding issuer and management disclosure statements; (5) enacting analyst conflict of interest provisions; (6) increasing the Security Exchange Commission's ("SEC") funding and enforcement and requiring various studies and reports; and (7) creating criminal fraud violation statutes relating to securities fraud and enhancing the penalties for fraud offenses.[2]

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[1] Public Law 107-204. In addition to the text of the Act, throughout writing this article, the author consulted Hamilton, Trutman, *Sarbanes-Oxley Act of 2002, Law and Explanation*, CCH Incorporated, 2002.

[2] Act, Section 1.

Although the majority of the requirements in the Act only affect public companies and the professionals rendering services to them,[3] there is a concern that these standards may trickle down. For example, national and/or state accounting organizations may adopt some of the requirements and codes in the Act, and there are several bills currently pending in state legislatures that attempt to do exactly that.[4]

Regardless of whether the Act is extended to non-public companies, the Act's requirements will drastically change the accounting industry and many aspects of the financial workings of public companies. This article summarizes the Act in regulations promulgated thereunder. Because most of the Act's requirements have recently or will soon become effective, it is anybody's guess how the federalization of the accounting industry will work.

Public Company Accounting Oversight Board

Title I of the Act contains the most fundamental reforms and establishes a public company accounting oversight board ("PCAOB"), a regulatory body subject to SEC supervision that is independent of the accounting industry.[5] The PCAOB began operations on April 26, 2003.

Purpose

The PCAOB's purpose is to oversee the audit of public companies subject to federal securities law in order to help ensure the accuracy and independence of financial reporting. Consequently, Title I of the Act only applies to public companies and professionals rendering services to them.

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[3] The Act applies to issuers. Section 2(a)(7) defines issuer as follows:

> The term "issuer" means an issuer (as defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)), the securities of which are registered under section 12 of that Act (15 U.S.C. 781), or that is required to file reports under section 15(d) (15 U.S.C. 78o(d)), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 771[,] *et seq.*), and that it has not withdrawn.

[4] www.aicpa.org.

[5] Act, §§ 101, 107 and 108.

Membership

The PCAOB must have five members that meet certain standards of competence and independence.[6] The PCAOB's members must be prominent individuals of integrity and reputation and must understand: (1) the responsibilities for, and nature of, the financial disclosures required under federal securities law; and (2) the obligations of accountants in preparing and issuing audit reports concerning those disclosures.[7]

The Act restricts the PCAOB's ties to the accounting industry. The Act states that only two members must be or have been certified public accountants.[8] The members must serve on a full-time basis and cannot be employed by any other person or engage in any other professional or business activity.[9] Generally, each PCAOB member will serve a five year term.[10] After some controversy the following five members have been designated.

- William Webster – Initial Chairman – Resigned
- William J. McDonough – Replacement – (designated 4/15/03)
- Daniel Goelzer – 2006
- Kayla Gillan – 2005
- Willis Gradison, Jr. – 2004
- Charles Niemeier – 2003

The PCAOB's Dutyies

Registration

Public accounting firms that prepare audit reports must register with the PCAOB. Beginning 180 days after the SEC determines that the PCAOB is capable of fulfilling its duties, or on October 23, 2003, only public accounting firms that register with the PCAOB may prepare or issue, or participate in preparing or issuing, any audit report concerning any issuer.[11]

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[6] Act, § 101(e).

[7] Act, § 101(e)(1).

[8] Act, § 101(e)(2).

[9] Act, § 101(e)(3).

[10] Act § 101(e)(5).

[11] Act, § 102(a).

Section 102(b) of the Act governs applications for registration. The application requires the accounting firm to submit basic information regarding the firm, its accountants, financial information, and disciplinary proceedings. The registration application must include a consent to cooperate with any investigative measures taken by the PCAOB. Once registered, accounting firms must file periodic reports with the PCAOB. The firm's registration application and subsequent annual reports are subject to public inspection.

Setting Standards

The Act gives the PCAOB authority to set standards for the accounting industry.[12] The PCAOB must adopt rules that establish audit standards, quality control, and ethics standards for accountants.

Auditing Standards. As a part of its auditing standards, the PCAOB must adopt three requirements. First, the PCAOB must establish a requirement that each public accounting firm must prepare or maintain, for at least seven years, audit work papers and other information relating to any audit report in sufficient detail to support the conclusion reached in that report.[13] Second, the PCAOB must require accounting firms to provide a concurring or second partner review of each audit report.[14] Third, the PCAOB must require accounting firms to describe their testing of the client's internal accounting controls as required by § 404(b).[15] Section 404(b) requires that with respect to the internal control assessments, each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under subsection 404(b) shall be made in accordance with standards for attestation engagements issued or adopted by the PCAOB, and any such attestation shall not be the subject of a separate engagement.

The firm must also present: (1) the auditor's findings from the testing; (2) an evaluation of whether the company's internal accounting controls (a) include maintenance of records that in reasonable detail accurately reflect the company's transactions and dispositions of assets, (b) reasonably ensure that the companyies will enable the preparation of GAAP-compliant financial statements, and (c) reasonably ensure that a company's receipts and expenditures received the proper

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[12] Act, § 103.

[13] Act, § 103(a)(2)(A)(i).

[14] Act, § 103(a)(2)(A)(ii).

[15] Act, § 103(a)(2)(A)(iii).

authorization from its management and directors; and (3) a description of any material weakness in those internal controls and of any material non-compliant found based on such testing.[16]

Quality Control. The PCAOB must also adopt quality control requirements. These specifically include the following: (1) monitoring of professional ethics and independence from issuers on behalf of which the firm issues audit reports; (2) consultation within such firm on accounting and auditing questions; (3) supervision of audit work; (4) hiring, professional development, and advancement of personnel; (5) the acceptance and continuation of engagements; (6) internal inspections; and (7) such other requirements as the PCAOB may prescribe.[17]

Authority to Adopt Other Standards. The Act authorizes the PCAOB to adopt standards governing professional and advisory groups.[18] The PCAOB may adopt as its own certain standards developed by a professional group of accountants, adopt other standards, or modify previously adopted standards including those adopted from another professional group.[19]

Advisory Groups. The PCAOB must convene an expert advisory group to help set auditing and other professional standards. These groups may make recommendations concerning the content of auditing, quality control, ethics, independence, or other standard and may include practicing accountants and other experts.[20] The PCAOB must cooperate with these groups on an ongoing basis.[21]

Independent Standard and Rules. The PCAOB must also establish rules as may be necessary or appropriate in the public interest or for the protection of investors, to implement, or as authorized under Title II of the Act.[22] Title II of the Act includes independence standards and rules that are explained in more detail in the following section of this article.

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[16] Act, § 103(a)(2)(A)(iii).

[17] Act, § 103(a)(2)(B).

[18] Act, § 103(a)(3).

[19] Act, § 103(a)(3)(A).

[20] Act, § 103(a)(4).

[21] Act, § 103(c)(1).

[22] Act, § 103(b).

Inspections

The PCAOB has broad powers to inspect accounting firms.[23] The PCAOB must conduct a continuing program of inspections to assess the degree of compliance of each registered public accounting firm and associated persons with the Act, the PCAOB's rules, SEC rules, or professional standards, in connection with the firm's audit work.[24]

The frequency of the PCAOB's inspections depends on the extent of the firm's auditing activity. For registered accounting firms that regularly provide audit reports for more than 100 companies, the PCAOB will conduct annual inspections. For firms that provide audit reports for 100 or fewer companies, the inspections will occur at least once every three years.[25]

In conducting the inspection, the PCAOB must inspect and review selected audits and review engagements of the firm, performed at various offices and by various associated persons, as selected by the PCAOB.[26] The PCAOB must evaluate the sufficiency of the firm's quality control systems, the manner of the systems documentation and communication by the firm.[27] The PCAOB must also perform any other testing of the firm's audit, supervisory, and quality control procedures that are necessary or appropriate.[28] The PCAOB may also impose special record retention rules for inspection purposes.[29]

After an inspection, the PCAOB will issue an inspection report. The firm may respond to the report before a final report is issued.[30] The report is public information; however, confidential information may be redacted.[31] The PCAOB must also transmit a written report of its findings to the SEC and each appropriate

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[23] Act, § 104.

[24] Act, § 104(a).

[25] Act, § 104(b)(1).

[26] Act, § 104(b)(1).

[27] Act, § 104(d)(2).

[28] Act, § 104(d)(3).

[29] Act, § 104(e).

[30] Act, § 104(f).

[31] Act, §§ 104(f) and (g).

state regulatory authority.[32]

An accounting firm may seek review of the report by the SEC, in two circumstances.[33] First, the firm may seek review if it provided the PCAOB with a response to particular items in a draft report, and the firm disagrees to the assessments in the final report following the firm's response.[34] Second, the firm may seek review if it disagrees with the PCAOB's determination that the firm failed to address criticisms or defects identified in the report, within twelve months after the report.[35] The firm has 30 days from the event giving rise to the review to seek review.[36]

Investigation and Disciplinary Actions

Section 105 of the Act requires the PCAOB to establish fair procedures for the investigation and disciplining of registered public accounting firms and associated persons of such firms.[37] The Act gives the PCAOB expansive powers in these areas.

The PCAOB may conduct an investigation of any act, practice, or omission by a registered accounting firm and/or its associated persons that may violate the Act, the PCAOB's rules, the Federal Securities laws, and SEC rules related to the preparing and issuing of audit reports and professional standards.[38] During its investigation, the PCAOB may compel testimony and the production of documents.[39]

The PCAOB may also impose sanctions for a firm's failing to cooperate with the investigation. The sanctions include: (1) suspending or barring a person from his or her association with a registered accounting firm or requiring the firm to end the association; (2) suspending or revoking the firm's registration; and (3) invoking

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[32] Act, § 104(g)(1).

[33] Act, § 104(h).

[34] Act, § 104(h)(1)(A).

[35] Act, § 104(h)(1)(B).

[36] Act, § 104(h).

[37] Act, § 105(a).

[38] Act, § 105(b)(1).

[39] Act, § 105(b)(2).

any other lesser sanctions that the PCAOB deems appropriate.[40]

Although there are disclosure protections regarding information obtained during the course of an investigation, there are exceptions. Generally speaking, documents and information obtained during an investigation are confidential and privileged [§ 105(b)(5)(A)]. Exceptions to the confidentiality and privilege requirements include disclosure to the SEC and, if necessary to accomplish the Act's purposes or to protect investors, to the United States Attorney General, an appropriate federal function regulator, a State Attorney General, and any appropriate State regulatory authority.[41] Moreover, the PCAOB must coordinate its investigations with the SEC's enforcement activities and may refer the investigations to the SEC or other appropriate body. In fact, under § 105(b)(4)(A) the PCAOB must notify the SEC of any pending PCAOB investigation involving a potential violation of the securities laws and coordinate its work with the SEC's enforcement division as necessary to protect an ongoing SEC investigation.

The PCAOB may impose a variety of sanctions for specified violations. The sanctions include the following:

- Temporary suspension or permanent revocation of the firm's registration;
- Temporary or permanent bar of a person from further association with any registered accounting firm;
- Temporary or permanent limitation on the activities, functions, or operations of the firm or person;
- A civil money penalty for each violation of up to $100,000 for individuals and $2,000,000 for firms, except that, for violations involving intentional, reckless, or repeated negligent conduct, the limit is $750,000 for individuals and $15,000,000 for firms;
- Censure;
- Required professional education or training; and
- Any other appropriate sanctions that the PCAOB's rules permit.[42]

The temporary or permanent injunctive remedies listed in the first three items above and the larger of the two civil penalties only apply to the following conduct: (1) intentional or reckless conduct that results in a violation of applicable statutory, regulatory or professional standards; or (2) repeated instances of negligent conduct, each resulting in a violation of applicable statutory, regulatory, or professional

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[40] Act, § 105(b)(3)(A).

[41] Act, § 105(b)(5)(B).

[42] Act, § 105(c)(4).

standards.[43]

The PCAOB may also impose sanctions for failure to supervise. These sanctions may be imposed if the PCAOB finds that (1) the firm failed to reasonably supervise an associated person; and (2) that person violated the Act, the PCAOB's rules, or the Federal Securities laws relating to auditing or professional standards.[44] The Act does provide a safe harbor, however. If the firm established procedures complying with the applicable PCAOB rules that would reasonably be expected to prevent and detect such violations by the associated person and that person's supervisor reasonably discharged his or her duties by reason of those procedures and had no reasonable cause to believe that the procedures were not being complied with, there cannot be a finding that the firm failed reasonably to supervise.[45]

Accounting Standards

The Act formalizes and recognizes the SEC's reliance on principals, standards and practices promulgated by the Financial Accounting Standards Board ("FASB").[46] It also strengthens the independence of FASB by assuring its funding and eliminating any need for it to seek contributions from firms who's financial statements must conform to FASB's rules.

The SEC must conduct a study of the adoption by United States Financial Reporting System of a principal – based accounting system. This is in response to a concern that the overly-detailed approach of the United State standard setters may have delayed the updating of necessary guidance and at the same time drawn the focus of auditors away from the overriding principal that a set of financial statement must fairly and completely reflect the economic results and operations of the company being audited. The SEC must submit a report on the results of that study to Congress within one year from July 30, 2002.[47]

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[43] Act, § 105(c)(5).

[44] Act, § 105(c)(6).

[45] Act, § 105(c)(6)(B).

[46] Act, § 108.

[47] Act, § 108(d).

Auditor Independence

Auditor independence is a critical goal of the Act. Congress argues that an inherent conflict exists because an auditor is paid by the company for which the audit is being performed. In the last decade, the rapid growth in management consulting services offered by the major accounting firms has created a second and arguably more substantial conflict that Congress believes has eroded the auditors' independence. Title II of the Act only applies to accounting firms that audit issuers.[48]

Prohibited Services

In response to the perceived lack of independence, the Act establishes a separation of the auditing function and other consulting functions that accountants can perform. Non-audit services means any professional service provided to a company by a registered public accounting firm, other than those provided to a company in connection with an audit or review of the financial statements of an issuer. Generally, a firm cannot be both an auditor and a consultant.

A public accounting firm registered with the PCAOB that performs an audit of a public company cannot provide, contemporaneously with the audit, the following non-audit services:

- Bookkeeping or other services related to the accounting records or financial statements of the audit client;
- Financial information systems design and implementation;
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- Actuarial services;
- Internal audit outsourcing services;
- Management functions or human resources;
- Broker or dealer, investment advisor, or investment banking services;
- Legal services and expert services unrelated to the audit; and
- Any other services that the PCAOB determines, by regulations, is impermissible.[49]

A registered public accounting firm may engage in any non-audit service, including tax services, that is not described in the previous paragraph for an audit client, *only if* the activity is approved in advance by the audit committee of the

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[48] Act, § 209.

[49] Act, § 201.

issuer. This is discussed in further detail in the following subsection. The SEC adopted rules, in January 2003, providing more detailed guidance on what are prohibited services.[50] These rules should definitely be consulted if an audit firm is performing non-audit services for an issuer.

Audit Committee Pre-approval of Services

Audit services, as well as non-audit services other than those in the Act, must be pre-approved by the audit committee of the company's board of directors. However, a company's audit committee need not pre-approve non-audit services provided by an accounting firm that is not auditing the company. There is also an exception for de minimus engagements.[51]

In January 2003, the SEC adopted amendments to its existing requirements regarding the critical role played by audit committees in the financial reporting process and the unique position of audit committees in assuring auditor independence.[52]

Report to Audit Committee

Congress believes that it is important for the audit committee to be aware of key assumptions underlying a company's financial statement and disagreements that the auditor has with management. Consequently, each registered accounting firm that performs any audit required by Title II of the Act shall in a timely manner report to the audit committee of the issuer the following:

- All critical accounting policies and practices to be used;
- All alternative treatment of financial information within generally accepted accounting ("GAAP") principals that have been discussed with management, ramifications of the use of such alternative disclosures and treatments, and treatment performed by the registered public accounting firm; and
- Other material, written communications between the registered public accounting firm and the management of the issuer, such as any management letter or schedule of any adjusted differences.[53]

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[50] Rule 208, § 208-3.

[51] Act, § 202.

[52] Rule 208, § 208-5.

[53] Act, § 204.

The SEC adopted Rules in January 2003 providing additional guidance on this issue.[54] Examples of additional written communications likely to be considered material to an issuer include:

- Management representation letter;
- Reports on observations and recommendations on internal control;
- Schedule of unadjusted audit differences and a listing of adjustments and reclassifications not recorded, if any;
- Engagement letter; and
- Independence letter.[55]

These examples from the rules are not exhaustive, and accountants are encouraged to consider what additional written communications should be provided to audit committees.

Audit Partner Rotation and Compensation

Although the Act does not require issuers to rotate accounting firms, the firm must rotate its lead or coordinating audit partner and its review partner on audits so that neither role is performed by the same accountant for the same company for more than five consecutive years.[56] SEC adopted rules in January 2003 providing additional guidance on partner rotation.[57] It is important to note that Congress has requested a study from the United States General Accounting offices to review the requirement of rotating the audit firm.[58] Consequently, this may become a requirement in the future.

Rule 208, § 208-6 also contains limitations on accountants being compensated by their firms for selling non-audit products and services to their audit clients. Essentially, this rule prohibits accounting firms from establishing an audit partners' compensation or allocation of partnership units based on the sale of non-audit services to the partners' audit clients. However, firms with fewer than five audit clients that are issuers and fewer than ten partners are exempt from this rule.

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[54] Rule 208, § 208-8.

[55] *Id.*

[56] Act, § 203.

[57] Rule 208, § 208-4.

[58] Act, §§ 203 and 207.

Conflicts of Interest

The Act imposes a one year period that applies to the employees of an accounting firm who worked on the company's audit and subsequently seek to be employed by that company in a senior management capacity. Therefore, an accounting firm may not provide audit services for a public company if that company's chief executive officer, controller, chief financial officer, chief accounting officer, or other individual serving in an equivalent position worked on the company's audit during the year before the start of the audit services. This restriction does not apply if the senior official worked for the auditor, but did not work on that company's audit or if a member of the team is hired by the company for a position that is not considered senior management capacity.[59]

Consistent with Section 206 of the Act, rules adopted by the SEC, in January 2003, restrict employment with audit clients by former employees of the accounting firm.[60] For purposes of this rule, audit procedures are deemed to have commenced for the current audit engagement period the day after the prior year's periodic annual report is filed with the commission. The audit engagement period for the current year is deemed to conclude the day the current year's periodic annual report is filed with the commission.

To illustrate the application of this rule, assume that Issuer A's Forms 10-K are filed on March 15, 2003; April 5, 2004; March 10, 2005; and March 30, 2006. Issuer A is a calendar-year reporting entity. The audit engagement periods would be deemed to commence and end:

Annual Period	Engagement Period Commences	Engagement Period Ends
2003	March 16, 2003	April 5, 2004
2004	April 6, 2004	March 10, 2005
2005	March 11, 2005	March 30, 2006

If audit engagement person B provided audit, review, or attest services for Issuer A *at any time* during the 2003 engagement period (March 16, 2003-April 5, 2004), and he or she begins employment with Issuer A in a financial reporting oversight role prior to March 11, 2005, the accounting firm would be deemed to be not independent with respect to Issuer A.

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[59] Act, § 206.

[60] Rule 208, § 208-2.

Corporate Governance and Responsibility

Reforms involving corporate governance and responsibility are another critical aspect of the Act. Not only does Title III of the Act contain measures to monitor corporations and their auditors, but it also contains harsh penalties for noncompliance.

Audit Committees

The Act requires audit committees to be directly responsible for the appointment, compensation, and oversight of the work of the auditors and defines "audit committee" as a committee established by and among the company's board of directors for the purpose of overseeing the accounting and financial reporting purposes of the company and audits of its financial statements. If there is no such committee with respect to a company, the Act designates the entire board of directors as the audit committee. The public accounting firms must report directly to the audit committee.[61]

Audit committee members must be independent. In order to be considered independent, a member of an audit committee of an issuer may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee, (1) accept any consulting, advisory, or other compensatory fee from the issuer or (2) be an affiliated with the issuer or any subsidiary thereof. If the commission determines it appropriate in the light of the circumstances, the commission may exempt a particular relationship with respect to an audit committee member.[62]

The audit committees must have in place procedures to receive and address complaints regarding accounting, internal control, or auditing issues. The Act provides for the protection for corporate whistleblowers by requiring audit committees to establish procedures for employees' anonymous submission of concerns regarding accounting or auditing matters.[63]

On April 14, 2003, the SEC adopted a final rule to direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the audit committee requirements mandated by the Act. *Standards Relating to Listed Company Audit Committees* are found in Rule 301, which became effective on April 25, 2003.

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[61] Act, § 301.

[62] *Id.*

[63] *Id.*

Under the rule, listed issuers must be in compliance with the new listing rules by the earlier of their first annual shareholders meeting after January 15, 2004, or October 31, 2004. Foreign private issuers and small business issuers have additional time to comply.

Certification of Financial Statements

The Act makes clear that chief executive officers ("CEO's") and chief financial officers ("CFO's") are responsible for the presentation of material in a company's financial reports. CEO's and CFO's are required to certify, in periodic reports containing financial statements filed with the commission, the appropriateness of the financial statements and disclosures contained therein, and that those financials and disclosures fairly present the company's operation and financial condition.[64]

The Act requires that the following must be certified in each annual or quarterly report.

- The signing 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 which are (in light of the circumstances under which such statements were made) not misleading;
- Based on such officer's knowledge, the financial statements and other financial information included in the report should fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report;
- The signing officers:
  - Are responsible for establishing and maintaining internal controls;
  - Have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared;
  - Have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report; and
  - Have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date.

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[64] Act, § 302.

- The signing officers have disclosed to the issuer's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function):
  - All significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize, and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and
  - Any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls.

- 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.[65]

These provisions became effective in August 2002, and on August 29, 2002, the SEC adopted rules regarding these requirements.[66] In January 2003, the SEC adopted additional rules, imposing the § 302 requirements on registered management investment companies.[67] Rule 404 also amends the Act to require issuers to provide the certifications required by §§ 302 and 906 of the Act as exhibits to certain periodic reports. Notably, § 906 of the Act imposes criminal penalties for falsely certifying that a financial statement does not comply with all of the requirements set forth in this section.

Signing Tax Returns

With regard to federal income tax returns, § 1001 of the Act declares that the senate believes that the federal income tax return of a corporation should be signed by its chief executive officer. Although this is not a requirement under the Act, it appears that this may become a requirement in subsequent legislation.

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[65] *Id.*

[66] Rule 302, § 302-2.

[67] Rule 302, § 302-4.

Improper Influence on Audits

The Act makes it unlawful for any officer or director of an issuer, or any other person acting under their direction, to take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of an issuer for the purpose of rendering such financial statements materially misleading.[68] The commission has exclusive authority to enforce this section in any civil proceeding.[69]

As directed by § 303(a) of the Act, the SEC issued a final rule, effective June 27, 2003, to implement these requirements.[70] The rules, in combination with the existing rules under Regulation 13B-2, are designed to ensure that management makes open and full disclosures to, and has honest discussions with, the auditor of the issuer's financial statements.

Forfeiture of Bonuses and Profits and Funds for Investors

The Act includes provisions designed to prevent CEO's and CFO's from making large profits by selling company stock or receiving company bonuses while misleading the public about the poor financial health of the company. Specifically, the Act requires that in the case of accounting statements that result from material non-compliance with SEC reporting requirements, CEO's and CFO's must disgorge bonuses and other incentive-based compensation and profit, if the non-compliance results from misconduct. The disgorgement applies to amounts received for the twelve months after the first public issuance or filing of a financial document embodying such financial reporting requirement. The SEC may exempt any person from the application of the requirements discussed in this paragraph, as it deems necessary and appropriate.

Additionally, § 308 of the Act takes the civil penalties levied by the SEC as a result of any judicial or administrative action and directs them to a disgorgement fund for the benefit of the harmed investors. It also authorizes the SEC to accept gifts and bequests for the fund. Moreover, the SEC must develop methods to improve collection rates and prepare a report regarding the same.[71]

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[68] § 303(a).

[69] Act, § 303(b).

[70] Rule 303.

[71] Act, § 308.

Officer and Director Bar

The SEC may bar persons from serving as officers or directors if they committed a securities law violation and/or exhibited conduct unfit to serve as an officer or director. Therefore, now, the SEC may bar an officer or director, where the commission has not yet instituted an enforcement action.[72]

Prohibition of Insider Trades During Pension Fund Blackout

Section 305 contains some of the Act's most widely-publicized reforms. It prohibits key individuals, such as directors and executive officers, from engaging in transactions involving any equity security of the issuer acquired in connection with service or employment as a director or executive officer during a blackout period when at least half of the issuer's individual account plan participants are not permitted to purchase, sell, or otherwise transfer their interest in that equity security. Participants in Section 401(k) retirement plan must receive written notice at least thirty (30) days before a blackout.[73]

On January 22, 2003, the SEC adopted final rules regarding this issue.[74] The rules specify the content and timing of the notice that issuers must provide to their directors, executive officers, and the SEC about a blackout period. The rules also define key terms and provide exemptions from the rule and exceptions to the blackout period. Finally, the rules provide guidance on bringing actions for profit in violation of the rules.

Attorney Professional Responsibility

One of the more controversial reforms in the Act involves attorney professional responsibility. Critics have commented that some of the Act's requirements contradict the attorney-client privilege. A lawyer who learns of certain legal violations by a corporation would have to report evidence of a material violation of securities law, breach of fiduciary duty, or similar violation by the company or one of its agents to the chief legal counsel or CEO of the company. If the counsel or officer does not appropriately respond , the attorney must report the evidence to the board's audit committee or to another board committee comprised solely of directors not employed directly or indirectly by the

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[72] Act, § 1105.

[73] Act, § 306.

[74] Rule 306.

company or to the board of directors.[75]

In January 2003, the SEC adopted a final rule establishing standards of professional conduct for attorneys who appear and practice before the Commission on behalf of issuers.[76] The rules provide guidance on terms in the Act and rules, including "appearing and practicing before the commission," "appropriate response," "breach of a fiduciary duty," "evidence of a material violation," and "in the representation of an issuer." In certain situations, such as "self-defense" or certain future misconduct, the rules allow an attorney to disclose issuer confidences. The rule also includes guidance on responsibilities of supervisory and subordinate attorneys. Finally, the rules set forth sanctions and discipline for violating the rules. The SEC is still considering the "noisy withdrawal" provisions of its original proposal under § 307.

Enhanced Financial Disclosure

The Act imposes enhanced financial disclosures. These requirements generally apply to financial statements filed with the SEC. However, there is an exception for registered investment companies.

Disclosures in Periodic Reports

The Act requires that financial statements filed with the SEC reflect any material adjustment under GAAP that the auditor identifies. It also requires annual and quarterly reports filed with the SEC to disclose all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the company with unconsolidated entities or other persons that may have a material current or future affect on financial conditions, changes in financial conditions, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses.[77]

Congress also sought to address the problems with pro forma financial disclosures by having the SEC adopt rules requiring that companies publish pro forma data with a reconciliation to comparable financial data calculated according to GAAP in a way that is not misleading and does not contain untrue statements.[78]

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[75] Act, § 307.

[76] Rule 307.

[77] Act, § 401.

[78] Act, § 401.

In January 2003, the SEC adopted amendments to its rules to require disclosure of off-balance sheet arrangements.[79] The amendments require a registrant to provide an explanation of its off-balance sheet arrangements in a separately captioned subsection of the "Management's Discussion and Analysis" ("MD&A") section of a registrant's disclosure documents. The SEC adopted disclosure requirements that are more consistent with the principles-based approach found in MD&A rules. The principle throughout the amendments is that the registrant should disclose information to the extent that it is necessary to an understanding of a registrant's material off-balance sheet arrangements and their material effects on financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures, or capital resources. Consistent with traditional MD&A disclosure, management has the responsibility to identify and address the key variables and other qualitative and quantitative factors that are peculiar to, and necessary for, an understanding and evaluation of the company. The amendments contain the following four specific items to bolster the principles-based approach. These items require disclosure of the following information to the extent necessary for an understanding of a registrant's off-balance sheet arrangements and their effects:

- The nature and business purpose of the registrant's off-balance sheet arrangements;
- The importance of the off-balance sheet arrangements to the registrant for liquidity, capital resources, market risk or credit risk support, or other benefits;
- The financial impact of the arrangements on the registrant (*e.g.*, revenues, expenses, cash flows, or securities issued) and the registrant's exposure to risk as a result of the arrangements (*e.g.*, retained interests or contingent liabilities); and
- Known events, demands, commitments, trends, or uncertainties that affect the availability or benefits to the registrant of material off-balance sheet arrangements.

In addition, the amendments require the registrant to provide any other information that it believes to be necessary for an understanding of its off-balance sheet arrangements and their material effects on the registrant's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures, or capital resources. The amendments also require registrants (other than small business issuers) to provide an overview of certain known contractual obligations in a tabular format.

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[79] Rule 401(a).

Registrants must comply with the off-balance sheet arrangement disclosure requirements in registration statements, annual reports, and proxy or information statements that are required to include financial statements for their fiscal years ending on or after June 15, 2003. Registrants (other than small business issuers) must include the table of contractual obligations in registration statements, annual reports, and proxy or information statements that are required to include financial statements for the fiscal years ending on or after December 15, 2003. Registrants may voluntarily comply with the new disclosure requirements before the compliance dates.

On March 28, 2003, Rule 401(b) became effective. This rule provides guidance for use of non-GAAP financial measures. Specifically, the rules address public companies' disclosure or release of certain financial information that is calculated and presented on the basis of methodologies other than GAAP. A new disclosure regulation, Regulation G, will require public companies that disclose or release such non-GAAP financial measures to include in that disclosure or release a presentation of the most directly comparable GAAP financial measure and a reconciliation of the disclosed non-GAAP financial measure to the most directly comparable GAAP financial measure. The rules also contain amendments to current law which provide additional guidance to those registrants that include non-GAAP financial measures in commission filings.

The Act also directs the SEC to conduct a comprehensive study on all aspects of special purpose entities ("SPE"), the potential exposure faced by investors due to them, whether they should be disclosed on company balance sheets, if the material participation requirements are adequate, and if FASB's guidance on SPEs are sufficient to protect investors. The SEC must make recommendations to congress on SPEs to provide transparency and protection to investors if it determines that FASB's rules are insufficient.[80]

Loans to Executives

Section 402 of the Act prohibits loans by a public company to any of its directors or executive officers. This prohibition is designed to sharply limit the types of hidden compensation that can be offered to executives without being disclosed to shareholders.

There are several exceptions to this prohibition, however. For example, the prohibition does not apply the loans to corporate executives that are currently outstanding. Also, credit and charge cards issued by businesses to their employees

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[80] Act, § 401.

will not be subject to the loan prohibition, nor will margin loans for personal securities brokerage accounts held by employers of a brokerage firm. There are also exemptions for home improvement and manufactured home loans. Finally, loans by a financial institution to their employees that are already subject to regulation by the federal reserve are exempt.[81]

Insider Transactions

Currently, insiders are required to report trades by the tenth day of the month following the month in which the transaction was executed. The Act amends that requirement and requires directors, officers, and ten percent equity holders to report their purchases and sales of securities more promptly, or by the end of the second day following the transaction or such other time established by the SEC where the two-day period is not feasible.[82]

On August 29, 2002, the SEC adopted rules regarding disclosure of these transactions.[83] The rules apply to transactions which occur on or after August 29, 2002. Within one year of enactment of the Act, the three additional requirements go into effect:

- The two-day statement reporting insider transactions must be filed electronically;
- The SEC must provide a two-day statement on a publicly accessible Internet site by the end of the business day following the filing; and
- The company, if it maintains a corporate website, must provide the statement on that website by the end of the business day following the filing.[84]

Internal Controls

To enhance the quality of reporting and increase investor confidence, the Act requires that annual reports filed with the SEC must be accompanied by a statement by company management that management is responsible for creating and maintaining adequate internal controls. Management must also present its

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[81] Act, § 402.

[82] Act, § 403.

[83] Rules 403 and 403ET.

[84] Act, § 403.

assessment of the effectiveness of those controls.[85] The company's auditor must also report on and attest to management assessment of the company's internal controls. Congress intends that the auditors' assessment should be considered an integral part of the audit report.

The SEC adopted final rules regarding management's reports on internal control over financial reporting and certification of disclosure in Exchange Act Periodic Reports.[86] The rules provided additional guidance regarding the reporting requirements of § 404 of the Act, which applies to issuers other than registered investment companies, regarding the management report on the company's internal control over financial reporting. The internal control report must include: (1) a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company; (2) management's assessments of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year; (3) a statement identifying the framework used by management to evaluate the effectiveness of the company's internal control over financial reporting; and (4) a statement that any registered public accounting firm that audited the company's financial statements that were included in the annual report has issued an attestation report on management's assessments of the company's internal control over financial reporting. Under the new rules, a company is required to file the registered public accounting firm's attestation report as a part of the annual report. There is also a requirement that management evaluate any change in the company's internal control over financial reporting that occurred during the fiscal quarter that has materially affected, or has reasonably likely to materially affect, the company's internal control over financial reporting.

Financial Officer Code of Ethics

The Act requires companies to disclose whether or not they have adopted a code of ethics for senior financial officers and, if not, why. It also requires immediate disclosure of any change in or waiver of the company's code of ethics. Disclosures may be made by filing a Form 8-K with the SEC by the Internet or other electronic means.[87]

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[85] Act, § 404.

[86] Rule 404.

[87] Act, § 406.

In January 2003, the SEC adopted final rules and amendments regarding § 406.[88] The rules define the term "code of ethics" and require a company to include the new code of ethics disclosure in its annual report filed on Form 10-K, 10-KSB, 20-F or 40-F, and, under certain circumstances, disclosure is also required on Form 8-K or the Internet Regarding Changes to, or Waivers from, the Code of Ethics.

Audit Committee Financial Expert

The Act requires the SEC to adopt rules requiring companies to disclose whether their audit committees include at least one financial expert. A financial expert must understand GAAP and financial statements, have experience preparing or auditing financial statements, and have experience with internal accounting controls and understand audit committee functions.[89]

In January 2003, the SEC adopted final rules and amendments to require a company to disclose whether it has at least one "audit committee financial expert" serving on its audit committee, and if so, the name of the expert and whether the expert is independent of management.[90] A company that does not have an audit committee financial expert must disclose this fact and explain why it has no such expert. The rules also provide guidance on defining the term "audit committee financial expert" and disclosure of the number of experts and their independence from management.

Companies, other than small business issuers, must comply with the audit committee financial expert disclosure requirements promulgated under § 407 of the Act in their annual reports for fiscal years ending on or after July 15, 2003. Small business issuers must comply with the audit committee financial expert disclosure requirements in their annual reports for fiscal years ending on or after December 15, 2003.

Enhanced SEC Review of Disclosures and Real Time Filing

Under § 408, the SEC must regularly and systematically review corporate filings, at least once every three years. Section 409 requires companies to disclose, in plain English, additional information concerning material changes in their financial conditions or operations on a rapid and current basis.

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[88] Rule 406/407; Rule RMIC.

[89] Act, § 407.

[90] Rule 406/407; Rule RMIC.

Analysts Conflict of Interest

Title V of the Act contains provisions attempting to reduce or eliminate potential analysts' conflict of interest. Section 501 requires the SEC or registered securities association or national securities exchange, within one year, to adopt rules designed to address conflicts of interest facing securities analyst. The rules must be designed to foster greater public confidence in securities research and protect the objectivity and independence of stock analysts who publish research intended for the public by doing the following:

- Restricting the pre-publication clearance of such research or recommendation by investment banking or other staff not directly responsible for investment research;
- Limiting the supervision and compensatory valuation of such research personnel to officials not engaged in the investment banking activity; and
- Protecting securities analysts from retaliation or threats of retaliation by investment banking staff because of negative research reports, provided that the rule cannot limit the authority of a broker or dealer to discipline a securities analyst for causes other than such report in accordance with the firm's policies and procedures.[91]

The rules must also define periods during which brokers and dealers who participate in a public offering of securities as underwriters or dealers cannot publish research recommendations about the company's securities. The rules must also define periods during which brokers or dealers participating in a public offering as underwriters or dealers should not distribute research reports relating to the issuer securities.[92]

SEC Resources and Authority and Future Studies and Reports

The Act generally gives the SEC authority to promulgate rules consistent with the Act and provide that a violation of the Act or of any rule of the Commission or of the new PCAOB will be treated for all purposes as a violation of the Exchange Act and rules there under.[93] So that the SEC may carry out its obligations under the Act, congress has increased its resources. Under § 601, appropriations of $776 million dollars were authorized for the SEC for fiscal year 2003.

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[91] Act, § 501.

[92] *Id.*

[93] Act, § 3.

Practice Before the Commission

The SEC also has a procedure to discipline professionals, including accountants, who lack the requisite qualifications to practice before the commission. The Act codifies the SEC's authority to censure or deny, temporarily or permanently, the privilege of appearing or practicing before it to any person whom the SEC, after notice and an opportunity for hearing, finds that: (1) does not possess the requisite qualifications to represent others; (2) is lacking in character or integrity or has engaged in unethical or improper professional conduct; or (3) has willfully violated, or willfully aided and abided the violation of, any provision of the federal securities laws or the rules and regulations thereunder.[94]

Penny Stock Bar

The Act authorizes federal courts to impose a penny stock bar, conditionally or unconditionally and temporarily or permanently, to prohibit a person from participating in a penny stock offering.[95] Under current law, the penny stock bar is available only through administrative proceedings.

Securities Industry Bar

In order to reduce the migration of fraud perpetrators into the securities industry, the SEC is authorized to bar from the securities industry persons suspended or barred by the state securities, banking, or insurance regulator because of fraudulent, manipulative, or deceptive conduct.[96]

Freeze Authority

The SEC is allowed, during an investigation, to seek an order in federal court imposing a 45-day freeze on extraordinary payments to corporate executives. The order can be extended upon a showing of good cause. This provision is designed to prevent corporate executives from enriching themselves while a company is subject to a SEC investigation, but before the SEC gathers sufficient evidence to file formal charges.[97]

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[94] Act, § 602.

[95] Act, § 603.

[96] Act, § 604.

[97] Act, § 1103.

Future Reports

The Act mandates a number of studies and reports, including:

- The consolidation of accounting firms and its impact on the quality of audit services, audit costs, auditor independence, or other problems for businesses[98] (GAO);
- An examination of the role of credit rating agencies[99] (SEC);
- A review othe number of securities professionals who have been found to have aided and abetted a violation of the federal securities laws, but who have not been sanctioned, disciplined, or otherwise penalized as a primary violator in any administrative action or civil proceeding and who have been found to have been primary violators of the federal securities laws[100] (SEC);
- A review of all enforcement actions involving violations of securities laws reporting requirements and all financial statements over the past five years[101] (SEC);
- A study of the role of investment bank and financial advisors assisting public companies and manipulating their earnings and hiding their true financial condition[102] (SEC);
- Mandatory rotation of audit firms[103] (GAO);
- Potential for adoption of principles-based accounting system[104] (SEC);
- Disgorgement remedies and SEC's actions[105] (SEC); and
- Role of SPEs and off-balance sheet transactions[106] (SEC).

These reports are of particular interest because there may be subsequent reforms in these areas based upon the findings of the studies.

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[98] Act, § 701.

[99] Act, § 702.

[100] Act, § 703.

[101] Act, § 704.

[102] Act, § 705.

[103] Act, §§ 203 and 207.

[104] Act, § 108.

[105] Act, § 308.

[106] Act, § 401.

Fraud and Criminal Penalties[107]

Titles XIII and IX of the Act contain numerous measures regarding corporate and criminal fraud accountability and white-collar crime penalty enhancement. It is important to note that other than the provisions specifically limited to public companies, the criminal provisions and penalties may apply to individuals and entities not subject to the Act.

Securities Fraud

Section 807 of the Act creates a violation for defrauding shareholders of publicly traded companies, which is codified at 18 U.S.C. § 1348. This provision complements existing securities law. The statute requires a nexus to certain types of securities; no proof of the use of the mails or wires is required. The text of the new section provides:

> Whoever knowingly executes, or attempts to execute, a scheme or artifice–
>
> (1) to defraud any person in connection with any security of an issuer with a class of securities registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 781) or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 780(d)); or
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> (2) to obtain, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale of any security of an issuer with a class of securities registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 781) or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 780(d));
>
> shall be fined under this title, or imprisoned not more than 25 years, or both.

Section 804 of the Act extends the statute of limitations for securities fraud, in civil actions, to not later than the earlier of two years after the discovery of the facts constituting the violation or five years after said violation. This extension is not limited to the companies to which 18 U.S.C. § 1348 applies.

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[107] In addition to the cited provisions in the Act, the author also extensively consulted the Attorney General's August 1, 2002 memorandum on the Sarbanes-Oxley Act of 2002.

Obstruction of Justice

18 U.S.C. § 1519

Section 802 of the Act adds two new criminal provisions, 18 U.S.C. §§ 1519 and 1520. Section 1519 expands existing obstruction law to cover the alteration, destruction, or falsification of records, documents, or tangible objects, by any person, with intent to impede, obstruct, or influence the investigation or proper administration of any "matters" within the jurisdiction of any department or agency of the United States, or any bankruptcy proceeding, or in relation to or contemplation of any such matter or proceeding. This section explicitly reaches activities by an individual "in relation to or contemplation of" any matters. No corrupt persuasion is required. New § 1519 should be read in conjunction with the amendment to 18 U.S.C. § 1512 added by § 1102 of the Act, which similarly bars corrupt acts to destroy, alter, mutilate, or conceal evidence, in contemplation of an "official proceeding." New 18 U.S.C. § 1519 provides:

> Whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or any case filed under title 11, or in relation to or contemplation of any such matter or case, shall be fined under this tile, imprisoned not more than 20 years, or both.

Rule 802 provides further guidance regarding the retention of records relevant to audits and reviews. Consistent with the Act, the rules require accounting firms to retain for seven years certain records relevant to their audits in reviews of issuers' financial statements. Records to be retained include an accounting firm's work papers and certain other documents that contain conclusions, opinions, analyses, or financial data related to the audit or review.

18 U.S.C. § 1512

Prior to the Act, anyone who "corruptly persuades" others to destroy, alter, or conceal evidence could be prosecuted under 18 U.S.C. § 1512. Section 1512 addressed destruction of evidence with intent to obstruct an official proceeding which may not yet have been commenced. However, § 1512 did not deal with the "individual shredder." While prosecution of obstruction under 18 U.S.C. § 1505 does not require "corrupt persuasion," it does require the existence of a pending proceeding. In addition, existing law did not explicitly address the retention of accounting work papers for a fixed period of time.

Section 1102 of the Act adds new subsection (c) to § 1512, which imposes a fine and/or a term of imprisonment of up to 20 years on any person who corruptly alters, destroys, mutilates, or conceals a record, document, or other object with the intent to impair the object's integrity or availability for use in an official proceeding, or who otherwise obstructs, influences, or impedes an official proceeding. The term "corruptly" shall be construed as requiring proof of a criminal state of mind on the part of the defendant. New Section 1512(c) provides:

> (c) Whoever corruptly –
>
> (1) alters, destroys, mutilates, or conceals a record, document, or other object, or attempts to do so, with the intent to impair the object's integrity or availability for use in an official proceeding; or
>
> (2) otherwise obstructs, influences, or impedes any official proceeding, or attempts to do so,
>
> shall be fined under this title or imprisoned not more than 20 years, or both.

18 U.S.C. § 1520

Accountants who failed to retain the audit or review work papers of a covered audit for a period of five years will violate Section 1520, which creates a new felony with a maximum period of incarceration of ten years. New 18 U.S.C. § 1520 provides:

> (a)(1) Any accountant who conducts an audit of an issuer of securities to which section 10A(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78j-l(a)) applies, shall maintain all audit or review work papers for a period of 5 years from the end of the fiscal period in which the audit or review was concluded.
>
> (2) The Securities and Exchange Commission shall promulgate, within 180 days, after adequate notice and an opportunity for comment, such rules and regulations, as are reasonably necessary, relating to the retention of relevant records such as work papers, documents that form the basis of an audit or review, memoranda, correspondence, communications, other documents, and records (including electronic records) which are created, sent, or received in connection with an audit or review and contain conclusions, opinions, analyses, or financial data relating to such an audit or review, which is conducted by any accountant who conducts an audit of an issuer of securities to which section 10A(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78j-l(a)) applies. . . .

(b) Whoever knowingly and willfully violates subsection(a)(l), or any rule or regulation promulgated by the Securities and Exchange Commission under subsection (a)(2), shall be fined under this title, imprisoned not more than 10 years, or both.

(c) Nothing in this section shall be deemed to diminish or relieve any person of any other duty or obligation imposed by Federal or State law or regulation to maintain, or refrain from destroying, any document.

Certification of Financial Reports

Section 906 enacts new 18 U.S.C. § 1350, which creates a requirement that the chief executive officer and the chief financial officer (or the equivalent thereof) of the issuer provide a statement which certifies that the periodic reports containing the financial statements, filed by an issuer with the SEC, fully comply with the requirements of Sections 13(a) and 15(d) of the Securities Exchange Act of 1934, and that the information contained in the periodic reports fairly presents in all material respects, the financial condition and results of operations of the issuer. Certifying a report knowing that it does not comport with all of the requirements of § 1350, is punishable by a fine of not more than $1,000,000 and imprisonment of up to ten years. A willful violation is punishable by a fine of not more than $5,000,000 and imprisonment of up to 20 years. New Section 1350 provides:

(a) Certification of Periodic Financial Reports. – Each periodic report containing financial statements filed by an issuer with the Securities Exchange Commission pursuant to section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(a) or 78O(d) shall be accompanied by a written statement by the chief executive officer and chief financial officer (or equivalent thereof) of the issuer.

(b) Content. – The statement required under subsection (a) shall certify that the periodic report containing the financial statements fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) and that information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer.

(c) Criminal Penalties. – Whoever

(1) certifies any statement as set forth in subsections (a) and (b) of this section knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than $1,000,000 or imprisoned not more than 10 years, or both; or

(2) willfully certifies any statement as set forth in subsections (a) and (b) of this section knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than $5,000,000, or imprisoned not more than 20 years, or both.

Attempts and Conspiracy

Previously, under Chapter 63 (Mail Fraud) of Title XVIIIconspiracies to violate the mail fraud statute (§ 1341), the wire fraud statute (§ 1343), the bank fraud statute (§ 1344), and the health care fraud statute (§ 1347) were punishable by a maximum five-year sentence. The wire fraud offense did not explicitly address "attempts" to commit the substantive offense. However, this was not an impediment in practice, because proof of a scheme to defraud did not necessarily require proof that the scheme was successful.

New 18 U.S.C. § 1349 provides that attempts and conspiracies to commit the substantive federal fraud offenses listed above, as well as the new securities fraud offense, will have the same maximum punishment as the substantive crime. This section also effectively adds an "attempt" to commit the wire fraud offense as a federal crime. The remainder of the fraud statutes listed above already include "attempts." New 18 U.S.C. § 1349 provides:

> Any person who attempts or conspires to commit any offense under this chapter shall be subject to the same penalties as those prescribed for the offense, the commission of which was the object of the attempt or conspiracy.[108]

Whistle Blower Protection

Section 806 of the Act provides for federal protection for whistle blowers and employees of public companies when they act lawfully to disclose information about fraudulent activities within their company. The statute specifically protects employees taking lawful steps to disclose information or otherwise assist criminal investigators, federal regulators, Congress, supervisors, other people within a corporation, or parties in a judicial proceeding in detecting and stopping fraud. If the employer takes illegal action in retaliation for lawful and protected conduct, the statute allows the employee to file a complaint with the Department of Labor. The employee can also bring the matter to federal court in certain situations. Section 1107 of the Act also makes it a federal criminal offense to protect from retaliation

[108] Act, § 902.

an individual who provides truthful information to law enforcement concerning the commission or possible commission of a federal offense.

Bankruptcy Discharge

The Act protects victims of securities fraud by amending the Bankruptcy Code to make judgments and settlement stays under securities law violations non-dischargeable.[109]

Penalties and Sentencing Guidelines

In addition to new crimes, the Act imposes harsher penalties for securities fraud related crimes. The Act also directs the United States sentencing commission ("Sentencing Commission") to review the United States sentencing guidelines ("USSG") of obstruction of justice and extensive criminal fraud.[110]

Amendments to the Sentencing Guidelines

In response to concerns of whether the USSG sufficiently address white collar offenses and offenses related to securities, accounting, and pension fraud, §§ 905 and 1104 of the Act directed the Sentencing Commission to amend the USSG within 180 days of the enactment of the Act. Consequently, on April 16, 2003, the Sentencing Commission approved amendments to the USSG. Under certain circumstances, defendants convicted under federal fraud laws will face higher sentences. The amendments will become effective November 1 unless Congress takes action to block or change them.

> **Fraud Offenses**. With regard to fraud offenses, the Sentencing Commission adopted an emergency amendment to implement the Act and followed up with a proposal to make the amendment or some variant of it permanent. The proposal tracks the emergency amendment by extending the upper end of the table in U.S.S.G. § 2B1.1(b)(1), which adds incremental offense-level increases tied to loss amounts. Previously, the table topped out at a 26-level boost for a loss of more than $100 million. The proposed amendment would make permanent the addition of two more increments: increases of 28 and 30 levels for loss amounts greater than $200 million and $400 million, respectively. Similarly, the proposed amendment would make permanent the emergency changes to the tax loss table, U.S.S.G. § 2T4.1, which added

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[109] Act, § 803.

[110] Act, § 805.

boosts of 34 and 36 levels for losses greater than $200 million and $400 million, respectively.

Moreover, the base offense level for defendants whose offenses of conviction are covered by § 2B1.1 will become seven, rather than six, if the offense of conviction "has a statutory maximum term of imprisonment of 20 years or more." After the Act, that category includes mail and wire fraud and numerous securities law violations.

The Sentencing Commission also decided to expand a provision that, as set out in the emergency amendment as U.S.S.G. § 2B1.1(b)(13), adds four levels if the offense involved a violation of securities law and the defendant was an officer or director of a publicly traded company. Under the amendment that will go to Congress, this provision also applies if the defendant was a registered broker or dealer, an investment adviser, or a person associated with a broker, dealer, or investment adviser. The same increase is provided if the offense involved a violation of commodities law and the defendant was an officer or director of a futures commission merchant, an introducing broker, a commodities trading adviser, or a commodity pool operator.

The emergency amendment, U.S.S.G. § 1B1.1(b)(2)(C), added a six-level enhancement for fraud and theft cases involving more than 250 victims. It also extended the reach of a four-level increase that applied to offenses that "substantially jeopardized the safety and soundness of a financial institution." The latter provision was made applicable to cases in which the offense substantially endangered the solvency or financial security of 100 or more victims or of an organization that, at any time during the offense, either had 1,000 or more employees or was a publicly traded company. The proposed permanent amendment retains these changes but would also provide that their cumulative effect shall not exceed an eight-level increase, unless that boost is insufficient to bring the offense level to 24.

Obstruction Offenses. With regard to obstruction offenses, the proposed amendment would carry forward, with one addition. The new offense created by the Act for "destruction, alteration, or falsification of records in federal investigations and bankruptcy" would be assigned to the guideline on obstruction of justice.

The amendment provides for a two-level enhancement if the offense "(A) involved the destruction, alteration, or fabrication of a substantial number of records, documents, or tangible objects; (B) involved the selection of any essential or especially probative record, document, or tangible object, to destroy or alter; or (C) was otherwise extensive in scope, planning, or preparation. . . ." More

generally, the amendment would increase the base offense level for obstruction crimes from 12 to 14.

Under the proposed amendment new 18 U.S.C. § 1520, which covers destruction of corporate audit records, is assigned to a guideline provision that governs false statements in certain required records, U.S.S.G. § 2E5.3. That provision has a lower base offense level than the obstruction guideline, but it would be amended to trigger the obstruction guideline if the offense was committed to facilitate or conceal an obstruction-of-justice offense. The one addition to the text of the obstruction guidelines is a proposed increase, from 12 to 14, of the base offense level provided by U.S.S.G. § 2J1.3 for perjury, subornation of perjury, and bribery of witnesses.

Criminal Penalties for Mail and Wire Fraud

Section 903 of the Act amends 18 U.S.C. §§ 1341 and 1343 by increasing the maximum five-year penalty for mail or wire fraud to 20 years. The maximum term of incarceration for fraud affecting a financial institution remains at a maximum of 30 years.

Criminal Penalties for Violations of the Employee Retirement and Security Act of 1974

Section 904 of the Act increases the fines in 29 U.S.C. § 1131 which punishes any person who willfully violates the reporting and disclosure requirements concerning employee benefit plans as set forth in 29 U.S.C. §§ 1021 through 1031, or any regulation or order issued thereunder. Previously, the maximum punishment was a fine and/or a term of imprisonment not to exceed one year. The amendment increases the fines to $100,000 for an individual and $500,000 for a person other than an individual. It also increases the maximum term of imprisonment from one year to ten years.

Exchange Act

Section 1106 of the Act amends the Securities Exchange Act of 1934, and specifically 15 U.S.C. § 78ff, so that the maximum fine is increased to $5,000,000 for individuals and $25,000,000 for anyone other than individual. Section 1106 also raises the maximum term of imprisonment to 20 years.

Conclusion

The Act contains sweeping reforms. Not only do its reforms reach the accounting industry, but they also drastically affect public companies, their

attorneys, and other professionals. It may reach even more professionals and entities if state legislatures, local and state agencies, and professional boards expand the Act's reach.

Although the Act was enacted in July 2002 and the majority of the related rules have been promulgated, there are still outstanding rules and studies. Perhaps one of the most anticipated items is the operation of the PCAOB and the requirements imposed on firms registering with it. The following are some of the websites that can be accessed for tracking the developments regarding the Act.

PCAOB On Line www.pcaob.com
PCAOB Official Website www.pcaobus.org
SEC Website www.sec.gov
AICPA Website www.aicpa.org

Overall, there are still many unanswered questions under the Act. It will be interesting to see how, and if, the federalization of the accounting industry will work.