



The New World of Corporate Responsibility

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The Sarbanes-Oxley Act, NYSE Listing
Requirements, and NASDAQ Proposals

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Sarbanes Oxley

AN OVERVIEW



Background



- The Sarbanes-Oxley Act of 2002 was approved by near unanimous vote in Congress (vote of 99-0 in the Senate and 423-3 in the House) and cleared the joint conference committee within a short period of one week
- Enron bankruptcy and related issues provided the impetus for Congress to act. The WorldCom accounting scandal and bankruptcy accelerated the pace with which the legislation was drafted
- The Bill was signed by President Bush on July 30, 2002 and several of the provisions became effective immediately and others will follow in the next several months
- Given the fast pace with which the Act was debated and approved the full impact of the Act is not likely to be appreciated immediately and there is going to be a need for numerous interpretations and explanations
- The Act has the potential to have far reaching impact on Corporate Governance and Conduct, Financial Reporting and the Public Accounting Profession
- The Act has provisions which impact legal community and investment banking analysts

Background (cont.)



- Several provisions of the Act require detailed regulations to be formulated by the SEC and other regulatory bodies
- The Act aims to restore investor confidence in financial reporting and public capital markets
- Broadly speaking the Act's provisions seem to be built around the following principles:
 - Independence
 - Integrity
 - Proper Oversight
 - Accountability
 - Strong Internal Controls
 - Transparency
 - Deterrence

Sarbanes-Oxley Act of 2002



The Act was signed into law on July 30, 2002 and includes eleven titled sections:

- Title I Public Company Accounting Oversight Board
- Title II Auditor Independence
- Title III Corporate Responsibility
- Title IV Enhanced Financial Disclosures
- Title V Analyst Conflicts of Interest
- Title VI Commission Resources and Authority
- Title VII Studies and Reports
- Title VIII Corporate and Criminal Fraud Accountability
- Title IX White Collar Crime Penalty Enhancements
- Title X Corporate Tax Returns
- Title XI Corporate Fraud and Accountability

Note – Some of the Act's provisions contemplate the issuance of corresponding SEC regulations or interpretive releases.

NYSE Listing Requirements

AN OVERVIEW



Introduction



- Board of Directors of NYSE approved new proposals in August
 - Heightened corporate governance standards through additional listing requirements
 - SEC, after public comment period, will vote to approve proposals

New Requirements



- New Governance Requirements

- **NYSE proposals**

- Majority of independent directors within 24 months
 - Independent Audit Committee
 - All Audit Committee members must be financially literate
 - At least one member of the Audit Committee must have accounting or related financial management expertise

New Requirements



- New Audit Committee Responsibilities

– **NYSE proposal** requires that Audit Committees:

- Hire and fire independent auditors, and approve any significant non-audit relationship with the independent auditors
- Have a written charter
- At least annually, obtain and review a report by the independent auditor describing the firm's internal quality control procedures; any material issues raised by the most recent internal quality control review, peer review or any inquiry or investigation within the preceding five years and assess the auditor's independence with respect to all relationships between the independent auditor and the company
- Discuss annual and quarterly financial statements with management and independent auditor, including MD&A

NASDAQ

AN OVERVIEW

Introduction



- Board of Directors of NASDAQ approved new proposals in May and July
 - Designed to enhance investor confidence by increasing accountability and transparency
 - SEC will vote to approve proposals

New Requirements



- New Governance Requirements
 - **NASDAQ proposals**
 - Majority of independent directors following first annual meeting that is at least 120 days after SEC approves proposals
 - Require all Audit Committee members be able to read and understand financial statements at the time of their appointment (rather than within a reasonable time thereafter)
 - Require that in selecting the financial expert necessary for compliance with the NASDAQ audit committee composition requirements, issuers consider whether a person has sufficient financial expertise in the accounting and auditing areas specified in the Act
 - Audit Committee must review and approve all related-party transactions

New Requirements



- New Audit Committee Responsibilities

- **NASDAQ proposals** require that Audit Committees:

- Set clear hiring policies for employees of the independent auditors
- Have sole authority to hire, compensate and fire outside auditor
- Approve, in advance, the provision by the auditor of all permissible non-audit services
- Authority to engage and determine funding for independent counsel and other advisors
- Limit time non-independent Audit Committee members can serve to 2 years; prohibited from serving as chair

The Impact of New Standards on Compliance Programs and Corporate Governance

Overview



- Requirements Affecting the Board of Directors and Audit Committee
- Requirements for Senior Executives
- Requirements Affecting In-House Lawyers
- New Criminal Penalties
- Reporting Requirements
- Internal Controls (Disclosure, Controls and Procedures)

Board and Audit Committee



- New Corporate Governance Standards
- Changes to Audit Committee Structure and Composition
- Increased Audit Committee Oversight Responsibilities
- New Auditor Independence Requirements

Provisions Affecting the Board of Directors and Audit Committee



Role of Audit Committee:

- Audit Committee and independent auditors seen as key to restoring faith in the process of financial reporting and oversight.
- Audit Committee will have enhanced role in corporate Governance.
- New Focus on Qualifications of Audit Committee:
 - Independence: All Audit Committee members must be independent and accept no fees from the Company.
 - Financial Expertise: Audit Committee must include at least one “financial expert.”

Provisions Affecting the Board of Directors and Audit Committee (cont'd)



- Audit Committee Resources:
 - Can hire independent counsel
 - Company must provide funding
 - Audit Committee can hire auditors
- Audit Committee Responsibilities:
 - Directly responsible for “appointment, compensation and oversight” of auditors
 - Complaint Procedures: Must establish procedures to receive and address complaints regarding accounting, internal accounting controls and auditing issues.

Provisions Affecting the Board of Directors and Audit Committee (cont'd)



- Procedures include providing mechanism for employees to submit concerns -- on a confidential, anonymous basis -- regarding questionable auditing or accounting matters.
- Must pre-approve all auditing and non-auditing service to be performed by outside auditors.

•New Auditor Independence Requirements

- Registered public accounting firms will be prohibited from providing eight types of non-audit services to audit clients:
 - Bookkeeping or other services related to company's accounting records or financial statements

Provisions Affecting the Board of Directors and Audit Committee (cont'd)



- Financial information systems design and implementation
- Appraisal or valuation services, fairness opinions
- Actuarial services
- Internal audit outsourcing services
- Management functions or human resources
- Broker or dealer, investment adviser or investment banking services
- Legal services and expert services unrelated to the audit
- Any other service determined to be impermissible by the future Public Company Accounting Oversight Board

Provisions Affecting the Board of Directors and Audit Committee (cont'd)



- Mandatory auditor rotation: Partner cannot be lead or review partner for more than 5 consecutive years
- Outside auditor must timely report to Audit Committee:
 - All critical accounting policies and practices to be used in financial reports
 - All alternative treatments of financial information within GAAP that have been discussed with management, ramifications of their use, and treatment preferred by the auditor
 - Other material written communications with management

Provisions Affecting Senior Management



- Prohibitions on top corporate management:
 - Public companies now prohibited from directly or indirectly making personal loans to executive officers
 - Elimination of other types of loan-related “sweetheart deals” for executive officers
 - CEOs and CFOs must forfeit bonuses and profits if company’s financial statements are restated due to misconduct
- New Certifications for CEOs and CFOs (see appendix for more detail)

Provisions Affecting Senior Management (cont'd)



- New financial reporting and disclosure requirements:
 - Intended to enhance accuracy and transparency of public companies' reported financial results
 - Improved financial disclosures seen as way to restore investor confidence in financial markets and public companies
- Companies must disclose “on a rapid and current basis” any additional information concerning material changes in financial condition or operations of the company.

Provisions Affecting Senior Management (cont'd)



- Act requires an internal control report in company's annual reports
- Internal control report must:
 - (1) State management's responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and
 - (2) Contain an assessment of the effectiveness of those controls, as of the end of the company's most recent fiscal year.

Special Issues for Lawyers and Compliance Officials



- Document retention and destruction
- Whistleblowers
- Special rules for SEC Lawyers

Documents (cont'd)



- 18 U.S.C. § 1519: “Whoever knowingly alters, destroys . . . with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any [U.S.] department or agency . . . or in relation to or contemplation of any such matter or case . . .”
- Highlighted language raises questions:
 - Could common document retention/destruction policies result in violations where they call for destruction of documents relevant to a matter that could arise in the future?
 - Potential problem if a document retention program is set up with the intent to avoid future Government liability.

Documents (cont'd)



- Need to develop a business justification for every element of the document destruction plan
- Document destruction program should exempt from destruction all documents that could be used in future investigations
- Company's e-mail policy and document retention policies should be reviewed and revised to accord with new statutory requirements.

SEC Lawyers



- New Lawyer Disclosure Obligation: SEC to issue rules within 180 days setting minimum standards for lawyers appearing/practicing before the SEC (Sec. 307)
- Two-tiered disclosure obligation:
 - (1) Rules will require in-house and outside counsel to report securities law violations to company's CEO or chief legal officer;
 - (2) If they don't respond appropriately, lawyer must report directly to Board of Directors or designated Board committee

SEC Lawyers (cont'd)



- **Materiality standard:** SEC is to adopt rule “requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof ”
- Good news
 - “Materiality” limitation
 - No reporting outside the company is required
- Troublesome issues:
 - “Practicing before the Commission” is a broad standard; will probably include work on registration statements
 - What kind of “evidence” should an attorney have?

SEC Lawyers (cont'd)



- What is a “similar violation?”
 - What is an “inappropriate” response on the part of the CEO or Chief Legal Officer, that would require the attorney to go to the Audit Committee or full Board?
 - What if the Audit Committee or Board are complicit in the wrongdoing, or refuse to take remedial action?
- Legal department may want to articulate and disseminate standards to staff as to when they must come forward to the General Counsel

Whistleblowers (cont'd)



- Sweeping new protections for whistleblowers--
 - Modeled after protections for airline employees reporting safety violations
- Two new criminal provisions to protect whistleblowers
 - 18 U.S.C. § 1513
 - 18 U.S.C. § 1514A

Whistleblowers (cont'd)



- 18 U.S.C. § 1513: “Whoever knowingly, with the intent to retaliate, takes any action harmful to any person . . . for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense . . .”
- Elements added to 18 U.S.C. § 1513(e):
 - Knowing and intentional action to retaliate
 - Against any person (not just an employee)
 - Providing truthful information relating to commission or possible commission
 - A law enforcement official (not just a Federal agent)
 - Regarding any Federal offense

Whistleblowers (cont'd)



- Elements of 18 U.S.C. § 1514A:

- Prohibits a company from sanctioning an employee because of any lawful act to provide information about “fraud against shareholders” to (1) a Federal agency, (2) Congress, or (3) employee’s supervisor.
- Authorizes civil action for damages and equitable relief, including reinstatement, back pay, attorneys’ fees, etc.
- 90-day statute of limitations: employee must file claim within 90 days of retaliation.
- Provision construed narrowly: applies only to information provided in connection with an ongoing proceeding.

New Felonies and Increased Criminal Penalties



- Substantive new offenses added by the Act:
 - 18 U.S.C. § 1348: Scheme or artifice to defraud
 - 18 U.S.C. § 1350: Knowing violations involving new CEO/CFO certifications
- Enhanced Penalties:
 - Multiple directives to U.S. Sentencing Commission to boost penalties for obstruction of justice, criminal fraud, accounting and securities fraud, and the new “white collar” provisions in the Act related to document destruction or tampering

New Felonies and Increased Criminal Penalties (cont'd)



- Enhanced penalties for conspiracies (from 5 years to same level as underlying offense)
- Stiffer penalties for criminal ERISA violations
- Doubles the penalties for criminal violations of Securities Act of 1934

Final Observation



The Sarbanes-Oxley legislation has established a new paradigm for corporate responsibility, accountability, transparency, and behavior. Responsibilities of some parties have increased; while those of others have been made more explicit. And the Act has established a new standard for companies regarding the reporting of internal control effectiveness.

Good internal controls are not just a best practice.....the Act reinforces them in the Law!

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APPENDIX

Reporting & Internal Controls

Act Imposes Important Reporting Requirements on Management



Section 302 (and related SEC rule) – CEO/CFO Must Certify Quarterly and Annually that:

- SEC report being filed has been reviewed
- Report does not contain any untrue statements or omit any material facts necessary to make the statements made not misleading
- Financial statements fairly present, in all material respects, the financial position, results of operations and cash flows
- He/she is responsible for and has designed, established, and maintained Disclosure Controls & Procedures (“DC&P”), as well as evaluated and reported on the effectiveness of those controls and procedures within 90 days of the report filing date
- Deficiencies and material weaknesses in internal control have been disclosed to Audit Committee and auditors, as well as any fraud (material or not) involving anyone with a significant role in internal control
- Significant changes in internal control affecting controls for periods beyond review have been reported in the certification, including any corrective actions with regard to significant deficiencies and material weaknesses

Note: Individual certifications above and any corresponding disclosure requirements have various effective dates beginning with filings made after August 29, 2002.

Act Imposes Important Reporting Requirements on Management

(continued)



Section 404 – Management Must Assess Internal Controls Annually

(Effective date pending)

- Internal control report states management's responsibility for establishing and maintaining adequate internal control structure and procedures for financial reporting
- Management must assess effectiveness of internal control structure and procedures for financial reporting as of the end of the most recent fiscal year
- Attestation by external auditor (Section 404 and 103)

Section 906 – CEO/CFO Must Certify that Periodic Financial Reports

(Effective July 30, 2002)

- Fully comply with 34 Act and information fairly presents financial condition and results of operations

Cautionary Note



Recent CEO/CFO certifications filed with the SEC (either in respect of its “one time” Order or pursuant to Section 906) do not contain any explicit assertions about internal controls. As Section 302 and 404 provisions require certification or assessment of specified controls, companies will need to assess the implications of these expanded reporting responsibilities, and determine the nature of any additional steps that should be taken in response thereto.

General Rather Than Specific Requirements Have Been Established



- Management must determine for themselves the structure, approach and level of documentation and formalization that gives the CEO/CFO the requisite basis (and confidence) to provide Section 302 quarterly certifications.
- The SEC provides a definition of Disclosure Controls and Procedures and related objectives but does not outline specific requirements, other than recommending the establishment of a disclosure committee.
- In general, the new certification requirements may require some companies to formalize control structures, enhance controls and establish monitoring programs to enable CEOs and CFOs to make their evaluations and report their conclusions.

The SEC expects that each company will develop a process that is consistent with its business and internal management and supervisory practices.

Understanding Requirements for Disclosure Controls and Procedures



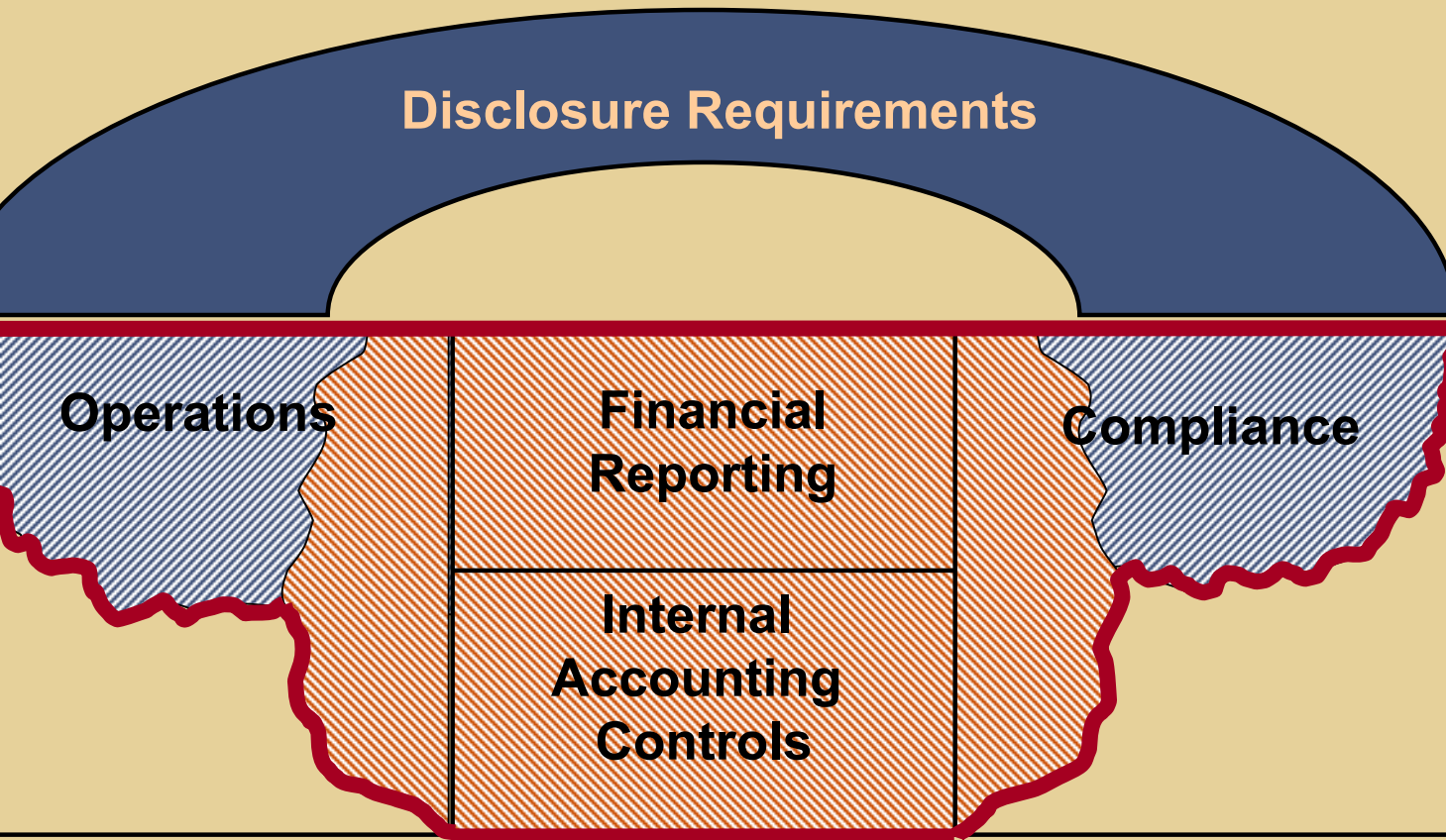
The SEC defines DC&P as follows:

Controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports filed or submitted by it under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms.




"Disclosure controls and procedures" include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in its Exchange Act reports is accumulated and communicated to the issuer's management, including its principal executive and financial officers, as appropriate to allow timely decisions regarding required disclosure.

In this regard, the SEC intends that companies maintain controls and procedures (commensurate with those already required with respect to *financial reporting*) for gathering, analyzing and disclosing all information – BOTH financial and non-financial – that is required to be disclosed in specified and periodic filings.

Addressing DC&P Requirements



LEGEND

-  — Disclosure Controls and Procedures
-  — Other aspects of Compliance and Operations pertaining to DC&P
-  — Internal Controls Over Financial Reporting

Many companies have already based their controls on the recognized COSO framework



While enterprise-wide Internal Control was not defined in the Act, the COSO definition has been accepted by the US government and its agencies, incorporated in US auditing standards (AU 319), and is a generally accepted integrated framework for control infrastructure.

Internal Control is defined as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations

COSO identifies five components of internal control that need to be in place and integrated to ensure the achievement of each of the objectives.

COSO is an integrated control framework which, when implemented, may provide a baseline to establish a control structure responsive to Section 302 requirements.

The Five Components under the COSO Framework



Monitoring

Assessment of a control system's performance over time.

Combination of ongoing and separate evaluation.

Management and supervisory activities.

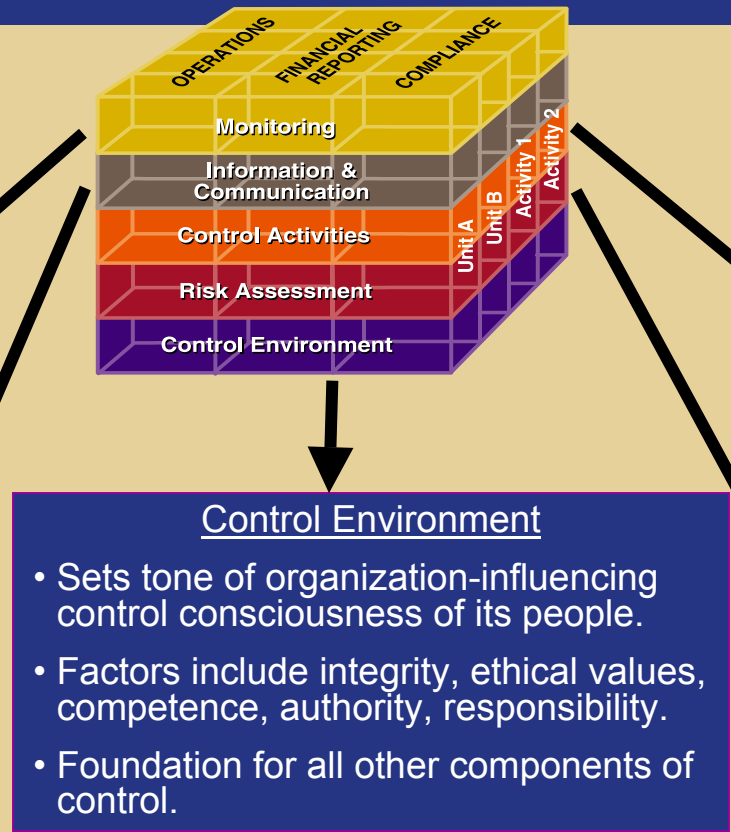
Internal audit activities.

Information and Communication

Relevant information identified, captured and communicated in a timely manner.

Access to internal and externally generated information.

Flow of information that allows for successful control actions from instructions on responsibilities to summary of findings for management action.



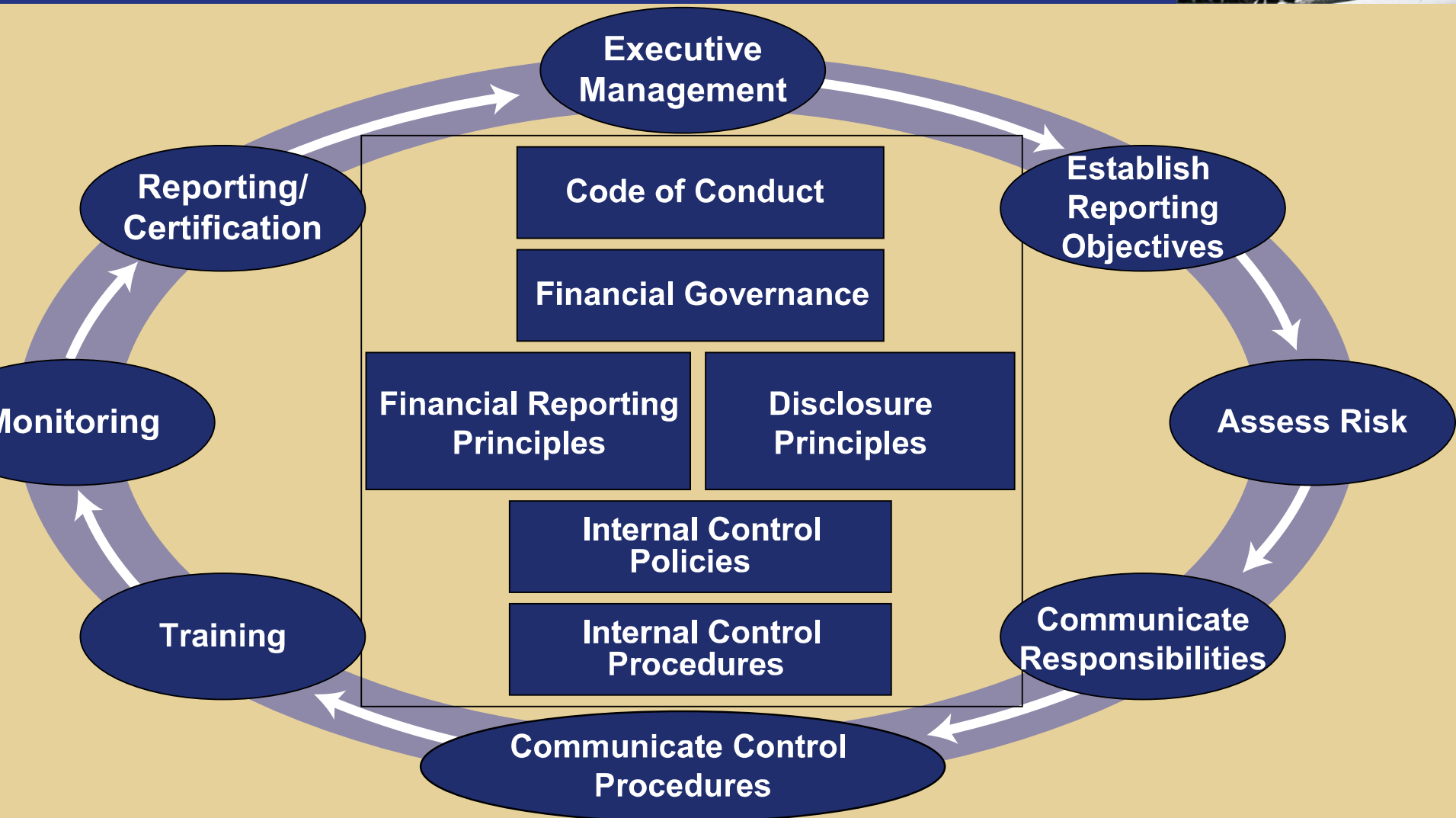
Control Activities

- Policies/procedures that ensure management directives are carried out.
- Range of activities including approvals, authorizations, verifications, recommendations, performance reviews, asset security and segregation of duties.

Risk Assessment

- Risk assessment is the identification and analysis of relevant risks to achieving the entity's objectives-forming the basis for determining control activities.

Operationalizing the Control Structure, Including the Certification Effort



Key Elements of a Highly Effective Control Structure



- **A documented internal control structure that includes all relevant policies, procedures and operating principles**
- **A structure that is robust and able to deal with the changes of a dynamic organization**
- **An infrastructure to support the internal control structure that facilitates risk assessment, communication, reporting, training, incident identification and issues management**
- **An infrastructure that facilitates rollup certifications, acknowledgements and monitoring**
- **An infrastructure that facilitates management's ability to have confidence that the control structure is effective and one that can be tested**
- **An infrastructure that can support monitoring the completion of applicable control procedures on a real time basis**
- **A dashboard confirming ability to sign certification**

Initial/On-Going Quarterly Certification Process – One Approach



Determine effectiveness of controls over financial reporting

Perform financial reporting requirements risk assessment
Review existing policies and procedures
Map existing procedures to control requirements
Determine gaps and corrective action
Test operational effectiveness of structure
Determine steps required for quarterly certification

Develop/Formalize Disclosure Controls & Procedures

- Establish disclosure committee
- Perform disclosure requirement risk assessment
- Communicate policy principles and responsibility
- Establish process for information flow
- Test for completeness
- Analyze information and disclose
- Conclude on effectiveness of disclosure process

Quarterly Certification Process

Based on evaluation of effectiveness of financial and disclosure reporting policies:

- Obtain acknowledgment and roll-up certifications
- Evaluate reporting of critical control procedures
- Consider requirements for limited/extensive testing by I/A
- Consider need to validate final report
- Consult with legal counsel
- Communicate with auditors and audit committee
- Conclude on process and certify

Actions to Consider for Improving Efficiency over Future Certifications



- **Evaluate and implement longer term control improvements**
 - **Eliminate temporary procedures**
 - **Automate controls to improve efficiency**
- **Consider technology as a platform to operationalize certification process**
- **Based upon control structure, re-evaluate internal audit activities**

Benefits of the New Law



- **Increased confidence of CEO/CFO in meeting reporting requirements**
- **Improved coordination of Company Management Team**
- **Improved and clarified Corporate Governance process**
- **Systematized process for early identification of business risks/ whistle blowing issues/incident management**
- **Systematized approach to dealing with change (i.e., transactions, personnel, accounting principles, internal controls and operating procedures)**
- **Increased operational effectiveness**