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PRESIDENT SIGNS SARBANES-OXLEY ACT

By Curtis R. Hearn and Allison C. Bell

On Tuesday, the President signed the Sarbanes-Oxley Act of 2002, comprehensive reform legislation directly bearing on the corporate boardroom, the executive suite, and the outside auditors. Certain provisions of the Act are now effective and will require public companies to take swift action. Others will take effect in the near future.

Corporate Governance

CEO and CFO Criminal and Civil Certification Requirements

- Effective immediately, each periodic report containing financial statements filed by a public company must be accompanied by a written certification from the CEO and CFO that the signing officer has reviewed the report, and based on the officer's knowledge, the report (i) does not misstate or omit a material fact, (ii) fully complies with the requirements of the Securities Exchange Act of 1934, and (iii) fairly presents, in all material respects, the financial condition and results of operations of the company.

- The certification must also state (i) that the signing officers are responsible for and have established and examined internal controls to ensure that material information relating to the company is made known to the signing officers, (ii) that the signing officers have disclosed to the company's auditors and audit committee any significant deficiencies in the internal controls and any fraud that involves management or other employees who have a significant role in the company's internal controls, and (iii) whether or not there were any significant changes in internal controls or other factors that could significantly affect internal controls.

- Any CEO or CFO who makes a certification knowing that a periodic report does not comply with the requirements of the Exchange Act is subject to a fine of between $1,000,000 and $5,000,000 and may serve 10 to 20 years in prison.

- In addition to this criminal law certification, the Act requires the SEC to issue a rule within 30 days requiring CEOs and CFOs to make similar and additional certifications with respect to periodic reports filed by public companies. This certification requirement would be subject to civil enforcement by the SEC.

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Audit Committees

The Act requires the SEC, within 270 days of the date of enactment, to issue rule with respect to the function and independence of public company audit committees. This rule will require that:

- each member of the audit committee be a director and be independent (to be "independent," a director may not accept any consulting, advisory, or other compensatory fee from the company and could not be an affiliate of the company);
- audit committees be directly responsible for the appointment, compensation, and oversight of the company's independent auditor; and
- audit committees have the independent authority to engage independent counsel and other advisors.

In addition, this rule will prohibit exchanges from listing companies that do not have an audit committee that is in full compliance with the above requirements.

Requirements for Officers and Directors

The Act also imposes additional requirements for officers and directors:

- The Act requires the SEC to propose a rule within 90 days prohibiting officers and directors from taking any action to fraudulently mislead any accountant for the purpose of making a public company's financial statements materially misleading.
- Effective 180 days from the date of enactment, corporate executives and directors would be generally banned from trading in company securities during benefit plan blackout periods. For purposes of the Act, a "blackout period" is defined as any period of more than three days during which at least 50% of the participants in any company benefit plan are prohibited from trading in the company's securities. A company must give timely advance notice to its executives and directors of the blackout period, and at least 30 days notice to plan participants.

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Penalties for Officer and Director Misconduct

- Effective immediately, if, as a result of misconduct, a public company is required to prepare an accounting restatement due to the material noncompliance of the company with any financial reporting requirement under the securities laws, the CEO and CFO will be required to return to the company any bonus or other incentive-based or equity-based compensation received by that person during the 12-month period following the filing of the financial document in question with the SEC, and any profits realized from the sale of securities of the company during that same period.

- The Act empowers the SEC to bar dishonest corporate officials from serving as directors and officers of public companies.

- The Act also provides that companies and corporate officers who lose securities fraud suits are prohibited from using bankruptcy laws to avoid payments to plaintiffs.

Corporate Loans

- Effective immediately, public companies are generally prohibited from extending personal loans to any of their directors or executive officers. There is an exception for certain home improvement loans by public companies who are in the business of making commercial or consumer loans, as long as any loan to a director or officer is on terms no more favorable than those offered to the general public.

Enhanced Disclosure Obligations

Enhanced Financial Disclosure

The Act provides for enhanced disclosure of financial information about public companies and instructs the SEC to require by rule, within 180 days from the date of enactment:

- disclosure of all material off-balance sheet transactions and relationships that may have a material effect upon the financial status of a public company; and

- the presentation of pro forma financial information in a manner that is not misleading, and which reconciles it with the financial condition of the company under GAAP.

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Disclosure of Transactions Involving Management and Principal Stockholders

- Effective 30 days from the date of enactment, the mandatory period for senior executives and principal stockholders to disclose changes in ownership of securities or security-based swap agreements will be reduced from within the first ten days of the month following the date of the transaction to within two days following the date of the transaction.

- Currently, the SEC has proposed rules which would require public companies to report these transactions on a Form 8-K within the same time period.

Disclosure of Audit Committee Financial Expert

- The Act requires the SEC, within 180 days from the date of enactment, to issue a rule requiring public companies to disclose in their periodic reports whether or not (and if not, the reasons therefor) at least one member of the audit committee is a "financial expert." The SEC will be required to define the term "financial expert."

Disclosure of Code of Ethics

- The Act requires the SEC, within 180 days from the date of enactment, to issue a rule requiring public companies to disclose in their periodic reports whether the company has adopted a code of ethics for senior financial officers. The code must promote ethical conduct and full, fair, timely, accurate and understandable disclosure in periodic reports.

Accounting Standards and Oversight

Public Company Accounting Oversight Board

- The Act establishes a single "Public Company Accounting Oversight Board" to set standards for the accounting industry.

- Specifically, the Act requires the SEC to appoint five individuals, only two of whom may have accounting backgrounds, to the Board to (i) oversee the audit of public companies that are subject to the securities laws, (ii) establish audit report standards and rules, and (iii) investigate, inspect, and enforce compliance relating to registered public accounting firms, associated persons, and the obligations and liabilities of accountants.

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- The Act also mandates that every public accounting firm that performs or participates in any audit report with respect to any public company register with the Board.

Auditor Independence

With respect to auditor independence, the Act:

- prohibits a registered public accounting firm from performing certain enumerated non-audit services for a public company while performing a mandatory audit of the company:
  - 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 service that the Board determines, by regulation, is impermissible;
- permits a registered public accounting firm to engage in any non-audit service for an audit client, *including tax services*, that is not described above, but only if the activity is approved in advance by the company's audit committee (this preapproval requirement is waived, however, if the non-audit service provided does not constitute more than 5 percent of the total amount of revenues paid by the company to its auditor during that fiscal year);
- requires accounting firms to change the lead audit partner af-

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ter five consecutive years of auditing a particular public company;

- requires an accounting firm that performs an audit for a public company to deliver a report to the audit committee describing the audit process; and

- prohibits a registered public accounting firm from performing audit services for a public company if any members of the public company's senior management had been employed by that accounting firm and participated in the audit of the company during the prior year.

Corporate and Criminal Fraud

In addition to the criminal penalties imposed by the Act in connection with CEO and CFO certifications, the Act imposes numerous new corporate and criminal fraud accountability laws, which could expose public companies and their management to additional securities fraud actions and which would stiffen the penalties currently in effect for securities fraud violations. Specifically, the Act:

- creates a new felony statute for securities fraud and increases penalties for document shredding;

- increases penalties for white-collar crimes, including increasing to 20 years the maximum prison term for mail and wire fraud; and

- extends the statute of limitations from one and three years to two and five years for bringing securities fraud actions against public companies.

Requirements for Attorneys

The Act also imposes additional responsibilities upon attorneys representing public companies. The Act requires the SEC, within 180 days from the date of enactment, to issue a rule that sets forth minimum standards of professional conduct for attorneys appearing and practicing before the SEC, including a requirement that:

- attorneys report any evidence of a material violation of the securities laws or a breach of fiduciary duty by the company or any employee to the chief legal counsel for the company or the CEO; and

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- if those individuals do not respond appropriately, evidence of the violation or breach be reported to the company's audit committee.

Nothing in the Act would require an attorney to make a report to the SEC or any other regulatory agency. It is unknown whether attorneys who violate this legal requirement will be subjected solely to SEC sanctions or whether there will also be a private cause of action.

* * * * * *

The SEC has also proposed numerous rules with respect to corporate governance and the accounting industry, which, when finalized, will conform with the contents of the Sarbanes-Oxley Act, and, in some cases, will impose more stringent requirements upon public companies and their independent auditors. We will provide you with updates as to the development of these rules as they become available.

NASDAQ PROPOSES ADDITIONAL CORPORATE GOVERNANCE REFORMS

By Carl C. Hanemann and Amos J. Oelking III

Last week, The Nasdaq Stock Market approved 25 corporate governance proposals. These rule changes are in addition to the proposals approved by Nasdaq in May and are substantially similar to the reforms proposed by the New York Stock Exchange in June. *(Click here to link to our E*Zines regarding Nasdaq's May proposals and the NYSE's June proposals.)*

Formal rule changes incorporating these proposals will be filed with the SEC in the near future and will be subject to public comment. The rule changes will not become effective until adopted by the SEC. Significant provisions of the proposed reforms for Nasdaq-listed companies are as follows:

Independence of Directors

- Majority of directors must be independent and must meet in regular "executive sessions."
- Definition of "independent director" tightened to *exclude*:
  - *any* relative of an executive officer;
  - any 20% shareholder;

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- executive officers of charities receiving significant payments from the company; and
- former partners or employees of the outside auditor who worked on the company's audit engagement.

- A 3-year "cooling-off" period for directors who are not independent due to:
  - membership on interlocking compensation committees;
  - the receipt by the director or a family member of the director of payments from the company exceeding $60,000 other than for board service; or
  - having worked on the company's audit engagement.
- Committee of independent directors or majority of all independent directors must approve all director nominations and executive officer compensation.

Audit Committees

- Would have sole authority to hire and fire auditors.
- Could retain and consult with legal, accounting and other experts.
- Must review and approve all related-party transactions.
- Must give advance approval of any non-audit services provided by the company's auditor.
- In "exceptional and limited circumstances" a non-independent director may serve on the audit committee for only 2 years (but not as chairman).
- Regulation S-B filers, like other issuers, will be required to have audit committees consisting of 3 independent directors who are able to read and understand financial statements, one of whom must be "financially sophisticated" as defined in Nasdaq Rule 4350.
- All audit committee members must be able to read and understand financial statements *at the time of* their appointment (as opposed to current rules requiring financial literacy only *within a reasonable period of time after* appointment).

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Stock Option Plans

Shareholder approval will be required for the adoption of or material modification to *any* stock plan. "Inducement grants" to new employees would not require shareholder approval if such grants are approved by an independent compensation committee or a majority of the company's independent directors. Exemptions would also be available for certain tax-qualified plans, such as ESOPs, and for the assumption of pre-existing plans in connection with an acquisition or merger.

Insider Stock Transactions

Companies will be required to disclose any transaction in company stock by an officer or director that exceeds $100,000 within two business days of the transaction. Disclosure of transactions involving less than $100,000 would be required not later than the second business day of the following week. These proposed disclosure requirements are substantially similar to the Form 8-K disclosure of insider transactions proposed by the SEC in April. *(Click here to link to our E*Zine regarding the SEC's proposed Form 8-K disclosures.)*

Continuing Education for Directors; Codes of Conduct

Nasdaq's proposals would also mandate continuing education for *all* directors, and require companies to implement and make publicly available a code of conduct addressing matters such as conflicts of interest and legal and regulatory compliance.

Non-U.S. Companies

Under Nasdaq's proposals, listed non-U.S. companies will become subject to heightened requirements as to governance, SEC filings and quantitative listing standards.

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SEC EXPANDS SHAREHOLDER POWER TO APPROVE EQUITY COMPENSATION PLANS

By L. R. McMillan, II

The SEC Staff recently announced in Staff Legal Bulletin No. 14A that it has modified its position on the ability of companies to exclude shareholder proposals relating to shareholder approval of equity compensation plans. *(Click here to link to the full text of Staff Legal Bulletin No. 14A.)*

Previously, the Staff consistently took the position that companies could exclude proposals relating to general employee compensation under Rule 14a-8(i)(7) because employee compensation is an ordinary business matter, but could not exclude proposals that related only to senior executive and director compensation because they focused on "significant social policy issues" and therefore were an appropriate subject for a shareholder vote.

In view of the current public debate regarding shareholder approval of equity compensation plans, the Staff has now concluded that it should treat proposals that focus on equity compensation plans as follows:

- If the plan compensates only senior executive officers and directors, a proposal to require shareholder approval may not be excluded.
- If the plan also compensates the general workforce or only compensates the general workforce, a proposal to require shareholder approval may be excluded unless adoption of the plan would potentially result in material dilution to existing shareholders. The Staff did not indicate what level of dilution would be considered "material."

Of course, the fact that the proposal cannot be excluded under Rule 14a-8(i)(7) does not mean that it could not be excluded for another reason.

SEC PROVIDES ADDITIONAL GUIDANCE REGARDING CEO/CFO CERTIFICATIONS

By Amos J. Oelking III

Earlier this week, the SEC provided additional guidance regarding its June 27th order requiring the principal executive and principal financial officers of the largest SEC-registered companies to personally attest, in

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writing and under oath, as to the truthfulness and completeness of their company's recent Exchange Act filings. *(Click here to link to our E*Zine regarding the SEC's June 27th order.)*

Given the high degree of public interest in these written attestations, the statements should, until publicly disclosed, "be handled in the same manner as all other material non-public information." Accordingly, in addition to delivering the statements to the SEC as required by the order, a Form 8-K should be filed, disclosing the delivery of the statements and attaching the statements as exhibits. In addition, companies should post the statements on their websites and take whatever additional steps they believe are appropriate "to ensure broad dissemination of the statements."

The SEC has also posted on its website answers to frequently-asked questions regarding its June 27th order. *(Click here to link to the SEC's 3 question-and-answer releases regarding its June 27th order.)*

Please remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues you may contact the head of our Corporate and Securities practice group:

L. Richards McMillan, II
Jones Walker
201 St. Charles Ave., 51st Fl.
New Orleans, LA 70170-5100
ph. 504.582.8188
email rmcmillan@joneswalker.com

Corporate and Securities Practice Group

BRAD J. AXELROD
ALLISON C. BELL
LISA MANGET BUCHANAN
SCOTT DAVID CHENEVERT
DOUGLAS N. CURRAULT, II
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