The Sarbanes-Oxley Act's Regulation of the "Gatekeepers"

Congress and the SEC have greatly increased the rules and restrictions that apply to lawyers and accountants and the companies they serve.

HOWARD E. BERKENBLIT

In the midst of various high profile scandals that involved Enron, WorldCom, and other corporate giants, a recurring questions asked by legislators and investors alike has been "Where were the accountants and lawyers?" While no one excused the abhorrent actions of CEOs and other executives, a sentiment developed that someone should have been able to detect those bad actors long before their behavior evolved into massive financial fraud. As a response to the various scandals, in July 2002, the Sarbanes-Oxley Act of 2002 (the "Act") was signed into law.[1] This law, together with rulemaking initiatives by the Securities and Exchange Commission (the SEC) under the law, does not just regulate matters of corporate governance. Included in its breadth are a series of sweeping changes to the regulation of the accounting profession, as well as a new federalization of some of the rules governing attorney ethics. The Act created some new laws that were immediately effective by its terms. Many other laws, however, were set forth in minimal form with direction to the SEC or other bodies to enact more detailed regulations. This article describes the primary provisions under the Act and related SEC rules that directly impact accountants and attorneys.[2]

Howard E. Berkenblit is an attorney with Sullivan & Worcester LLP, a leading corporate law firm with offices in Boston, New York and Washington, D.C. He can be reached at hberkenblit@sandw.com.

ACCOUNTANTS

New Oversight Board Created Perhaps the broadest sweeping change for accountants under the Act, is the creation of a Public Company Accounting Oversight Board (PCAOB). Even before the enactment of the Act, the SEC had proposed to create a system for private sector regulation of the accounting profession that would not be under the control of accountants. Traditionally, accountants have been primarily self-regulated, with a peer review system and disciplinary mechanisms. The demise of Arthur Andersen LLP brought attention to the lack of effective oversight of supposedly independent auditors. The SEC has stated that effective oversight in the accounting profession is

> critical to quality financial information and trust in and reliance on that information. By having effective oversight, investors are assured that skilled, disinterested professionals operating under high ethical standards and strict quality control procedures are auditing financial statements. Strong oversight helps to strengthen audit practice and to detect and deter weaknesses that could detract from can accountant's ability to fulfill the goal of having financial statements audited by competent, independent accountants.[3]

Building on the SEC's articulated goal of improving oversight of, and investor confidence in, the quality of companies' financial reports, Title I of the Act calls for the PCAOB to be operational by April 26, 2003.[4] The PCAOB is assigned with overseeing the auditing of public companies and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports for companies the securities of which are sold to, and by and for, public

investors.[5] While serving as an independent body, the PCAOB is subject to the oversight and enforcement authority of the SEC.[6] For example, the SEC must approve the rules governing the PCAOB and review disciplinary actions taken by the PCAOB, and the PCAOB must submit an annual report to the SEC.[7]

The Public Company Accounting Oversight Board is assigned with overseeing the auditing of public companies and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports for companies the securities of which are sold to, and by and for, public investors.

Make-up and Operation of the PCAOB. The nonprofit PCAOB will have five members appointed from among

> prominent individuals of integrity and reputation who have a demonstrated commitment to investors and the public, and an understanding of the responsibilities for and nature of the financial disclosures required of issuers[8] under the securities laws and the obligations of accountants with respect to the preparation and issuance of audit reports with respect to such disclosures.[9]

Only two of the five members can be certified public accountants.[10] All of the members must devote their full-time resources to the position and be independent of public accounting firms.[11] Each member will be appointed for a five-year term, with one member coming up for appointment each year. Each member will have a two term limit.[12] While the SEC met its October 2002 deadline of appointing five initial members, William Webster, the original chairman of the PCAOB, resigned amid controversy surrounding his ties to a public company being investigated by the SEC. This controversy also led to the resignations of then SEC Chairman Harvey Pitt and Chief Accountant Robert Herdman. The SEC subsequently nominated William Donaldson to chair the SEC, though as of the date of this article, a new permanent chair of the PCAOB has not yet been named. The PCAOB is currently in the process of working on its initial budget and other administrative matters necessary to commence operations.

Beginning 180 days after the SEC determines that the PCAOB is ready to be operational, every accounting firm preparing or issuing, or participating in the preparation of or issuance of, any audit report with respect to any issuer, must register with the PCAOB.[13] The budget of the PCAOB will be paid for by mandatory fees assessed on issuers, as well as registration and annual fees payable by registered public accounting firms.[14]

Responsibilities of the PCAOB. The Act assigns to the PCAOB specific responsibilities, namely to:

- register public accounting firms that prepare audits for issuers;
- establish or adopt by rule auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers. The PCAOB is charged with establishing and amending, through adoption of standards proposed by one or more professional groups of accountants or advisory groups, auditing and related attestation standards, quality control standards and ethics standards to be used by registered public accounting firms in their preparation and issuance of audit reports;
- conduct inspections of public accounting firms. This will be annual for firms auditing

---

[1] See Sarbanes-Oxley Act of 2002, PL 107-204, 116 Stat. 745 et seq.

[2] This article does not attempt to cover related initiatives by accounting standards setters such as the American Institute of Certified Public Accountants, the Financial Accounting Standards Board, the International Accounting Standards Board or the Emerging Issues Task Force. These accounting groups have undertaken a variety of initiatives and convergence projects with the goal of improving the transparency and consistency of financial reporting.

[3] Framework for Enhancing the Quality of Financial Information Through Improvement of Oversight of the Auditing Process, Release Nos. 33-8109, 34-46120, 35-27543, IA-2039, IC-25624, 67 Fed. Reg. 44964 (proposed July 5, 2002).

[4] See Sarbanes-Oxley Act, § 101(d), 116 Stat. 751 (the Act).

[5] Act § 101(a), 116 Stat. 750.

[6] Act § 107, 116 Stat. 765-68.

[7] Act § 101(h), 116 Stat. 753.

[8] For purposes of the Act, "issuer" is defined as an issuer (as defined in section 3 of the Securities Exchange Act of 1934), the securities of which are registered under section 12 of the Securities Exchange Act of 1934, or that is required to file reports under section 15(d), or that files or has file a registration statement that has not yet become effective under the Securities Act of 1933, and that it has not withdrawn. See id. at § 2(a)(7), 116 Stat. 747.

[9] Act § 101(e), 116 Stat. 751-52.

[10] Id.

[11] Id.

[12] Id.

[13] Act § 102(a), 116 Stat. 753.

[14] See Act § 102(f), 116 Stat. 755 and § 109(d), 116 Stat. 770.

- more than 100 issuers and at least every three years for others;[15]
- conduct investigations and disciplinary proceedings concerning, and impose appropriate sanctions where justified upon, registered public accounting firms and associated persons of such firms;
- perform such other duties or functions necessary or appropriate to promote high professional standards among, and improve the quality of audit services offered by, registered public accounting firms and associated persons thereof in order to protect investors or to further the public interest;
- enforce compliance with the Act, the rules of the PCAOB, and the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, by registered public accounting firms and associated persons; and
- set the budget and manage the operations of the PCAOB and its staff.[16]

The Act requires the PCAOB to establish auditing standards that include a requirement that each registered public accounting firm prepare, and maintain for a period of not less than seven years, audit work papers, and other information related to any audit report, in sufficient detail to support the conclusions reached in such report.[17] The auditing standards must also provide for a concurring or second partner review and approval of each audit report.[18] A registered public accounting firm will also need to describe in each audit report the scope of the auditor's testing of the internal control structure and procedures of the issuer (see the discussion of Section 404(b) of the Act below) and present the findings of the auditor from such testing and an evaluation of the internal control structure and procedures.[19] The evaluation will review whether an issuer maintains records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer, and provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles (GAAP) and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and the issuer's directors.[20] The evaluation will describe material weaknesses in such internal controls and of any material noncompliance found on the basis of such testing.[21] Finally, the auditing standards to be established by the PCAOB will include quality control standards for registered public accounting firms themselves regarding monitoring of ethics and independence, supervision of audit work, hiring, professional development and advancement of personnel, internal inspection, the acceptance and continuation of engagements and internal inspections.[22]

Foreign firms that prepare or furnish an audit report with respect to any issuer are subject to the Act and the rules of the PCAOB and SEC.[23] If a foreign public accounting firm issues an opinion or performs material services upon which a registered public accounting firm relies in issuing an opinion contained in any audit report, under the Act that foreign firm will be deemed to have consented to produce its audit workpapers for the PCAOB or SEC in connection with any investigation and to be subject to U.S. courts for purposes of enforcement of any request for production of such workpapers.[24] The SEC has authority to exempt foreign public accounting firms if necessary in the public interest or for the protection of investors.[25]

Auditor Independence Restrictions Increased. One area of concern that proponents of the Act focused on was the need to assure true independence of outside accountants from the companies they audit. Accounting firms were perceived to be reaping large consulting and other fees from the companies they were auditing, potentially compromising their objectivity as they lobbied for more business. The SEC

The Oversight Board is charged with establishing and amending, through adoption of standards proposed by one or more professional groups of accountants or advisory groups, auditing and related attestation standards, quality control standards and ethics standards to be used by registered public accounting firms in their preparation and issuance of audit reports.

[15] See Act § 104(b), 116 Stat. 757-58.

[16] See Act § 101(c), 116 Stat. 750-51.

[17] See Act § 103(a), 116 Stat. 755-57. This conflicted with Section 802 of the Act, discussed below, which required retention for only five years. For consistency, the SEC has extended the time period under Section 802 to seven years.

[18] Id.

[19] Id.

[20] Id.

[21] Id.

[22] Id.

[23] See Act § 106(a), 116 Stat. 764.

[24] See Act § 106(b), 116 Stat. 765.

[25] See Act § 106(c), 116 Stat. 765.

has adopted rules under the Act designed to enhance the independence of accountants that audit and review financial statements and prepare attestation reports filed with the SEC.[26] The rules will require certain disclosures and reports by auditors and set conditions under which auditing firms would not be considered independent for purposes of performing audits of public company financial statements.

Prohibited Non-Audit Services. Under SEC rules adopted in November 2000, the SEC already deemed several major categories of non-audit services to impair auditor independence.[27] However, those rules represented several compromises and contained qualifications and exceptions after a political battle partly won by influential lobbying at the time. The rules called for by the Act increase the independence requirements, though with more exceptions than originally proposed by the SEC. For example, several of the listed services will be permitted if it is reasonable to conclude that the results of the services will not be subject to audit procedures.[28] The rules revise regulations related to the non-audit services that, if provided to an audit client, would impair an accounting firm's independence.[29] In addition, the SEC has added a rule making it unlawful for an auditor not to be independent under these rules.[30] The SEC has focused on three overarching policy considerations that will dictate what types of non-audit services are impermissible, namely (1) an auditor cannot audit his or her own work, (2) an auditor cannot perform management functions, and (3) an auditor cannot act as an advocate for the client.[31] Under the rules, an accounting firm will not be deemed independent beginning in May 2003 if it performs for any issuer contemporaneously with the audit any of the following non-audit services:

> **Under SEC rules adopted in November 2000, the SEC already deemed several major categories of non-audit services to impair auditor independence, but those rules represented several compromises and contained qualifications and exceptions after a political battle partly won by influential lobbying.**

- *Bookkeeping or other services related to the accounting records or financial statements of the audit client.* The rules prohibit an accountant from auditing the bookkeeping work performed by his or her accounting firm, unless it is reasonable to conclude that the results will not be subject to audit procedures.[32] These services involve maintaining or preparing accounting records, preparing financial statements that are filed with the SEC or the information which forms the basis of financial statements filed with the SEC or preparing or originating source data underlying financial statements.[33] These services are already deemed to impair independence except in limited circumstances, such as in an emergency.[34] The exceptions have been eliminated.
- *Financial information systems design and implementation.* Many of these services are already deemed to impair independence, subject to an exception if management follows certain evaluation and oversight procedures.[35] Under the new rules, an accountant will not be independent if the accountant directly or indirectly operates or supervises the operation of the audit client's information system or manages the client's local area network, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the client's financial statements.[36] The accountant is not permitted to design or implement a hardware or software system that aggregates source data underlying the financial statements or generates information that is significant to the client's financial systems taken as a whole.[37] The rules do not prohibit an audit firm from working on systems that are unrelated to the client's financial statements or accounting records (so long as the services are pre-approved by the issuer's

[26] Strengthening the Commission's Requirement Regarding Auditor Independence, Release Nos. 33-8183, 34-47265, 35-27642, IC-25915, IA-2103, 68 Fed. Reg. 6006 et seq. (February 5, 2003)(to be codified at 17 CFR 210.240 et al.).

[27] See generally Regulation S-X, Rule 2-01, 17 CFR 210.2-01.

[28] Se 68 Fed. Reg. 6011.

[29] The rules would not prohibit these services from being provided by an accounting firm to non-audit clients.

[30] See 68 Fed. Reg. 6010 (to be codified at 17 CFR 240.10A-2).

[31] 68 Fed. Reg. 6010.

[32] Id. at 6011 (to be codified at 17 CFR 210.2-01(c)(4)(i)).

[33] Id.

[34] See 17 CFR 210.2-01(c)(4)(i).

[35] See 17 CFR 210.2-01(c)(4)(ii).

[36] 68 Fed. Reg. 6011 (to be codified at 17 CFR 210.2-01(c)(4)(ii)).

[37] Id.

audit committee).[38] Auditors may also evaluate internal controls of a system as it is being designed, implemented or operated either as part of an audit or attest service and make recommendations on internal control matters to management or other service providers in conjunction with the design and installation of a system by another service provider.[39]

- *Appraisal or valuation services, fairness opinions, or contribution-in-kind reports.* These services are already deemed to impair independence, subject to various exceptions such as reviews of other specialists' valuations, valuations of pension obligations and for implementing tax-planning strategies.[40] The new rules prohibit the accountant from providing these services, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the client's financial statements.[41] The rules still allow such services for non-financial reporting purposes, such as transfer pricing studies or cost segregation studies.[42]
- *Actuarial services.* Actuarial services related to insurance policy reserves and related accounts are currently deemed to impair independence.[43] Accountants are currently permitted to assist management in developing appropriate methods, assumptions and amounts for reserves and other actuarial items.[44] The revised rules prohibit an accountant from providing any actuarially oriented advisory service involving the amounts recorded in the financial statements and related accounts, unless it is reasonable to conclude that the results of the services will not be subject to audit procedures during an audit of the client's financial statements.[45] Accountants may still assist a client in understanding the methods, models, assumptions and inputs used in computing an amount.[46]
- *Internal audit outsourcing services.* Current SEC rules allow a company to outsource part of its internal audit, subject to designated limits and oversight.[47] The revised rules prohibit an auditor from performing internal audit services related to the internal accounting controls, financial systems or financial statements for an audit client, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the client's financial statements.[48] This does not include nonrecurring evaluations of discrete items or programs that are not in substance the outsourcing of the internal audit function.[49] It also does not include operational internal audits unrelated to internal accounting controls, financial systems or financial statements.[50] During the conduct of the audit or when providing attest services related to internal controls the auditor may make recommendations to the client for improvements to the controls, as this is part of the accountant's responsibilities.[51]
- *Management functions.* Currently, an outside auditor may not act, temporarily or permanently, as a director, officer or employee of an audit client or perform any supervisory, decision-making or ongoing monitoring function for the client.[52] The revised rules contain the same prohibition, while permitting the auditor to perform services in connection with the assessment of internal accounting and risk management controls and provide recommendations for improvements.[53] The auditor may not, however, design or implement their recommendations.[54]

Accounting firms were perceived to be reaping large consulting and other fees from the companies they were auditing, potentially compromising their objectivity as they lobbied for more business.

[38] See id. at 6011.

[39] Id. at 6012.

[40] See 17 CFR 210.2-01(c)(4)(iii).

[41] 68 Fed. Reg. 6012 (to be codified at 17 CFR 210.2-01(c)(4)(iii)).

[42] See id.

[43] See 17 CFR 210.2-01(c)(4)(iv).

[44] Id.

[45] 68 Fed. Reg. 6013 (to be codified at 17 CFR 210.2-01(c)(4)(iv)).

[46] Id.

[47] See 17 CFR 210.2-01(c)(4)(v).

[48] 68 Fed. Reg. 6013 (to be codified at 17 CFR 210.2-01(c)(4)(v)).

[49] See id.

[50] Id.

[51] Id.

[52] See 17 CFR 210.2-01(c)(4)(vi).

[53] 68 Fed. Reg. 6014 (to be codified at 17 CFR 210.2-01(c)(4)(vi)).

[54] See id.

- *Human resources.* Existing SEC rules deem auditors not independent if they provide certain human resources functions such as searching for or seeking out management and director candidates, engaging in psychological or other testing, undertaking reference checks, negotiating conditions of employment, or recommending or advising a client to hire a specific candidate for a specific job.[55] The revised rules contain the same prohibitions.[56]
- *Broker or dealer, investment adviser or investment banking services.* Broker-dealer services, including acting as an underwriter, making investment decisions, having discretionary authority over an audit client's investments, executing a transaction to buy or sell an audit client's investment, or having custody of assets of an audit client, are already deemed to impair independence.[57] The revised rules add acting as an unregistered broker-dealer to this list.[58]
- *Legal services.* Legal services are already deemed to impair independence and the revised rules provide that an accountant is not independent of a client if the accountant provides any service to the audit client that, under the circumstances in which the service is provided, could be provided only by someone licensed, admitted or otherwise qualified to practice law in the jurisdiction in which the service is provided.[59] This will apply to foreign and U.S. accounting firms equally, though the SEC will consider whether the services labeled as legal services in foreign jurisdictions would be prohibited in the U.S.[60] This prohibition is designed to address the conflicting obligations of a lawyer's zealous advocacy and an accountant's objective independence.[61] This also may slow the growth of multidisciplinary practice firms.
- *Expert services.* Current rules do not prohibit an accounting firm from providing expert services to an audit client. The SEC added to its rules, pursuant to the Act, that an accountant's independence would be impaired as to an audit client if the accountant provides expert opinions or other expert services to the client for the purpose of advocating that client's interests in litigation or in an administrative or regulatory proceeding or investigation.[62] This prohibition includes providing consultation to an audit client's legal counsel in connection with litigation, administrative or regulatory proceedings.[63] It also includes providing expert witness services or providing forensic accounting services to the client's legal representative in connection with an SEC investigation.[64] An accountant may, however, provide factual accounts or testimony or explain positions taken or conclusions reached during the performance of any service by the accountant.[65] The rules do not prohibit an auditor from assisting the client's audit committee in fulfilling its responsibilities, such as by conducting its own investigation of a potential accounting impropriety.[66]

The SEC has focused on three overarching policy considerations that will dictate what types of non-audit services are impermissible, namely an auditor cannot audit his or her own work, an auditor cannot perform management functions, and an auditor cannot act as an advocate for the client.

Outside auditors may, however, engage in any non-audit service not delineated if such services are approved in advance by the issuer's audit committee.[67] In addition, impermissible arrangements already in place prior to the effective date of the rules, will be permitted for up to a year.[68] While the Act lists tax services as an example of a permissible non-audit service that may be provided after audit committee pre-approval, in its proposing release the SEC stated that even tax services may be impermissible if they

[55] See 17 CFR 210.2-01(c)(4)(vii).

[56] 68 Fed. Reg. 6014 (to be codified at 17 CFR 210.2-01(c)(4)(vii)).

[57] See 17 CFR 210.2-01(c)(4)(viii).

[58] 68 Fed. Reg. 6015 (to be codified at 17 CFR 210.2-01(c)(4)(viii)).

[59] See id. (to be codified at 17 CFR 210.2-01(c)(4)(ix)); 17 CFR 210.2-01(c)(4)(ix).

[60] 68 Fed. Reg. 6015.

[61] See id.

[62] Id. at 6016 (to be codified at 17 CFR 210.2-01(c)(4)(x)).

[63] See id.

[64] Id.

[65] Id. (to be codified at 17 CFR 210.2-01(c)(4)(x)).

[66] Id.

[67] See id. at 6022-24 (to be codified at 17 CFR 210.2-01(c)(7)).

[68] See id. at 6006 (to be codified at 17 CFR 210.2-01(e)(1)(iii)).

run afoul of one of the SEC's three policy considerations.[69] For example, while preparation of tax returns will usually be permissible, defending the tax returns in tax court would be an impermissible impairment of independence that requires the auditor to act as an advocate.[70] In its proposing release, the SEC indicated that the formulation of tax strategies such as tax shelters to minimize a company's tax obligations may also be problematic, as these services may require the accountant to audit its own work or to become an advocate for the client's position.[71] After many public comments, the final rules allow accountants to provide tax compliance, tax planning, and tax advice to audit clients, subject only to audit committee pre-approval and a prohibition on situations involving public advocacy.[72]

Pre-Approval by the Audit Committee. The SEC's rules require that an issuer's audit committee pre-approve all audit and non-audit services provided to the issuer by the auditor of an issuer's financial statements beginning in May 2003.[73] The Act contains a de minimis exception for services that account for not more than 5% of the total amount paid to the auditor in a fiscal year.[74] To rely on such exception, however, the services must not have been recognized by the issuer at the time of the engagement to be non-audit services.[75] Such services must promptly be brought to the attention of the issuer's audit committee and approved by the audit committee or a designee prior to completion of the audit.[76] The Act and the SEC would allow some flexibility to issuers by providing that pre-approval may be delegated to one member of the audit committee (but *not* to management).[77] In addition, pre-approval may either be specific or pursuant to detailed pre-approval policies and procedures established by the audit committee, after which the audit committee is informed on a timely basis of each service.[78] For investment companies, pre-approval will be required by the investment company's audit committee for services provided directly to the investment company or to an entity in the investment company complex where the nature of the services provided has a direct impact on the operations or financial reporting of the investment company.[79]

Additional Safeguards Designed to Ensure Auditor Independence. Early versions of the Act would have required rotation by an issuer of audit firms. Although the Act requires a study of the potential effects of mandatory rotation of firms, the final version of the Act does not go so far as to require firm rotation. The New York Stock Exchange (NYSE) suggests that audit committees of listed companies should consider whether auditor rotation is necessary in order to assure continuing auditor independence and present their conclusions to the full board of directors.[80] The Act does require rotation of lead and concurring partners on an audit team at least every five years.[81] The SEC proposed to go further and prohibit *any* partners on the audit engagement team from providing audit services to the issuer for more than five consecutive years and from returning to audit services with the same issuer within five years.[82] The final SEC rule covers lead and concurring partners, and other "audit partners" who have responsibility for decision making on significant auditing, accounting and reporting matters that affect the financial statements or who maintain regular contact with management and the audit committee.[83] This includes lead partners on the audit teams of subsidiaries of an issuer whose assets or revenues constitute 20% or more of the con-

The accountant is not permitted to design or implement a hardware or software system that aggregates source data underlying the financial statements or generates information that is significant to the client's financial systems taken as a whole.

[69] Compare Act § 201(a), 116 Stat. 772, with Strengthening the Commission's Requirements Regarding Auditor Independence, Release Nos. 33-8154, 34-46934,35-27610, IC-25838, IA-2088, 67 Fed. Reg. 76780, 76790 (proposed December 13, 2002).

[70] See 67 Fed. Reg. 76790.

[71] Id.

[72] 68 Fed. Reg. 6016-17.

[73] Id. at 6006, 6022-24 (to be codified at 17 CFR 210.2-01(c)(7)).

[74] Act § 202, 116 Stat. 772. See also 68 Fed. Reg. 6022-23 (to be codified at 17 CFR 210.2-01(c)(7)(i)(C)).

[75] Id.

[76] Id.

[77] Act § 202, 116 Stat. 773; 68 Fed. Reg. 6022 (to be codified at 17 CFR 210.2-01(c)(7)(i)(B)).

[78] 68 Fed. Reg. 6022-23 (to be codified at 17 CFR 210.2-01(c)(7)(i)).

[79] Id. at 6023 (to be codified at 17 CFR 210.2-01(c)(7)(ii)).

[80] See Corporate Governance Rule Proposals Reflecting Recommendations from the NYSE Corporate Accountability and Listing Standards Committee (NYSE Proposal) (submitted to SEC on Aug. 15, 2002) at § 7(b)(ii)(B) Commentary.

[81] Act § 203, 116 Stat. 773.

[82] 67 Fed. Reg. 76791.

[83] 68 Fed. Reg. 6017-22 (to be codified at 17 CFR 210.2-01(c)(6)).210.2-01(c)(6)(i)(A)(2)).

solidated assets or revenues of the issuer.[84] Audit partners other than lead and concurring partners will be subject to rotation after seven years, not five.[85] Lead and concurring partners will have to stay off the audit team for five years before being allowed to re-join, while other audit partners subject to the rule will have a two-year "time out" period.[86] For lead and concurring partners, once the rules becomes effective in May 2003, time served in those capacities before the rules will count against the five year limit, while for other audit partners and audit partners with foreign firms the time period will run prospectively from the effective date of the rules.[87]

The SEC recommends that accounting firms stagger their rotations to provide a continuity of knowledge about particular companies.

The SEC recommends that accounting firms stagger their rotations to provide a continuity of knowledge about particular companies.[88] The rotation rules do not cover partners in a national office who provide technical expertise, but are not involved in the audit per se and do not routinely interact or develop business relationships with the audit client.[89] The SEC considered alternatives to partner rotation such as the periodic performance of forensic audits by a second independent audit firm.[90] Some expressed concern that forced rotations will reduce the number of accountants available to issuers, particularly for small accounting firms. Smaller companies could be forced to incur greater expense by retaining larger accounting firms with more capacity to rotate partners. The SEC responded to these concerns exempting small accounting firms from the rotation requirements.[91]

Additional SEC rulemaking measures designed to address independence include:

- *Restrictions on employment of auditor personnel.* The rules prohibit an accounting firm from auditing a client's financial statements if any person acting in a financial reporting oversight role with the client had been a lead or concurring partner or a member of the accounting firm's audit engagement team who provided more than ten hours of audit, review or attest services within the one-year period preceding the commencement of audit procedures.[92] Existing relationships prior to the new rules' effectiveness are permitted, as are conflicts that are created through a merger or acquisition (as long as the audit committee is aware of the conflict).[93]
- *Reports to the audit committee.* The rules require that the auditor of an issuer's financial statements report, in writing or orally, prior to the filing of an audit report with the SEC (or more frequently) certain matters to the issuer's audit committee, including "critical accounting policies" used by the issuer, alternative treatments of financial information within GAAP that have been discussed with management, ramifications of the use of such alternative disclosures and treatments and the treatment preferred by the accounting firm, and other material written communications between the accounting firm and management.[94]
- *Disclosure of fees and pre-approval policies.* The rules require disclosure by issuers to investors of information related to the audit and non-audit services provided by, and fees paid by the issuer to, the auditor of the issuer's financial statements.[95] The

---

[84] Id. at 6019 (to be codified at 17 CFR 210.2-01(f)(7)(ii)(D)).

[85] Id. at 6020 (to be codified at 17 CFR 210.2-01 (c)(6)(i)(A)(2)).

[86] Id. at 6018, 6020 (to be codified at 17 CFR 210.2-01(c)(6)(i)(B)).

[87] Id. at 6021-22 (to be codified at 17 CFR 210.2-01(e)(1)(v)). While the time periods will be retroactive for concurring partners, despite the May 2003 effective date of the rules, concurring partners' independence will not be impaired for violating this limit until fiscal years beginning a full year after the effective date. Id.

[88] See 67 Fed. Reg. 76791.

[89] 68 Fed. Reg. 6020. The rotation requirements and time-out periods also apply to investment companies. Audit partners may not rotate within an investment company complex to avoid the rules. Id. at 6020-21 (to be codified at 17 CFR 210.2-01(c)(6)(iii)).

[90] See 67 Fed. Reg. 76792.

[91] 68 Fed. Reg. 6020 (to be codified at 17 CFR 210.2-01(c)(6)(ii)).

[92] Id. at 6007-10 (to be codified at 17 CFR 210.2-01(c)(2)(iii)). For registered investment companies, an accounting firm would not be independent if a former audit engagement team member is employed in a financial reporting oversight role with any entity in the investment company complex that is responsible for the financial reporting or operations of the registered investment company or any other registered investment company in the same investment company complex. Id. at 6009-10 (to be codified at 17 CFR 210.2-01(c)(2)(iii)(C)).

[93] See id. at 6006, 6009 (to be codified at 17 CFR 210.2-01(c)(2)(iii)(B)(2)(ii)). An exemption is available in limited, emergency circumstances. See id. at 6009 (to be codified at 17 CFR 210.2-01(c)(2)(iii)(B)(2)(iii)).

[94] Id. at 6027-29 (to be codified at 17 CFR 210.2-07).

[95] Id. at 6030-32 (to be codified at 17 CFR 240.14a-101, Item 9(e), with parallel amendments to Forms 10-K, 20-F and 40-F).

disclosures, to be made in issuers' annual reports and proxy statements, will include clear, concise and understandable descriptions of any policies and procedures developed by the audit committee concerning pre-approval of audit and non-audit services, as well as the percentage of fees paid to the auditor where the de minimis exception was used.[96] Fees paid by issuers for audit services, audit-related services, and tax services and all other fees will also be disclosed in both a company's annual report and proxy statement, and the nature of the services comprising the fees will need to be described.[97] The rules require disclosure of fees for the year covered by the filing and for the previous year.[98] Previous rules required disclosure of the audit fees, financial information systems design and implementation fees and all other fees paid to the auditor for the past year only.[99] Some have argued that the new broadened category of audit fees will be overinclusive and result in less useful information for investors due to less clarity about the diversity of fees that get lumped in to that single category. Financial systems design and implementation fees have been eliminated because these services are mostly prohibited under the rules described above relating to non-audit services.[100]

- *No compensation for selling non-audit services.* The rules provide that going forward an accountant is not independent from an audit client if any audit partner earned or received compensation based directly on selling engagements to the audit client to provide any services, other than audit, review and attest services.[101] This rule by the SEC goes beyond the direct mandate of the Act. Small audit firms are exempt from this rule.[102]

New Requirements for Retention of Records. The days of accounting firms shredding documents appear to be over. Section 802 of the Act is intended to address the destruction or fabrication of evidence and the preservation of financial and audit records.[103] Pursuant to Section 802, the SEC has adopted rules effective October 31, 2003 relating to the Act's requirement that any accountant who conducts an audit of an issuer maintain all audit or review workpapers for a period of seven years from the end of the fiscal period in which the audit or review was concluded.[104] These records retention requirements also apply to any audit or review of the financial statements of any registered investment companies and the performance of such services by foreign auditors.[105] The penalties for violation of Section 802 include fines or up to ten years imprisonment.[106]

The SEC's rules specify the information that must be retained by auditors. The rules specify that auditors must retain workpapers and other documents that form the basis of the audit or review and memoranda, correspondence, communications, other documents, and records (including electronic records), that are created, sent or received in connection with the audit or review and contain conclusions, opinions, analyses, or financial data related to the audit or review.[107] The SEC defines workpapers as documentation of auditing or review procedures applied, evidence obtained, and conclusions reached by the accoun-

Fees paid by issuers for audit services, audit-related services, tax services and all other fees will be disclosed in both a company's annual report and proxy statement, and the nature of the services comprising the fees will need to be described.

[96] See id. at 6031 (to be codified at 17 CFR 240.14a-101, Item 9(e)(5)(ii) with parallel amendments to Forms 10-K, 20-F and 40-F). If greater than 50%, the percentage of hours expended on the auditor's engagement to audit the most recent year's financial statements that were attributed to work performed by persons other than the principal auditor's full-time, permanent employees also needs to be disclosed. See 17 CFR 240.14a-101, Item 9(e)(5)(to be recodified as Item 9(e)(6)).

[97] Id. at 6030-31 (to be codified at 17 CFR 240.14a-101, Item 9(e)(1)-(4), with parallel amendments to Forms 10-K, 20-F and 40-F). Registered management investment companies will have to provide similar disclosure in annual reports on proposed Form N-CSR. Id. at 6031-32.

[98] Id.

[99] See Item 9(e) of Schedule 14A, 17 CFR 240.14a-101, Item 9(e).

[100] 67 Fed. Reg. 76799.

[101] Id. at 6024-25 (to be codified at 17 CFR § 210.2-01(c)(8)).

[102] Id.

[103] Act § 802, 116 Stat. 800.

[104] Retention of Records Relevant to Audits and Reviews, Release Nos. 33-8180, 34-47241, IC-25911, 68 Fed. Reg. 4862 et seq. (January 30, 2003 (to be codified at 17 CFR 210.2-06). Section 802 of the Act required retention for only five years, but was inconsistent with the PCAOB's guidelines under § 103(a) of the Act.

[105] See id. at 4862.

[106] Act § 802(a), 116 Stat. 800.

[107] 68 Fed. Reg. 4863 (to be codified at 17 CFR 210.2-06(a)).

tant in the audit or review engagement, as required by standards established or adopted by the SEC or PCAOB.[108] The requirements do not apply to non-substantive materials not part of the workpapers and other documents that do not contain relevant financial data or conclusions, opinions or analyses.[109] The SEC had proposed that records should be retained whether the conclusions, opinions, analyses or financial data in the records would support or cast doubt on the final conclusions reached by the auditor.[110] According to the SEC, the rules would ensure preservation of those records that reflected differing professional judgments and views (both within the accounting firm and between the firm and the issuer) and how those differences were resolved.[111] After many comments that the "cast doubt" language was unworkable and would lead accounting firms to retain documents related to virtually every exchange of ideas on any topic, the SEC replaced this language with a requirement to keep records that either support the auditor's final conclusions or contain information or data, relating to a significant matter, that is inconsistent with the final conclusions of the auditor on that matter or on the audit or review.[112] This will include records documenting consultations on, or resolutions of, differences in professional judgment.[113] Critics have argued that these requirements are overly broad and will require retention of a excessive amount of documentation not previously kept. Production of all such documents in litigation could become quite costly. Others worry that accountants might be deterred from writing down certain analyses for fear of having to retain additional documents.

After many comments that the "cast doubt" language was unworkable and would lead accounting firms to retain documents related to virtually every exchange of ideas on any topic, the SEC replaced this language with a requirement to keep records that either support the auditor's final conclusions or contain information or data, relating to a significant matter, that is inconsistent with the final conclusions of the auditor on that matter or on the audit or review.

Internal Control Attestations. Proposed SEC rules under Section 404(b) of the Act would require an issuer to file an annual internal control report as part of its annual report.[114] This report would address management's responsibility to establish internal controls and procedures for financial reporting and require management to evaluate the effectiveness of those controls and procedures as of the last day of the company's fiscal year.[115] Internal controls and procedures would be defined by reference to the definition of internal controls in existing accounting literature, including the American Institute of Certified Public Accountants' Codification of Statements on Auditing Standards Section 319, subject to revision by the PCAOB.[116] Internal controls and procedures should ensure that companies have processes designed to provide reasonable assurance that the company's transactions are properly authorized, the company's assets are safeguarded against unauthorized or improper use and the company's transactions are properly recorded and reported in order to permit the preparation of the company's financial statements in conformity with GAAP.[117] An issuer's auditor will have to attest to, and report on, management's assertions in the internal control report.[118] The company must file the auditor's attestation in its annual report.[119] In addition, recently adopted SEC rules require companies to conduct a quarterly evaluation of their disclosure procedures and controls.[120] The proposed rules would also require companies to conduct quarterly evaluations of their internal controls and procedures for financial reporting.[121]

---

[108] Id. at 4864 (to be codified at 17 CFR 210.2-06(b)).

[109] See id. at 4863.

[110] See Retention of Records Relevant to Audits and Reviews, Release Nos. 33-8151, 34-46869, IC-25830, 67 Fed. Reg. 71018 (proposed November 27, 2002).

[111] Id. at 71020.

[112] 68 Fed. Reg. 4864-66 (to be codified at 17 CFR 210.2-06(c)).

[113] Id.

[114] See Disclosure Required by §§ 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, Release Nos. 33-8138, 34-46701, IC-25775, 67 Fed. Reg. 66208 et seq. (proposed October 30, 2002); Act § 404(b), 116 Stat. 789.

[115] 67 Fed. Reg. 66218-19.

[116] See id. at 66219-20.

[117] Id. at 66220.

[118] Id.

[119] Id.

[120] See 17 CFR 240.13a-14; 17 CFR 240.15d-14. The SEC defines disclosure controls and procedures as controls and other procedures designed to ensure that information required to be disclosed by the issuer in reports filed or submitted by it under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported, within the time periods specified. The term includes controls and procedures designed to ensure that information required to be disclosed is accumulated and communicated to management, including the CEO and CFO, to allow timely decisions regarding required disclosure. See 17 CFR 240.13a-14(c); 17 CFR 240.15d-14(c).

[121] 67 Fed. Reg. 66221-22.

Conforming revisions would be made to recently adopted certifications required by a company's principal executive and financial officers regarding the company's quarterly and annual reports.[122] The SEC has deferred action on these proposals until later in 2003.

Broad Prohibition on the Improper Influence on the Conduct of Audits. As directed by Section 303(a) of the Act, the SEC has proposed rules (to be final by April 26, 2003) to prohibit officers and directors of an issuer or registered investment company, and persons acting under the direction of an officer or director, from taking any action to fraudulently influence, coerce, manipulate or mislead the auditor of the issuer's financial statements for the purpose of rendering the financial statements materially misleading.[123] Under the proposed rule, an officer, director or person acting under their direction could be culpable even if he or she did not know that the improper influence could, if successful, result in rendering financial statements materially misleading, if he or she was unreasonable in not knowing as such.[124] Some critics have argued that the law should prohibit only intentional acts. The proposed rules, in combination with existing rules, 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.[125] Existing rules address the falsification of books, records, and accounts and false or misleading statements or omissions to accountants.[126] Persons acting under the direction of officers and directors can include individuals beyond those under the supervision or control of the officer or director, such as customers, vendors or creditors who under the direction of an officer or director provide false or misleading information to auditors.[127] The term may also include accountants and attorneys, securities professionals, or other advisors.[128] For a registered investment company, persons acting under the direction of officers and directors may include officers, directors, and employees of the investment company's investment advisor, sponsor, or a similar party.[129]

The rules would prohibit officers or directors of an issuer, or persons acting under their direction, from subverting the auditor's responsibilities to investors to conduct a diligent audit of the financial statements and to provide a true report of the auditor's findings.[130] Actions that could if successful, result in rendering financial statements materially misleading include actions to fraudulently influence, coerce manipulate or mislead an auditor to issue a report on an issuer's financial statements that is not warranted in the circumstances, not to perform audit, review or other procedures required by generally accepted auditing standards or other professional standards, not to withdraw an issued report or not to communicate matters to an issuer's audit committee.[131] The last of these is consistent with, but also adds to, the greater emphasis given in the Act and stock exchange listing standards to providing all relevant financial information to audit committees. Examples of improper influence include offering or paying bribes or other financial incentives, including offering future employment for contracts for non-audit services, providing an auditor with inaccurate or misleading legal analysis, threatening to cancel or canceling existing non-audit engagements if the auditor objects to the issuer's accounting, seeking to have a partner removed from the audit engagement because the partner objects to the issuer's accounting, blackmailing or making physical threats.[132] The rules would cover not only annually audited financial statements but also quarterly reviewed financial statements.[133]

The rules would prohibit officers or directors of an issuer, or persons acting under their direction, from subverting the auditor's responsibilities to investors to conduct a diligent audit of the financial statements and to provide a true report of the auditor's findings.

Other Sections of the Act Impacting Accountants

Reflecting Material Correcting Adjustments. Section 401 of the Act requires that each financial report that contains financial statements and is required to be prepared in accordance with GAAP and filed with the SEC reflect all material correcting adjustments that have been identified by a registered public accounting firm.[134]

---

122 See id.

123 See Act § 303(a), 116 Stat. 778; Improper Influence on Conduct of Audits, Release Nos. 34-46685, IC-25773, 67 Fed. Reg. 65325 et seq. (proposed October 24, 2002).

124 See 67 Fed. Reg. 65328.

125 Id. at 65325.

126 See 17 CFR 240.13b2-1 et seq.

127 67 Fed. Reg. 65326.

128 Id.

129 Id. at 65326-27.

130 Id. at 69325-26.

131 Id. at 65328.

132 Id. at 65327.

133 Id. at 65328.

134 Act § 401(a), 116 Stat. 785-86.

More Disclosure About Non-GAAP Financial Measures, Off-Balance Sheet Arrangements and in MD&A. Accountants will likely be involved in reviewing a variety of new disclosure items to be required under recent and pending SEC rules. Some of these disclosures will be based upon numbers or policies derived from financial statements. While these disclosures are intended to provide greater transparency to investors, they are likely to lengthen documents filed with the SEC.

A company using a "non-GAAP financial measure" in an SEC filing must include a quantitative reconciliation with the most comparable GAAP financial measure, a statement regarding the purposes for which management uses the non-GAAP financial measure, and a statement as to why management believes the presentation of the non-GAAP financial measure is useful to investors.

Pursuant to the Act, the SEC has adopted rules that require a company using a "non-GAAP financial measure" in an SEC filing (relating to a period ending after March 28, 2003) to include certain information such as a quantitative reconciliation with the most comparable GAAP financial measure, a statement regarding the purposes for which management uses the non-GAAP financial measure, and a statement as to why management believes the presentation of the non-GAAP financial measure is useful to investors.[135] There are also new limits on the prominence of non-GAAP financial measures and on what they are permitted to include and exclude.[136] A non-GAAP financial measure is defined by the SEC as a numerical measure of a company's historical or future financial performance, financial position or cash flows that (1) excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the comparable measure calculated and presented in accordance with GAAP in the statement of income, balance sheet or statement of cash flows, or (2) includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the comparable measure so calculated and presented.[137] A common example is the use of EBITDA when disclosing financial results. Non-GAAP financial measures do not include certain operating and other statistical measures, such as unit sales or number of employees.[138]

In addition, the SEC has adopted new rules regarding greater disclosure about off-balance sheet arrangements.[139] Much of the content of these rules has already been unofficially "required" under SEC interpretive guidance from January 2002 regarding Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") and more generally under existing MD&A rules.[140] The Act also calls for a study of the extent of special purpose entities used in such arrangements and whether GAAP results in financial statements reflect the economics of off-balance sheet transactions to investors in a transparent fashion.[141] The new SEC rules will require companies to disclose for fiscal years ending on or after June 15, 2003 greater detail in the MD&A sections of their periodic reports and other SEC filings about all material off-balance sheet arrangements that have or are reasonably likely to have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources or significant components of revenues or expenses.[142] Off-balance sheet arrangements will include certain guarantee contracts, retained or contingent interests in assets transferred to an unconsolidated entity, derivative instruments that are classified as equity and material variable interests

---

[135] See Conditions for Use of Non-GAAP Financial Measures, Release Nos. 33-8176, 34-47226, 68 Fed. Reg. 4,820 et seq. (January 30, 2003)(to be codified at 17 CFR 228.10(h), 229.10(e), 244); Act § 401(b), 116 Stat. 786. The SEC's proposed rules would have prohibited non-GAAP per-share measures but the final rules did not include this prohibition. See Conditions for Use of Non-GAAP Financial Measures, Release Nos. 33-8145, 34-46788, 67 Fed. Reg. 68790, 68795 (proposed November 13, 2002). The rules also will require companies that issue earnings releases to furnish them on Current Reports on Form 8-K. See 68 Fed. Reg. 4825-27.

[136] Id. at 4824-25 (to be codified at 17 CFR 228.10(h), 229.10(e)).

[137] Id. at 4821-22 (to be codified at 17 CFR 228.10(h)(2), 229.10(e)(2), 244.101(a)(1)).

[138] See id. at 4822.

[139] Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, Release Nos. 33-8182, 34-47264, 68 Fed. Reg. 5982 et seq. (February 5, 2003)(to be codified at 17 CFR 228.303(c), 229.303(a)(4), with parallel amendments to Forms 20-F and 40-F).

[140] See Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations, Release Nos. 33-8056, 34-45321, 67 Fed. Reg. 3746 et seq. (January 25, 2002); 17 CFR 229.303.

[141] See Act § 401(c), 116 Stat. 786-87.

[142] 68 Fed. Reg. 5988 (to be codified at 17 CFR 228.303(c)(1), 229.303(a)(4)(i), with parallel amendments to Forms 20-F and 40-F). Quarterly updates will only be required for material changes.

in unconsolidated entities that conduct certain activities.[143] The disclosure will include the nature and business purpose, the importance to the issuer for liquidity, capital resources, market risk or credit risk support or other benefits, the financial impact and exposure to risk and known events, demands, commitments, trends or uncertainties that implicate the issuer's ability to benefit from its off-balance sheet arrangements.[144] Companies will need to consider disclosing additional information necessary for an understanding of their off-balance sheet arrangements and their material effects.[145] The disclosure is intended to provide insight into the overall magnitude of these activities, their impact and the circumstances that could cause material contingent obligations or liabilities to come to fruition.[146] These rules will also require MD&A to include a table detailing the amounts of payments due under specified contractual obligations, aggregated by category, for specified time periods.[147]

Pending SEC proposals would increase disclosure requirements in MD&A regarding a company's critical accounting estimates. Under SEC interpretations published in December 2001, the SEC encouraged companies to disclose in plain English those accounting policies that are most important to the portrayal of the company's financial condition and results, and that require management's most difficult, subjective or complex judgments.[148] The proposed rules would go beyond the interpretive guidance and require additional qualitative and quantitative analyses of the sensitivity of the judgments and estimates underlying critical accounting policies.[149] A company would have to identify the accounting estimates reflected in its financial statements that required it to make assumptions about matters that were highly uncertain at the time of estimation.[150] Disclosure about those estimates would then be required if different estimates that the company reasonably could have used in the period, or changes in the accounting estimate reasonably likely to occur from period to period, would have a material impact on the presentation of the company's financial condition, changes in financial condition or results of operations.[151] A company's disclosure about these critical accounting estimates would include a discussion of the methodology and assumptions underlying them, the effect the accounting estimates have on the company's financial presentation, and the effect of changes in the estimates.[152] A company that had initially adopted an accounting policy with a material impact would have to disclose information that includes what gave rise to the initial adoption, the impact of the adoption, the accounting principle adopted and method of applying it, and the choices it had among accounting principles.[153] Like the new rules for auditors, critical accounting estimates would need to be disclosed by management to the audit committee.[154]

Study of Consolidation of Accounting Firms. Section 701 of the Act calls for a study by the U.S. Comptroller General of the factors leading to consolidation of public accounting firms since 1989 and the reduction in the number of firms capable of providing audit services to large national and multi-national business organizations that are subject to the securities laws.[155] The study will also review the impact of such consolidation on capital formation and securities markets and ways to increase competition and the number of firms.[156] Finally, the study will cover problems resulting from limited competition among public accounting firms, including problems from higher costs, lower quality of services, impairment of auditor independence and lack of choice.[157]

Companies are to conduct quarterly evaluations of their internal controls and procedures for financial reporting.

CEO and CFO Certifications. Much has been written about new certifications by CEOs and CFOs

---

[143] Id. at 5,987-88 (to be codified at 17 CFR §§ 228.303(c)(2), 229.303(a)(4)(ii), with parallel amendments to Forms 20-F and 40-F).

[144] Id. at 5989-90 (to be codified at 17 CFR 228.303(c)(1), 229.303(a)(4)(i), with parallel amendments to Forms 20-F and 40-F).

[145] Id.

[146] See id. at 5989.

[147] 68 Fed. Reg. 5990-91 (to be codified at 17 CFR 229.303(a)(5), with parallel amendments to Forms 20-F and 40-F).

[148] See Cautionary Advice Regarding Disclosure About Critical Accounting Policies, Release Nos. 33-8040, 34-45149, 66 Fed. Reg. 65013-14 (December 17, 2001).

[149] See Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies, Release Nos. 33-8098, 34-45907, 67 Fed. Reg. 35620 et seq. (proposed May 20, 2002).

[150] 67 Fed. Reg. 35621, 35625-26.

[151] Id.

[152] Id.

[153] Id. at 35635-36.

[154] See id. at 35 621. See also note 94 supra.

[155] Act § 701, 116 Stat. 797.

[156] Id.

[157] Id.

contained in their companies' periodic reports filed with the SEC. While these don't directly impact accountants, one specific requirement in one of the sets of certification calls for the CEO and CFO to certify that they have disclosed to the company's auditor and audit committee, based on their most recent evaluation, (a) all significant deficiencies in the design or operation of internal controls which could adversely affect the company's ability to record, process, summarize and report financial data and have identified for the company's auditor 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.[158] This requirement is indicative of a larger theme under the Act; namely, maintaining the integrity of financial statements through three branches — management, the audit committee and the outside auditor.

While merely a disclosure requirement, companies may be reluctant to disclose that they have no audit committee financial experts.

Restatement Forfeitures. Section 304 of the Act requires certain forfeitures by CEOs and CFOs after restatements of financial statements due to material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws.[159] Specifically, the CEO and CFO must reimburse the issuer for any bonus or other incentive-based or equity-based compensation during the 12 month period following the first public issuance or filing with the SEC of the document embodying such financial reporting requirement and any profits realized from the sale of securities during that 12 month period.[160] While not directly impacting auditors, this section may lead to greater conflict between management reluctant to restate and accountants insistent on restatement.

NYSE/Nasdaq Governance Changes; Audit Committee Changes. The national stock exchanges and Nasdaq have proposed a series of corporate governance reforms for their listed companies, some of which may impact accountants or former accountants. Among other changes, boards of directors would need to have a majority of directors who are "independent," a term which would be more narrowly defined.[161] For example, Nasdaq would prohibit former partners or employees of the outside auditor of a company who worked on a company's audit engagement from being deemed independent for three years.[162] The NYSE would deem a director not independent if he or she is, or in the past five years has been, affiliated with or employed by a present or former auditor of the company or of an affiliate until five years after the end of either the affiliation or auditing relationship.[163] The Act also contains independence standards for audit committee members to be enacted by stock exchanges at the direction of the SEC.[164] The heightened independence requirements will reduce the number of individuals qualified to serve on boards and audit committees. Further, the Act and SEC rules pursuant thereto will now require public disclosure of whether or not audit committee members are "audit committee financial experts."[165] Financial experts are defined by the SEC to include individuals who have had extensive accounting experience.[166] While merely a disclosure requirement, companies may be reluctant to disclose that they have no audit committee financial experts. At the same time competition for recruitment of such experts will increase. As many former accountants may qualify as audit committee financial experts and be independent from many companies, they may have new opportunities to serve on boards and audit committees!

The NYSE and Nasdaq standards in compliance with the Act will provide that audit committees have sole authority to appoint, determine funding for and oversee the outside auditor.[167] NYSE rules would require an audit committee to at least annually obtain and review a report by the company's

158 See Act § 302, 116 Stat. 777; 17 CFR 240.13a-14; 17 CFR 240.15d-14.

159 Act § 304(a), 116 Stat. 778.

160 Id.

161 See NYSE Proposal at § 1; Proposed Rule Change by National Association of Securities Dealers, Inc. (NASD Proposal) (File No. SR-NASD-2002-141, submitted to SEC on Oct. 9, 2002) at 4.

162 See NASD Proposal at 4.

163 See NYSE Proposal at § 2(b)(ii).

164 Act § 301, 116 Stat. 776; Standards Relating to Listed Company Audit Committees, Release Nos. 33-8173, 34-47137, IC-25885, 68 Fed. Reg. 2638 et seq. (proposed January 17, 2003).

165 See Act § 407, 116 Stat. 790; Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Release Nos. 33-8177, 34-47235, 68 Fed. Reg. 5110 et seq. (January 31, 2003) (to be codified at 17 CFR 228.401(e), 229.401(h), with parallel amendments to Forms 20-F and 40-F).

166 See 68 Fed. Reg. 5113-17.

167 See Act § 301, 116 Stat. 776; NYSE Proposal at § 7(a); NASD Proposal at 8-9; 68 Fed. Reg. 2643-44.

independent auditor describing the firm's internal quality control procedures, any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues, and (to assess the auditor's independence) all relationships between the independent auditor and the company.[168] NYSE rules would also require the audit committee to discuss the annual and quarterly financial statements, including MD&A, with management and the auditor and meet separately, periodically, with the independent auditor and review with the independent auditor any audit problems or difficulties and management's response.[169] Audit committees would further need to set clear hiring policies for employees or former employees of the independent auditor.[170]

LAWYERS

Securities lawyers have certainly been busy as a result of the Act and related SEC rulemaking advising their clients on how best to steer through the maze of new regulation and comply with all of the requirements that now impact them. However, while many provisions of the Act and related SEC rulemaking directly regulate accountants, the Act contains only one provision that directly regulates attorneys.[171] The thrust behind regulating attorneys relates not only to perceived complicity by lawyers in fraudulent corporate activities, but also the view that corporate attorneys have strayed from their role as representatives of the company as a whole and become beholden to the interests of management, which may conflict with those of the company from time to time. Lawyers have, in the eyes of some, become skillful technicians, adhering to the letter of the law, but not necessarily its spirit, by finding technicalities and loopholes. The SEC has stated that the investing public must be able to rely on the integrity of lawyers, given their important and expanding role with issuers.[172] Like accountants, attorneys have traditionally been self-regulated by state bar associations overseen by state courts. Section 307 of the Act, together with the SEC's rule proposal thereunder, generated as much, if not more, controversy than the accounting reforms.

Section 307 of the Act. Section 307 of the Act calls for the SEC to issue rules setting forth minimum standards of professional conduct for attorneys appearing and practicing before the SEC in any way in the representation of issuers.[173] These standards are to include a 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 to the chief legal counsel or the CEO.[174] If the counsel or CEO does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), the attorney would be required to report the evidence to the audit committee or another committee of the board of directors comprised of non-employee directors or to the full board.[175]

The Act's mandate is significant in several respects. First, it represents the federalization of attorney conduct rules which for the most part have been left to individual states. Typically, state courts set forth and oversee rules of lawyer ethics in conjunction with state bars. The SEC's pursuit of lawyers in recent years has been limited. The SEC previously relied on its rules of practice to discipline attorneys who were incompetent or acted improperly.[176] This self-created approach was controversial and lacked the clear, express mandate of the Act. The SEC had also prevailed in sporadic court cases against lawyers,

Lawyers have, in the eyes of some, become skillful technicians, adhering to the letter of the law, but not necessarily its spirit, by finding technicalities and loopholes.

[168] NYSE Proposal at § 7(b).

[169] Id.

[170] Id.

[171] See Act § 307, 116 Stat. 784.

[172] Implementation of Standards of Professional Conduct for Attorneys, Release Nos. 33-8186, 34-47282, IC-25920, 68 Fed. Reg. 6324, 6325 (proposed February 6, 2003).

[173] Act § 307, 116 Stat. 784.

[174] Id.

[175] Id.

[176] See SEC Rules of Practice, Section 102(e), 17 CFR § 201.102(e). Section 102(e) provides that the SEC may censure or deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to a person who is found by the SEC after notice and opportunity for hearing: (i) not to possess the requisite qualifications to represent others or (ii) to be lacking in character or integrity or to have engaged in unethical or improper personal conduct or (iii) to have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws or the rules and regulations thereunder. Section 102(e) contains additional rules for accountants, but does not specifically address attorneys.

but without much consistency. While some uniform model rules exist, each state has developed its own unique system of attorney oversight. Outgoing SEC Chairman Harvey Pitt had indicated his displeasure with the generally low level of effective responses the SEC receives from state bar committees when it refers possible disciplinary proceedings to them.[177] Second, Section 307 represents a perceived intrusion into state law by covering not only violations of securities law, but also of breaches of fiduciary duty, an area governed by state law and company charter documents thereunder. Neither the Act nor the SEC rule discussed below provides much guidance on how far the scope of terms such as "evidence," "breach," "fiduciary duty" and "similar violations" may extend. Finally, the Act regulates foreign lawyers, an area traditionally left to the jurisdiction of foreign governments, though the SEC has made some accommodations in an attempt to ensure that its rules do not conflict or inappropriately interfere with the activities of non-U.S. lawyers.[178]

Neither the Act nor the SEC rule discussed below provides much guidance on how far the scope of terms such as "evidence," "breach," "fiduciary duty" and "similar violations" may extend.

The SEC's Proposal and Final Rules. The SEC responded by proposing a rule that not only covered the mandates under the Act, but went significantly beyond. After an extremely high number of public comments, the SEC issued a final rule that more closely tracks the Act.[179] The final rule, which will go into effect in August 2003, affirmatively states that an attorney representing an issuer represents the issuer as an organization rather than the officers or others with whom the attorney interacts in the course of that representation, and that the attorney is obligated to act in the best interests of the issuer.[180] Consistent with, but not exactly parallel with, the Act, the SEC's rule requires reporting to the chief legal officer (or equivalent) or *both* the chief legal officer and CEO of material violations.[181] If they do not respond appropriately, the attorney would have to report "up the ladder" to the board of directors, audit committee or another committee.[182] Alternatively, the attorney may report directly to a qualified legal compliance committee (QLCC), a newly-created concept.[183] The SEC's original proposal would have required, however, if the attorney had not received a satisfactory response from the full board or committee (a QLCC response, as discussed below, would be treated differently), the attorney would have to withdraw from its representation of the company, notify the SEC that it was doing so and disaffirm "tainted" SEC filings.[184] The SEC's final rule did not include this "noisy withdrawal" concept, but the SEC has solicited further comments on possibly requiring this or an alternative in the near future.[185]

Appearing and Practicing Before the SEC. The SEC's original proposed rule adopted an expansive view of who would be considered an attorney subject to the rule, covering all attorneys who were admitted, licensed or otherwise qualified to practice law whether employed in-house by a company or retained to perform legal work on behalf of an issuer.[186] This would have included non-practicing attorneys, such as corporate officers, who could be deemed to be appearing before the SEC. After many public commenters suggested that such a wide scope would cover individuals not really involved with SEC filings or who might not even be aware they were subject to the rule, the SEC narrowed its approach to include only attorneys providing legal services to an issuer who have an attorney-client relationship with the issuer and who have notice that

[177] See Speech by SEC Chairman Harvey L. Pitt: Remarks Before the Annual Meeting of the American Bar Association's Business Law Section (August 12, 2002).

[178] See Implementation of Standards of Professional Conduct for Attorneys, Release Nos. 33-8185, 34-47276, IC-25929, 68 Fed. Reg. 6296, 6303-04 (February 6, 2003). The SEC's initial proposal did not exempt foreign attorneys in any way, but did solicit comments on this topic. See Implementation of Standards of Professional Conduct for Attorneys, Release Nos. 33-8150, 34-46868, IC-25829, 67 Fed. Reg. 71670, 71676 (proposed December 2, 2002).

[179] See 68 Fed. Reg. 6296 et seq. (to be codified at 17 CFR 205).

[180] Id. at 6305-06 (to be codified at 17 CFR 205.3(a)). As proposed, the rule would have required lawyers to also act in the best interests of shareholders. Sec. 67 Fed. Reg. 71680-81. Many state ethics rules do not specifically name shareholders when stating that a corporate attorney represents the organization.

[181] 68 Fed. Reg. 6306 (to be codified at 17 CFR 205.3(b)(1)).

[182] Id. at 6307 (to be codified at 17 CFR 205.3(b)(3)).

[183] Id. at 6309 (to be codified at 17 CFR 205.3(c)).

[184] 67 Fed. Reg. 71688-89. Under the proposed rule, the SEC would also have required documentation by the attorney of his or her reports and responses, but this requirement was dropped from the final rules. See, e.g., 67 Fed. Reg. 71684-85, 71687.

[185] See 68 Fed. Reg. 6324.

[186] 67 Fed. Reg. 71677.

documents they are preparing or assisting in preparing will be filed with or submitted to the SEC.[187] Foreign attorneys not admitted in the United States, and who do not advise clients regarding U.S. law (so-called "non-appearing foreign attorneys"), are not covered by the rule.[188] Foreign attorneys who do provide legal advice regarding U.S. law are covered unless they provide the advice in consultation with U.S. counsel.[189] The rule covers attorneys who are "appearing and practicing" before the SEC, a concept defined broadly to include:

- transacting any business with the SEC, including communications in any form;
- representing an issuer in an SEC administrative proceeding or in connection with any SEC investigation, inquiry, information request or subpoena;
- providing advice in respect of U.S. securities laws or SEC rules or regulations regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the SEC, including the provision of such advice in the context of preparing, or participating in the preparation of, any such document; and
- advising an issuer as to whether information or a statement, opinion or other writing is required under U.S. securities laws or SEC rules and regulations to be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the SEC.[190]

An attorney retained or directed by an issuer to investigate evidence of a material violation will be deemed to be appearing and practicing before the SEC.[191] However, if the attorney was retained or directed by the issuer's chief legal officer to investigate evidence of a material violation, that attorney will not have an obligation to report if the attorney reports the results of the investigation to the chief legal officer and, except where the attorney and chief legal officer each reasonably believes that no material violation has occurred, is ongoing or is about to occur, the chief legal officer reports the results of the investigation to the board, an independent committee or a QLCC.[192] Further, such attorney will not have an obligation to report if the attorney was retained or directed by the chief legal officer to assert, consistent with his or her professional obligations, a "colorable defense" in an investigation or proceeding relating to the evidence of the material violation, and the chief legal officer provides reasonable and timely progress reports to the issuer's board, an independent committee or a QLCC.[193] An attorney retained by a QLCC to investigate evidence of a material violation or to assert a colorable defense will also not have an obligation to report the evidence.[194]

Reporting Evidence of Material Violations. The SEC's rule prescribes the duty of an attorney who appears or practices before the SEC in the representation of an issuer that becomes aware of evidence of a "material violation" to report as dictated by the rule.[195] A material violation is a violation of the securities laws, a material breach of fiduciary duty, or a similar material violation, terms which are in turn not themselves defined or vaguely defined.[196] The rule does not require an attorney to actually know that a violation has been committed. Rather, the rule's reporting obligation is triggered when an attorney becomes aware of credible evidence based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is occurring or is about to occur.[197] To be "reasonably likely," a material violation must be more than a mere possibility, but not necessarily more likely than not.[198] Some have opined that a more clearcut subjective knowledge standard would be more appropriate. Other critics have argued that determining whether evidence of a material violation exists is tantamount to making the attorney act as a grand jury to determine if there is a reasonable basis for his or her conclusion.[199] Securities and corporate law issues are often complex and require difficult judgments. Rea-

[187] 68 Fed. Reg. 6298 (to be codified at 17 CFR 205.2(a)).

[188] Id. at 6298, 6303-04 (to be codified at 17 CFR 205.2(a)(ii), 205.2(j)).

[189] Id. at 6303 (to be codified at 17 CFR 205.2(j)).

[190] Id. at 6297-98 (to be codified at 17 CFR 205.2(a)).

[191] Id. at 6308 (to be codified at 17 CFR 205.3(b)(5)).

[192] Id. (to be codified at 17 CFR 205.3(b)(6)).

[193] Id.

[194] Id. (to be codified at 17 CFR 205.3(b)(7)).

[195] For purposes of this rule, the term issuer includes any person controlled by an issuer where an attorney provides legal services to such person on behalf of or at the behest of, or for the benefit of the issuer. 68 Fed. Reg. 6303 (to be codified at 17 CFR 205.2(h)).

[196] Id. at 6301, 6303 (to be codified at 17 CFR 205.2(d), 205.2(i)). Material violations cover both United States federal and state laws. Id. (to be codified at 17 CFR 205.2(i)).

sonable attorneys may differ. The attorney is initially directed to make this report to the issuer's chief legal officer or the chief legal officer and the CEO (as opposed to the Act's permitting reporting only to the chief legal officer *or* the CEO).[200]

Reporting Up the Ladder. When presented with a report of a possible material violation, the rule obligates the issuer's chief legal officer to determine whether to conduct an inquiry into the reported material violation to ascertain whether in fact a violation has occurred, is occurring or about to occur.[201] A chief legal officer who reasonably concludes that there has been no material violation would have to provide notice to the reporting attorney of this conclusion.[202] The reasonable belief of a chief legal officer will be measured against a standard of whether the matter in question and circumstances are such that the belief is not unreasonable.[203] Under the rule, reasonableness is measured against conduct that would not be unreasonable for a prudent and competent attorney.[204] In other words, the rule uses an objective standard rather than looking to the subjective actions or state of mind of the particular attorney. A chief legal officer who concludes that a material violation has occurred, is occurring or is about to occur would be required to take reasonable steps to ensure that the issuer adopts appropriate remedial measures and/or sanctions, including appropriate disclosures.[205] Alternatively, instead of conducting an inquiry, the chief legal officer can refer the matter to a QLCC and be free of further obligation.[206]

As many former accountants may qualify as audit committee financial experts and be independent from many companies, they may have new opportunities to serve on boards and audit committees.

A reporting attorney who receives an appropriate response within a reasonable time will have satisfied all obligations under the rule. In the event a reporting attorney does not receive an appropriate response within a reasonable time, he or she would be required to report the evidence of a material violation to the issuer's audit committee, another committee of independent directors, or to the full board.[207] An "appropriate response" is a response that provides a basis for an attorney to reasonably believe that no material violation is occurring, has occurred or is about to occur or that the issuer has, as necessary, adopted remedial measures, including appropriate steps or sanctions to stop any material violation that is ongoing, prevent any material violation that has yet to occur and rectify or address any material violation that has already occurred, and to minimize the likelihood of its recurrence.[208] An appropriate response also includes when an attorney reasonably believes that the issuer, with the consent of the issuer's board of directors, an independent committee or a QLCC, has retained or directed an attorney to review the reported evidence of a material violation and either has implemented any remedial recommendations made by such attorney after a reasonable investigation and evaluation or has been advised that such attorney may assert a colorable defense on behalf of the issuer in response to the reported material violation.[209] Again, critics perceive the determination as to whether there has been an appropriate response to require the attorney to make a complex conclusion rather than creating a clearcut standard. Similarly, if the attorney reasonably believes that it would be futile to report evidence of a material violation to the chief legal officer and CEO, the attorney may report directly to the issuer's audit committee, another committee of independent directors, or to the full board.[210]

An attorney formerly employed or retained by an issuer who reasonably believes that he or she has been discharged because he or she fulfilled the reporting obligation imposed by the rule may, but is not

[197] Id. at 6301-02 (to be codified at 17 CFR 205.2(e)).

[198] See id. at 6302.

[199] See, e.g., Charles P. Axelrod, *A View of the SEC's Proposed Attorney Responsibility Rules Under Sarbanes-Oxley*, 34 SECURITIES REGULATION & LAW (December 23, 2002) at 2,053.

[200] Compare 68 Fed. Reg. 6306 (to be codified at 17 CFR 205.3(b)(1)) with Act § 307, 116 Stat. 784.

[201] 68 Fed. Reg. 6307 (to be codified at 17 CFR 205.3(b)(2)).

[202] Id.

[203] Id. at 6305 (to be codified at 17 CFR 205.2(m)).

[204] Id. (to be codified at 17 CFR 205.2(l)).

[205] Id. at 6307 (to be codified at 17 CFR 205.3(b)(2)).

[206] Id.

[207] Id. (to be codified at 17 CFR 205.3(b)(3)). The rule provides that for reporting to a committee of directors who are "not employed, directly or indirectly by the issuer." See id. (to be codified at 17 CFR 205.3(b)(3)(ii)). The SEC has indicated it will likely amend this standard of independence when it promulgates final rules under the Act relating to the criteria for audit committee members' independence. See id. at 6305.

[208] Id. at 6298-301 (to be codified at 17 CFR 205.2(b)).

[209] Id.

required to, notify the board of directors or a committee of his or her belief that he or she was discharged for reporting evidence of a material violation.[211] Under the noisy withdrawal provisions, if approved, the attorney would be permitted to notify the SEC and disaffirm tainted submissions.[212] In addition, Section 806 of the Act contains "whistleblower" protection that prohibits an issuer from retaliating against employees who lawfully provide information in an investigation relating to the possible commission of certain federal offenses, including violations of SEC rules and regulations.[213]

Creation of a Qualified Legal Compliance Committee. As an alternative process for considering reports of material violations, an issuer may (but is not required to) establish a QLCC comprised of at least one member of the issuer's audit committee, and two or more independent board members.[214] The QLCC may be the audit committee or another previously existing committee if an issuer does not want to create a new separate committee.[215] The QLCC would be established or designated in advance by the board of directors to investigate any report of evidence of a material violation by the issuer, its officers, directors, employees or agents.[216] The QLCC, if established, must create written procedures for the confidential receipt, treatment, retention and consideration of any report of evidence of a material violation.[217] The QLCC would also be authorized to recommend, by majority vote, that the issuer take remedial action.[218] If the issuer were to fail in any material respect to take any remedial measures that the QLCC has recommended to be taken, the QLCC would be permitted, though not required, to notify the SEC that the issuer has failed in a material respect to implement an appropriate response recommended by the QLCC.[219] Attorneys who reported evidence of a material violation to a QLCC would *not* have been subject to the noisy withdrawal requirements.[220] Some felt a QLCC would have improperly deprived the full board of its authority and responsibility for corporate decision-making, so the SEC changed the final rule to authorize recommendations by the QLCC, as opposed to direct action.[221]

The SEC's Proposal to Step Beyond the Act

Noisy Withdrawal Proposal. Under the SEC's initially proposed rule, an attorney who had not received an appropriate response from the issuer in certain instances would have been required to engage in a "noisy withdrawal" and disaffirm certain SEC submissions.[222] Outside attorneys who made a report and had not received an appropriate response and who reasonably believed that the reported material violation was ongoing or was about to occur *and* was likely to result in substantial injury to the financial interest or property of the issuer or of investors would have been required to withdraw from the representation, notify the SEC of their withdrawal and disaffirm any submission to the SEC that they had participated in preparing which was tainted by the violation.[223] Specifically, an attorney would have had to promptly disaffirm to the SEC any opinion, document, affirmation, representation, characterization, or the like in a document filed with or submitted to the SEC, or incorporated by reference into such a document, that the attorney had prepared or assisted in preparing and that the attorney reasonably believed was or may be materially false or misleading.[224] In-house attorneys who reasonably believed that the reported violation was ongoing or was about to occur and was likely to result in substantial injury to the financial interest or

Outgoing SEC Chairman Harvey Pitt had indicated his displeasure with the generally low level of effective responses the SEC receives from state bar committees when it refers possible disciplinary proceedings to them.

210 Id. at 6307-08 (to be codified at 17 CFR 205.3(b)(4)).

211 Id. at 6309 (to be codified at 17 CFR 205.3(b)(10)).

212 See 67 Fed. Reg. 71691.

213 See Act § 806, 116 Stat. 802-04. See also Act § 1107, 116 Stat. 810, which provides for fines or imprisonment against persons retaliating against informants to law enforcement regarding federal offenses.

214 68 Fed. Reg. 6304-05, 6309 (to be codified at 17 CFR 205.2(k), 205.3(c)).

215 Id. at 6304 (to be codified at 17 CFR 205.2(k)).

216 Id. (to be codified at 17 CFR 205.2(k)(3)).

217 Id (to be codified at 17 CFR 205.2(k)(2)).

218 Id. (to be codified at 17 CFR 205.2(k)(3)(iii)).

219 Id. (to be codified at 17 CFR 205.2(k)(4)).

220 See 67 Fed. Reg. 71687-88; 68 Fed. Reg. 6326.

221 See Comments of Henry A. McKinnell, Ph.D., Chairman of the Board and CEO, Pfizer Inc., Vice Chairman - Corporate Governance Task Force, Chairman — SEC Subcommittee, The Business Roundtable, to the SEC, dated December 20, 2002 (available at www.sec.gov/rules/proposed/s74502/hamckinnell1.htm). See also 68 Fed. Reg. 6305.

222 See 67 Fed. Reg. 71688-89.

property of the issuer or investors would have been required to disaffirm any tainted submission they had participated in preparing, but would not have been required to resign.[225] The provision distinguished between outside attorneys retained by the issuer and attorneys employed by the issuer because attorneys employed by an issuer face greater potential obstacles to compliance, and because the personal cost of compliance to an attorney employed by the issuer is greater.[226] The provision would have imposed an affirmative obligation on attorneys to disaffirm a document or filing where they believed a violation was ongoing or prospective because of the greater potential of harm to investors inherent in such a violation. The rule would also have provided that where an attorney filed a notification with the SEC as part of a noisy withdrawal, no violation of the attorney/client privilege would occur.[227] Issuers would have had to notify any attorneys replacing those that had withdrawn that the previous attorney withdrew based upon professional considerations.[228] Under the initially proposed SEC rule, in the event an attorney reasonably believed that a material violation had already occurred and had no ongoing effect, the attorney would have been permitted, but not required, to take these steps, so long as he or she also believed that the reported material violation was likely to have caused substantial injury to the financial interest or property of the issuer or of investors.[229]

Many attorneys were concerned that by notifying the SEC of their withdrawal, even without specifics, they would be clearly indicating to the SEC that investigation or enforcement activity against the issuer was necessary.

Concerns of the Bar Regarding Noisy Withdrawal and Attorney/Client Privilege. After the SEC proposed its rules, critics argued that requiring noisy withdrawals would have a chilling effect on attorney-client communications. They argued that companies would be less willing to share issues with their lawyers or seek advice on controversial topics for fear that an attorney could later use the information against them. The trust which is the foundation of an attorney and client relationship would be diminished. In-house lawyers might be less effective and their roles marginalized. The chair of an American Bar Association task force on the new rule has pointed out that when clients fear their secrets are unsafe, they may not seek or obtain legal advice that heads off behavior that harms the public.[230] The SEC had acknowledged even in its proposing release that it did not want its rule to impair zealous advocacy or to discourage issuers from seeking and obtaining effective and creative legal advice.[231] The American Bar Association urged the SEC to take its time in evaluating whether the noisy withdrawal requirement was really necessary.[232] As it was not part of the Act's mandate, it did not need to be part of the rule finalized by January 2003.

In addition, although the SEC categorically stated that a notification to the SEC under the rule would not breach the attorney-client privilege and believes that this is "largely settled law," critics were skeptical. State courts presented with a defense of attorney/client privilege might not agree that privilege had not been waived or that the court was bound by the SEC rule. An attorney's noisy withdrawal would simply state that the withdrawal was based on "professional considerations."[233] Many attorneys were concerned that by notifying the SEC of their withdrawal, even without specifics, they would be clearly indicating to the SEC that investigation or enforcement activity against the issuer was necessary. Many state ethical rules currently permit noisy disclosures, though few *require* them with respect to financial issues. Some states permit or require noisy withdrawal only to prevent imminent death or substantial bodily injury. Critics argued the differing federal and state standards would make it unclear which standards applied. Attorneys would be confused about how to act in circumstances covered by both state and federal rules that conflict. Others questioned the SEC's authority to go beyond the mandates of the Act.

Deferral of Decision on Noisy Withdrawal and Alternative Proposal. In light of all of the comments received and the lack of a mandate to include the noisy withdrawal requirements under the

223 Id.; 68 Fed. Reg. 6326.

224 Id.

225 Id.

226 See 67 Fed. Reg. 71690.

227 Id.

228 Id.; 68 Fed. Reg. 6327.

229 Id.

230 See Terry Carter, *Going Before the SEC: ABA, Others Criticize Proposed Lawyer Regs*, ABA JOURNAL REPORT (Dec. 20, 2002).

231 See, e.g., 67 Fed. Reg. 71673.

232 See Comments of Alfred P. Carlton, Jr., President, American Bar Association, to the SEC (December 18, 2002, available at www.sec.gov/rules/proposed/s74502/apcarlton1.htm).

233 See 67 Fed. Reg. 71688; 68 Fed. Reg. 6326-27.

Act, the SEC approved the rule without the noisy withdrawal requirements, but kept that part of its proposal open for comment for an additional 60 days.[234] The SEC may still approve this part of the rule in time for the effective date of the rest of the rule. According to the SEC's press release:

> Given the significance and complexity of the issues involved, including the implications of a reporting out requirement on the relationship between issuers and their counsel, the Commission decided to continue to seek comment and give thoughtful consideration to these issues.[235]

While still considering noisy withdrawal, the SEC has also proposed an alternative to noisy withdrawal that would require attorney withdrawal, but would require an issuer, rather than an attorney, to publicly disclose the attorney's withdrawal or written notice that the attorney did not receive an appropriate response to a report of a material violation.[236] An attorney would only need to act where he or she reasonably concluded that there was "substantial evidence" that a material violation was ongoing (rather than was "likely" to be ongoing) or was about to occur, and was likely to cause substantial injury to the issuer.[237] This alternative would not require an attorney to disaffirm documents filed with the SEC.[238] Specifically, an issuer that had received notice of an attorney's withdrawal would be required to report the notice and the circumstances related thereto on a Current Report on Form 8-K (or on a short form of Form 20-F or 40-F for foreign private issuers).[239] The Form 8-K, 20-F or 40-F would have to be filed within two business days of receiving the attorney's notice.[240] The SEC believes a public filing may provide better protection to investors by alerting them to the possibility of an ongoing material violation.[241] The SEC is considering exceptions to public disclosures where an issuer receives a second opinion indicating that the first attorney acted unreasonably or that the issuer had subsequently implemented an appropriate response.[242] The newly proposed rule also would *permit* an attorney, if an issuer has not complied with the disclosure requirement, to inform the SEC that the attorney had withdrawn from representing the issuer or provided the issuer with notice that the attorney had not received an appropriate response to a report of a material violation.[243] The SEC may or may not approve any of these variations.

Disclosure of Confidential Information. Under the SEC's rule, an attorney is authorized, in certain circumstances, to disclose confidential information related to his or her appearance and practice before the SEC in the representation of an issuer.[244] An attorney could reveal confidences if he or she reasonably believed it to be necessary to prevent the issuer from committing a material violation likely to cause substantial financial injury to the financial interests or property of the issuer or investors.[245] An attorney could also reveal confidential information to the SEC to the extent the attorney reasonably believes necessary to prevent the commission of perjury in an SEC proceeding or investigation or commission of an illegal act that is likely to perpetrate fraud upon the SEC.[246] Similarly, an attorney may disclose confidential information to rectify the consequences of a material violation by an issuer that caused or may cause substantial injury to the financial interest or property of the issuer or investors when such actions have been advanced by the use of the attorney's services.[247] While these disclosure provisions conflict with the ethical rules of some state bars, the SEC views its

An attorney could reveal confidences if he or she reasonably believed it to be necessary to prevent the issuer from committing a material violation likely to cause substantial financial injury to the financial interests or property of the issuer or investors.

rule as preempting applicable state rules forbidding disclosure, but not state rules that impose higher disclosure obligations than the SEC.[248] Again, however, it is not clear that courts would agree with the SEC's views on preemption.

---

234 See generally 68 Fed. Reg. 6324 et seq. In addition, even though the rest of the rule is final, the SEC has requested comments on the rule as adopted. See id. at 6326.

235 See SEC Adopts Attorney Conduct Rule Under Sarbanes-Oxley Act, Release 2003-13 (January 23, 2003)(available at www.sec.gov/news/press/2003-13.htm).

236 See 68 Fed. Reg. 6328-30.

237 Id. at 6328

238 Id.

239 Id. at 6329

240 Id. The SEC believes a public filing may provide better protection to investors by alerting them to the possibility of an ongoing material violation. Id.

241 See id.

242 Id.

243 Id. at 6330.

244 Id. at 6310-12 (to be codified at 17 CFR 205.3(d)).

245 Id. (to be codified at 17 CFR 205.3(d)(2)(i)).

246 Id. (to be codified at 17 CFR 205.3(d)(2)(ii)).

Responsibilities of Supervisory and Subordinate Attorneys. The SEC rule also details the respective responsibilities of supervisory and subordinate attorneys.[249] These provisions place the responsibility for compliance with the rule's reporting obligations upon the supervisory attorney after he or she has been informed of evidence of a material violation by a subordinate.[250] Supervisory attorneys are limited to those attorneys who actually direct or supervise the actions of a subordinate attorney appearing and practicing before the SEC.[251] For example, supervisory attorneys will not include partners in a law firm solely by virtue of their status as partners if they have no direct involvement on a matter in question.[252] Subordinate attorneys appearing and practicing before the SEC are not exempt from the rule, though they will have complied with it where they report evidence of material violations they learn about to their supervisory attorney.[253] If a subordinate attorney believes that his or her supervisory attorney has failed to comply with the reporting requirement, the subordinate attorney may, but is not required to, report the evidence himself or herself directly up the ladder within the issuer.[254] In-house counsel at any level are not deemed subordinate attorneys; i.e., they have direct reporting obligations.[255]

A violation of the new rule constitutes a violation of the Securities Exchange Act of 1934.

Sanctions for Violations of the SEC Rule and "Safe Harbor." A violation of the new rule constitutes a violation of the Securities Exchange Act of 1934.[256] Accordingly, violation of the rule would subject the violator to such possible remedies and sanctions as injunctions, cease and desist orders, and officer and director bars (for attorneys who are officers and directors).[257] The SEC can also seek to suspend or bar an attorney from practicing before it.[258] The SEC believes that it may impose discipline and sanctions on top of any state proceedings, but does not believe an attorney who complies in good faith with its rule will be subject to discipline in state proceedings.[259] Violations of this rule, without more, will not expose an attorney to criminal penalties.[260] Though some had argued that violations of Section 307 would be used against attorneys in malpractice cases and other litigation, the SEC created a "safe harbor" explicitly stating that the rule is not intended to, and does not, create a private right of action against any attorney, law firm or issuer based upon compliance or noncompliance with its provisions.[261] The SEC will have exclusive authority to enforce the new rule.[262]

Other Effects of the Act on Attorneys. Another potential impact on lawyers under the Act involves the SEC's proposed rules described above prohibiting improper influence on the conduct of audits. The SEC's proposing release gives as one example within the scope of the prohibition providing an auditor with inaccurate or misleading legal analysis.[263] Some commentators believe the text of the proposing release implies that a negligent response by a lawyer or law firm to an audit letter may rise to the level of a violation of the proposed rules. While the SEC may clarify this issue and the definitions in the final rules (due to be approved by April 26, 2003), in the meantime, attorneys will need to review and more consistently adhere to their policies regarding the preparation, back-up and review for audit letter responses.

CONCLUSION

While the surge of corporate reforms resulting from high profile financial scandals has slowly begun to fade from the headlines, its effects will be felt for months and years to come. The Act and related SEC rules and regulations will radically change the environment in which public companies operate. Reaching beyond corporate management, the "gatekeepers" will not only have to audit and advise their clients, but be mindful of the shift in regulation of their own professions. ■

---

247 Id. (to be codified at 17 CFR 205.3(d)(2)(iii)).

248 See id. at 6311.

249 Id. at 6313-14 (to be codified at 17 CFR 205.4, 205.5).

250 Id. (to be codified at 17 CFR 205.4(c)).

251 Id. (to be codified at 17 CFR 205.4(a)).

252 Id.

253 Id. (to be codified at 17 CFR 205.5(b)-(c)).

254 Id. at 6313 (to be codified at 17 CFR 205.5(d)).

255 Id. at 6314 (to be codified at 17 CFR 205.5(a)).

256 Id. at 6314 (to be codified at 17 CFR 205.6(a)).

257 See, e.g., 115 U.S.C. 78u(d) and 15 U.S.C. 78u-3.

258 See 15 U.S.C. 78d-3(a); 68 Fed. Reg. 6314 (to be codified at 17 CFR 205.6(b)).

259 68 Fed. Reg. 6314 (to be codified at 17 CFR 205.6(b)-(c)).

260 See id. (to be codified at 17 CFR 205.6(a)-(b)); 67 Fed. Reg. 71697.

261 68 Fed. Reg. 6315 (to be codified at 17 CFR 205.7(a)).

262 Id. (to be codified at 17 CFR 205.7(b)).

263 67 Fed. Reg. 65327.