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HRO Alert

The Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002 was signed by the President and became law on July 30, 2002. Enacted in response to recent corporate scandals and stock market uncertainty, the Act makes sweeping changes to the law applicable to public companies, including those that are organized outside of the United States, and their directors and officers. This memo includes brief summaries of some of the key provisions of the Act, followed by a chart that lists the effective dates of these provisions. This summary does not address all of the provisions included in the Act, and is not intended to address specific compliance issues that may arise in particular circumstances; nor does it constitute legal advice with respect to any specific situation. Clients in need of such advice are encouraged to contact any of the attorneys listed at the end of this summary.

CORPORATE GOVERNANCE

Revised Audit Committee Standards. The Act requires the SEC to adopt rules by April 26, 2003 that direct the national securities exchanges and Nasdaq to prohibit the listing of any security of a public company that fails to comply with the following audit committee requirements:

- **Oversight of the Audit Committee.** The company's audit committee shall be responsible for the appointment, compensation, and oversight of the work of the company's auditors, and the auditors shall report directly to the audit committee. The audit committee shall also oversee the resolution of any disagreements between the auditors and management regarding financial reporting.
- **Independence of Audit Committee Members.** Audit committees shall be comprised solely of independent board members. To remain independent an audit committee member shall not (i) accept any consulting, advisory or other compensatory fee (except directors' fees) from the company or (ii) be an affiliated person of the company or any of its subsidiaries.
- **Complaint Procedures.** Audit committees shall create procedures for the receipt, retention, and treatment of complaints received by the company regarding accounting, internal accounting controls or auditing matters. The procedures shall also allow for the confidential, anonymous submission by company employees of concerns regarding questionable accounting or auditing matters.
- **Audit Committee Advisors and Funding.** Audit committees shall have the authority to hire independent counsel and other advisors to help them carry out their duties, and the company shall provide adequate funding (as determined by the audit committee) for the payment of compensation to the company's auditors and other advisors hired by the audit committee.

Improper Influence on Conduct of Audits. It shall be unlawful for any officer or director of a company (or any other person acting under the direction of such officer or director) 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 such company's financial statements for the purpose of rendering such financial statements materially misleading. [The SEC is to issue proposed rules no later than 10/28/02, and such rules are to be final no later than 4/26/03.]

Disclosure of Audit Committee Financial Expert. Companies will be required to disclose in their periodic filings with the SEC whether their audit committee has at least one member who is a “financial expert,” as that term will be defined by the SEC, and if not, why not. In defining “financial expert,” the SEC is required to consider whether the person has (i) an understanding of GAAP and financial statements, (ii) experience in preparing or auditing financial statements of comparable companies and in accounting for estimates, accruals and reserves, (iii) experience with internal accounting controls, and (iv) an understanding of audit committee functions. [The SEC is to issue proposed rules no later than 10/28/02, and such rules are to be final no later than 1/26/03.]

CEO and CFO Forfeiture of Bonuses and Profits. If a company is required to restate its financial statements “due to the material noncompliance of the [company], as a result of misconduct, with any financial reporting requirement under the securities laws,” then the CEO and CFO are required to reimburse the company for (i) any bonus or incentive (including equity) based compensation received by such officer during the 12-month period following the issuance or filing of the noncompliant financial document, and (ii) any profits realized from the sale of company securities during such 12-month period. [Effective 7/30/02.]

Code of Ethics for Senior Financial Officers. Companies will be required to disclose in their periodic filings with the SEC whether they have adopted a code of ethics for their principal financial officer and principal accounting officer, and if not, why not. Companies also will be required to disclose in a Form 8-K any change in or waiver of their code of ethics. [The SEC is to issue proposed rules no later than 10/28/02, and such rules are to be final no later than 1/26/03.]

Prohibition on Loans to Executives. It is unlawful for any company to make or arrange for a personal loan or extension of credit to a director or officer. This rule does not apply to limited categories of loans (e.g. home improvement loans, consumer loans, charge card loans) (i) made in the ordinary course of a company's business, (ii) of a type generally made available to the public, and (iii) on market terms or terms no more favorable than those offered to the general public. Loans existing on July 30, 2002 may continue in effect, but may not be renewed or materially modified. [Effective 7/30/02.]

Enactment of Professional Responsibility Rules for Attorneys. The Act directs the SEC to issue rules no later than January 26, 2003 setting forth minimum standards of professional conduct for attorneys appearing before the SEC. This includes the company's general counsel and other counsel who participate in preparing and making securities filings. The rules shall require such attorneys to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by a company to the CEO or a company's chief legal counsel, and if such officer does not appropriately respond the attorney is required to report such evidence to the audit committee. An appropriate response is defined for this purpose as “appropriate remedial measures or sanctions with respect to the violation.” [Effective no later than 1/26/03.]

ENHANCED FINANCIAL DISCLOSURE

Certification of Financial Reports. There are two provisions in the Act that require certification of financial information by all companies filing periodic reports (including Forms 10-K, 10-Q and 8-K) with the SEC.

- **Section 906 Certification.** CEOs and CFOs must certify that the periodic report “fully complies” with the Securities Exchange Act and fairly presents, in all material respects, the financial condition and results of operation of the company. Knowing or willful certification of a non-compliant or false report can subject the CEO or CFO to criminal penalties (see discussion in Penalties and Enforcement section below). [Effective 7/30/02.]
- **Section 302 Certification.** CEOs and CFOs must certify as to each quarterly and annual report filed under the Exchange Act that:
 - (i) the signing officer has reviewed the report;
 - (ii) 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 made, in light of the circumstances under which such statements were made, not misleading;
 - (iii) based on such officer’s knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report;
 - (iv) the signing officers—
 - (a) are responsible for establishing and maintaining internal controls;
 - (b) 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;
 - (c) have evaluated the effectiveness of the issuer’s internal controls as of a date within 90 days prior to the report; and
 - (d) have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date;
 - (v) 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)—
 - (a) 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
 - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer’s internal controls; and
 - (vi) 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.

On August 2, 2002, the SEC issued a Release requesting comment by August 19, 2002 on rules it previously proposed relating to certification of reports and internal procedures that it intends to adopt to meet the certification requirements. The Release indicated its final rules will go beyond the Act’s mandate with respect to the maintenance of internal controls for gathering information to be included in periodic reports. [Effective no later than 8/29/02.]

Accuracy of Financial Reports. Each financial report filed with the SEC (including Forms 10-K, 10-Q and 8-K) and prepared in accordance with or reconciled to GAAP must reflect all material correcting adjustments identified by a company's accounting firm. [Effective 7/30/02.]

Off-Balance Sheet Transactions. The SEC is to adopt rules requiring that companies disclose material off-balance sheet transactions (including contingent obligations) in all quarterly and annual reports. [Effective no later than 1/26/03.]

Rules on Pro Forma Figures. The SEC must adopt rules requiring that a company's periodic reports or press releases that include pro forma financial information (such as "EBITDA") present such information in a manner that is not false or misleading. Further, the pro forma information must be accompanied by a reconciliation of such information with the financial condition and results of operations of the company as presented under GAAP. [Effective no later than 1/26/03.]

Assessment of Internal Controls. Each company's annual report must include "an internal control report." The report has to acknowledge management's responsibility to maintain "an adequate internal control structure and procedures for financial reporting." The report must also include management's assessment of effectiveness of the internal controls, attested by such company's accounting firm. [Effective within unspecified period upon issuance of final rules by SEC.]

Enhanced SEC Review of Periodic Disclosures. The SEC is charged with reviewing the Securities Exchange Act disclosures of each company at least once every three years, and is to take several factors into account in scheduling such reviews, including volatility of stock price, market capitalization, importance of the company to the economy and other factors. [Effective 7/30/02.]

Real Time Disclosures. In plain English, companies must disclose "on a rapid and current basis" material changes in financial condition, including trend and qualitative information, under rules to be issued by the SEC. [Effective with final rules within unspecified time period.]

PENALTIES AND ENFORCEMENT

Criminal Offenses. The Act establishes a number of new criminal offenses, including:

- (i) knowing or willful certification of non-complying or false financial statements,
- (ii) knowingly executing or attempting to execute a "scheme or artifice to defraud any person in connection with any security of" a public company,
- (iii) destruction or alteration of records in connection with a federal investigation or bankruptcy case,
- (iv) destruction of audit records by an accountant less than five years after the relevant fiscal period,
- (v) fraud "in connection with any security" of a public company,
- (vi) "corruptly" destroying, mutilating or concealing a document or object with the intent of impairing the object's integrity or availability "for use in an official proceeding" or impeding or attempting to impede an official proceeding, and
- (vii) retaliating against informants who provide truthful information in connection with the commission or possible commission of a federal offense.

The maximum fines and prison terms for these offenses are substantial, in some cases up to \$25 million and 25 years. The Act increases the maximum fines and prison terms applicable to existing

criminal offenses under the securities laws. The Act also instructs the United States Sentencing Commission to be more sensitive to the impact of financial fraud in establishing sentencing guidelines. [Effective 7/30/03.]

Equitable Relief and Unfitness to Serve as an Officer or Director. The SEC may seek equitable relief in any enforcement action “that may be appropriate or necessary for the benefit of investors.” In addition to its authority to seek such relief in a civil enforcement proceeding, the SEC in an administrative proceeding may bar an individual from serving as an officer or director of any public company if such individual is found, after notice and a hearing, to have violated the anti-fraud laws and his/her conduct “demonstrates unfitness to serve as an officer or director” of a public company. [Effective 7/30/02.]

Freeze of Extraordinary Payments. The SEC may, during the course of an investigation of a potential violation of federal securities laws, seek a federal court order that requires a company to place in escrow any extraordinary payments likely to be made to directors or officers. [Effective 7/30/02.]

Non-Dischargeable Fraud-Related Debts. Debts arising from violations of securities laws may not be discharged in bankruptcy. [Effective 7/30/02.]

Whistleblower Protection. A public company and its officers may not terminate, demote or harass an employee who provides information or otherwise participates in an investigation regarding securities fraud or a violation of the securities laws. [Effective 7/30/02.]

Statute of Limitations. A private action based on the fraud provisions of the securities laws or contrivance in contravention of a regulatory requirement under the securities laws may be brought not later than the earlier of two years after discovery of the violation or five years after such violation. This in most cases extends the statute of limitations applicable to private actions under the Securities Acts, which was one year after the violation was or should have been discovered and in no event more than 3 years after the violation. This is the principal provision of the Act that directly impacts private actions. A number of other provisions (for example, the certification of reports), however, are likely to be used by plaintiffs’ attorneys to augment their pleadings and otherwise initiate class actions. [Effective 7/30/02.]

REGULATION OF TRADING AND REPORTING

Acceleration of Form 4 Deadline. The deadline for filing Form 4, which reports stock transactions by directors and officers, is shortened to the second business day following execution of the transaction. Currently, these reports are due by the tenth day of the month following the month when the transaction occurs. The SEC is authorized to establish exceptions to this filing deadline for cases in which the two-day period is determined not to be feasible. [Effective 8/29/02.]

Electronic Filing of Form 4. All Forms 4 will be required to be filed electronically by Edgar. Currently, these filings may be made either in electronic or paper form. This change will require all directors, officers and ten percent stockholders to obtain their own Edgar CIK (pin number), which requires the filing of a Form ID. By the end of the business day following the filing, all Forms 4 must be made available to the public by (i) the SEC on its web site, and (ii) the company on its web site, if the company maintains one. [Effective no later than 7/30/03.]

Prohibition on Trades During Plan Blackout Periods. Directors and executive officers are prohibited from purchasing, selling or transferring a company's stock during any period when employees participating in certain company stock plans are not allowed to execute transactions in such company's stock. The prohibition includes all shares acquired by the director or officer in connection with his or her service to or employment with the company. Any profits obtained by a director or officer as a result of a transaction prohibited by this rule may be recovered by the company, or by a stockholder on behalf of the company, regardless of the director's or officer's intent. The SEC is directed to create exceptions from the rule for categories of trades as appropriate, and to provide further guidance on the types of blackout periods that should be covered by the prohibition. [Effective 1/26/03.]

REGULATION OF AUDIT FIRMS; NEW AUDITOR INDEPENDENCE STANDARDS

Public Company Accounting Oversight Board. The Act establishes a new regulatory board, under SEC control, to oversee the audit of public companies and those who perform the audits. Accounting firms that audit public companies will be required to register with, and be subject to, the authority of the board. Each public audit firm must agree that it will cooperate and comply with any request for testimony or production of documents made by the board. The board has sanctioning powers in the event of violations of the Act, the board's rules or accounting-related securities laws. The board will be funded, in large part, by annual fees imposed upon public companies, based primarily on their relative market capitalization. [Effective 7/30/02, although registration is not required until the date (the "Registration Date") that is 180 days after the SEC determines that the board has the capacity to fulfill its requirements, which determination shall be made not later than 4/26/03.]

SEC's Enhanced Power to Adopt New GAAP Standards. The Act provides the SEC with the authority to adopt, as GAAP for purposes of the securities laws, accounting standards established by the SEC or an independent standard setting body that is to be funded under the Act. That standard setting board is expected to be FASB, provided it conforms with the requirements of the Act. [Effective 7/30/02.]

Limitation on Non-Audit Services. The Act prohibits public audit firms (and their professional employees) from performing non-audit services for their public clients "contemporaneously with the audit." Such non-audit services include, but are not limited to, the following:

- (i) bookkeeping or other services related to the client's accounting records or financial statements;
- (ii) financial information systems design and implementation;
- (iii) appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- (iv) actuarial services;
- (v) internal audit outsourcing services;
- (vi) management functions or human resources;
- (vii) broker or dealer, investment adviser or investment banking services;
- (viii) legal services and expert services unrelated to the audit; and
- (ix) any other services the public company accounting oversight board (as described above) determines is impermissible.

Public audit firms may perform non-audit services not listed above (such as tax services) for their public clients, only if such services are approved, generally in advance, by the audit committee of any such client. [Effective following the Registration Date.]

Audit Partner Rotation; Management/Auditor Conflicts of Interest. The Act prohibits a public audit firm from (i) permitting the lead (or coordinating) audit partner to perform audit services for a public client for more than five consecutive years and (ii) auditing a public client if a CEO, controller, CFO, CAO or equivalent officer of the public client was employed by the audit firm and participated in any capacity in the audit of that client during the one-year period preceding the date of audit initiation. The Act does not require the rotation of auditing firms, but directs the Comptroller General of the United States to conduct a study and report to Congress within one year on the "potential effects" if a registered public accounting firm was limited as to the number of years it could act as "the auditor of record" for a public company. [Effective following the Registration Date.]

RELATED DEVELOPMENTS

Adding to the sum of additional rules for corporate governance, the New York Stock Exchange issued new listing standards on August 1, 2002. The new listing standards impose additional obligations that are not included in the Act. Among other things, the NYSE is requiring its listed companies to have an internal audit function, to hold executive sessions of non-management directors outside the presence of management personnel, and to hold stockholder votes on substantially all stock option plans. The new rules are likely to be the basis for the NYSE's compliance with the Act's provisions relating to audit committees, although they will have to be modified to some extent to be in full compliance. As noted, the NYSE rules go beyond what is required by the Act, and will require listed companies to have compensation and nominating/corporate governance committees meeting specified standards. These rules are subject to SEC approval, which is expected to be granted.

Over the next several months, the Act is likely to be the subject of substantial discussion and requests for interpretive guidance. Many of the Act's provisions overlap with existing SEC rule proposals, as well as proposals by the NYSE and NASD. With time, application of the Act to specific situations will become more clear, and the SEC will adopt additional implementing regulations. As issues arise, we encourage you to contact any of the attorneys listed below.

This summary does not address all of the provisions included in the Act, and is not intended to address specific compliance issues that may arise in particular circumstances; nor does it constitute legal advice with respect to any specific situation. Clients in need of such advice are encouraged to contact any of the attorneys listed at the end of this summary.

CORPORATE GOVERNANCE

Provision

Effective Time

Revised Audit Committee Standards (independence and responsibilities of committee members, etc.) [§301]	No later than 4/26/03, the SEC shall adopt a rule that requires the delisting of companies that are not in compliance with the following audit committee standards
Improper Influence on Conduct of Audits [§303]	No later than 4/16/03; SEC to issue proposed rules no later than 10/28/02
Disclosure of Audit Committee Financial Expert [§407]	No later than 1/26/03; SEC to issue proposed rules no later than 10/28/02
CEO and CFO Forfeiture of Bonuses and Profits [§304]	7/30/02
Code of Ethics for Senior Financial Officers [§406]	No later than 1/26/03; SEC to issue proposed rules no later than 10/28/02
Prohibition on Loans to Executives [§402]	7/30/02
Enactment of Professional Responsibility Rules for Attorneys [§307]	No later than 1/26/03

ENHANCED FINANCIAL DISCLOSURE

Provision

Effective Time

Certification of Financial Reports [§906] [§302]	7/30/02 No later than 8/29/02
Accuracy of Financial Reports [§401]	7/30/02
Off-Balance Sheet Transactions [§401]	No later than 1/26/03
Rules on Pro Forma Figures [§401]	No later than 1/26/03
Assessment of Internal Controls in Periodic Filings [§404]	Upon final rules within unspecified time period
Enhanced SEC Review of Periodic Disclosures [§408]	7/30/02
Requirement for Real Time Disclosures [§409]	Upon final rules within unspecified time period

PENALTIES AND ENFORCEMENT

Provision

Effective Time

Application to New and Existing Criminal Offenses [§§802, 807, 906, 1102 and 1107]	7/30/02
Equitable Relief and Unfitness to Serve as an Officer or Director of a Public Company [§§305 and 1105]	7/30/02
Freeze of Extraordinary Payments [§1103]	7/30/02
Non-Dischargeable Fraud-Related Debts [§803]	7/30/02
Whistleblower Protection [§806]	7/30/02
Statute of Limitations [§804]	7/30/02

REGULATION OF TRADING AND REPORTING

Provision	Effective Time
Acceleration of Form 4 Deadline [§403]	8/29/02
Electronic Filing of Form 4 [§403]	No later than 7/30/03
Prohibition on Trades During Plan Blackout Periods [§306]	1/26/03

REGULATION OF AUDIT FIRMS; NEW AUDITOR INDEPENDENCE STANDARDS

Provision	Effective Time
Public Company Accounting Oversight Board [§101]	7/30/02, although registration is not required until the date (the "Registration Date") that is 180 days after the SEC determines that the board has the capacity to fulfill its requirements, which determination shall be made not later than 4/26/03
SEC's Enhanced Power to Adopt New GAAP Standards [§108]	7/30/02
Limitation on Non-Audit Services [§201]	Following the Registration Date
Audit Partner Rotation; Management/Auditor Conflicts of Interest [§§203 and 206]	Following the Registration Date

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For an in-depth analysis of The Sarbanes-Oxley Act of 2002, please look for a forthcoming publication by Harold S. Bloomenthal to be published by WestGroup in the immediate future.

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