SARBANES-OXLEY ACT OF 2002
AND ITS NEW RULES
FOR SENIOR MANAGEMENT

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The U.S. federal securities laws have traditionally been described as embodying a "disclosure" approach to securities regulation. With the Sarbanes-Oxley Act of 2002, Congress has evidenced its views that disclosure has not satisfactorily addressed the host of accounting and corporate governance failures experienced in the U.S. in the recent past. The Sarbanes-Oxley Act imposes new substantive obligations on senior management of corporations.

The Sarbanes-Oxley Act addresses a range of corporate governance issues. Many of its provisions require SEC rulemaking (or clarification) for their effective implementation, and so numerous ambiguities continue to exist. This outline summarizes the current status of certain sections of the Sarbanes-Oxley Act that affect the activities of senior management: (1) loans to directors and officers; (2) disgorgement of profits following accounting restatements; (3) blackout periods on share sales; (4) influence over independent auditors; (5) codes of ethics; and (6) SEC authority to bar persons from serving in senior management. Numerous other sections of the Sarbanes-Oxley Act, notably those dealing with audit committees and certification of disclosure documents, affect directors and officers as well, and are covered elsewhere in this handbook.

I. Loans to Directors and Officers

- *Overview:* Section 402 of the Sarbanes-Oxley Act makes it "unlawful for any issuer..., directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer."

- The term "issuer" is defined under the Sarbanes-Oxley Act to mean an issuer the securities of which are listed on a national securities exchange or otherwise registered under Section 12 of the Securities Exchange Act of 1934, that is required to file reports under Section 15(d) of the Exchange Act, or that files or has filed a registration

statement that has not yet become effective under the Securities Act of 1933, and that has not been withdrawn.

- "Issuer" is not limited to U.S. companies and the Section 402 prohibition is not limited to extensions of credit or loans that are made in the United States or to extensions of credit or loans made to directors and executive officers that are located in the United States.

- The prohibition applies to directors and executive officers of the "issuer," but not to directors and executive officers of affiliates who are not also directors or executive officers of the "issuer."

- Extensions of credit made prior to July 30, 2002 are grandfathered, if they are not renewed or materially modified. Future loans under loan commitments that were legally binding on that date are probably also grandfathered, but that issue is not free from doubt.

- Nontraditional extensions of credit, such as split-dollar life insurance and cashless exercises of options, also may be subject to Section 402.

- Certain consumer credit loans to directors and executive officers of an issuer are exempt from the prohibition, but only if offered in the ordinary course of the issuer's business and on market terms.

- An express exemption for margin loans by brokers or dealers is confined to loans by brokers and dealers that are registered under the Exchange Act to their own employees (not those of affiliates) to buy stock other than stock of the issuer.

- Willful violations of Section 402 are subject to criminal penalties.

- *Effective Date:* Section 402 is effective as of July 30, 2002. Section 402 contains many ambiguities that may be clarified by future SEC interpretive guidance or exemptive relief, but no further SEC rulemaking or other action is required by the statute and none is expected in the near term. In fact, some U.S. senators have advised the SEC not to weaken Section 402.

- *"Executive Officer":* Section 402 does not define the term "executive officer." Rule 3b-7 under the Exchange Act provides the following definition:

"The term executive officer, when used with reference to a registrant, means its president, any vice president of the registrant in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy making function or any other person who performs similar policy making functions for the registrant. Executive officers of subsidiaries may be deemed

executive officers of the registrant if they perform such policy-making functions for the registrant."

- Section 402 applies to loans made by subsidiaries of the issuer, but it only applies to loans made to directors and executive officers of the issuer.

- Section 402 applies to loans that are "to or for" a director or an executive officer of the issuer. Pending the issuance of guidance by the SEC, it is unclear how broadly the term "for" will be interpreted. Loans to a family member of a director or an executive officer may be treated as loans "for" the director or executive officer. Loans to companies in which a director is a principal shareholder might be construed as loans "for" the director, but, if the company is a substantial operating company and the loan is made in the ordinary course of the issuer's business, the loan arguably would not be a "personal" loan covered by Section 402.

- *"Extension of Credit and Personal Loan":* Section 402 applies to an "extension of credit … in the form of a personal loan." The Sarbanes-Oxley Act does not define the term "extension of credit" and, although other provisions of the Exchange Act use the term, they do so in a context different than that contemplated by the Sarbanes-Oxley Act. Moreover, the extent to which the phrase "in the form of a personal loan" limits the scope of the prohibition is unclear.

- Extensions of credit for business purposes, such as business travel advances or loans to cover the company-paid costs of relocation, should be permissible. Where there is a personal element as well as a business element in a loan or advance the application of Section 402 is ambiguous.

- Examples of situations in which the interpretation of the word "personal" will be important are: personal use of company credit cards, company cars or company planes; relocation loans used for items reimbursable by the director or executive officer to the company; and loans to cover tuition costs of continuing education or executive masters programs.

- *Grandfathering of Existing Extensions of Credit:* Section 402 grandfathers an "extension of credit" maintained by the issuer on July 30, 2002 provided there is no material modification to any term or any renewal on or after July 30, 2002.

- Director or officer can probably draw on the unfunded portion of a line of credit or a loan commitment that was in place on July 30, 2002, although that conclusion is not free from doubt.

- *Treatment of Leveraged Co-Investment Programs:* Leveraged co-investment programs raise several issues under Section 402. In such a program, an issuer typically sponsors a partnership or other investment vehicle that purchases investment assets

with funds borrowed from third parties. Participants in the investment vehicle may include directors and officers (as well as other employees and unaffiliated investors).

- Such a program may be viewed as involving loans "to or for" directors and executive officers "arranged" by the sponsoring issuer. That conclusion would be troublesome, however, particularly when the programs are in the ordinary course of business of the issuer and the participation of directors and executive officers is minor compared with the investment by third parties.

- It is also unclear whether such programs in existence on July 30, 2002 would be protected under the grandfather provisions of Section 402.

- *Treatment of Split-Dollar Life Insurance:* An ambiguity exists as to whether Section 402's prohibition applies to split-dollar life insurance programs, under which employers may provide deferred compensation or life insurance coverage to executive officers. Under these arrangements, upon the death of the covered employee the employer receives back from the proceeds of the insurance policy at least the amount of the premiums paid by the employer and the employee's beneficiaries receive the balance of the proceeds of the policy, on a tax-free basis. Because these programs involve an employer financing, directly or indirectly, all or a substantial portion of the employee's life insurance policy premiums, an issue exists as to whether the programs will be viewed as extensions of credit for purposes of Section 402.

- It is unclear whether future premium payments under existing programs would be protected under the grandfather provisions of Section 402.

- Even if a program were otherwise grandfathered, modifications to make an existing program more tax efficient under proposed tax regulations may constitute a material modification, which could result in the modified program losing its grandfathered status.

- *Treatment of Cashless Option Exercise Programs:* Another issue relates to participation by executive officers and directors in an issuer's cashless exercise program for stock options. Typically, in such programs a broker accepts an executed exercise notice from the optionee instructing the issuer to deliver the securities to the broker. The short-term financing of the exercise by the broker is either paid off from the sale of the securities received pursuant to the exercise of the stock option or replaced with a margin loan against the securities.

- An agreement by an issuer to defer payment of the exercise price of the options until the broker receives the proceeds of a sale of securities may be an extension of credit by the issuer for the benefit of the optionee and may be prohibited if the optionee is a director or executive officer of the issuer.

- If the broker in a cashless exercise program provides the temporary financing and the broker were unaffiliated with the issuer, the question would remain as to whether the issuer "arranged" the extension of credit by the broker, which also would be prohibited.

- Section 402 would not preclude other means of exercising options, such as (1) an executive officer or director obtaining a loan from his or her broker, using the proceeds to exercise the options and instructing the broker to sell the shares immediately to repay the loan or (2) a stock for stock exercise.

- *Treatment of Other Extensions of Credit:* A number of other corporate arrangements raise concerns under Section 402:

- loans from 401(k) plans to an executive officer;

- advances pursuant to an issuer's standard director and officer indemnity to cover legal fees and costs prior to a final determination as to whether the indemnity is applicable and based solely on the recipient's promise, which is generally required under applicable state corporation law, to repay if indemnification is not applicable;

- reimbursement of mortgage origination fees or interest payments to an executive officer who moves at the request of an issuer; and

- other means issuers may use (such as preferred capital) to provide leverage to co-investment programs.

- *Exemption for Consumer Loans Made in the Ordinary Course of Business:* Section 402 exempts from its prohibition the following types of consumer loans, if made on market terms in the ordinary course of the issuer's business:

- home improvement and manufactured housing loans;

- extensions of credit under a credit card;

- "consumer credit," as defined in the Truth in Lending Act; and

- margin loans made by a registered broker or dealer to one of its employees to purchase securities (other than stock of the issuer).

The term "consumer credit" is defined in the Truth in Lending Act to include any credit that is extended to a natural person for "personal, family, or household purposes" (as opposed to credit extended for a business purpose). The term includes residential mortgage loans. In fact, the term "consumer credit" is broad enough to include all the other categories of loans specifically listed in Section 402.

- The consumer loans listed above (including margin loans) are exempt from Section 402 only if they:

- are of a type that is generally made available "by such issuer" to the public;

- are made "in the ordinary course of the consumer credit business of such issuer"; and

- are made on market terms.

Because the general restriction in Section 402 applies to loans made by an issuer through a subsidiary, the consumer credit exemption to Section 402 should be available for loans made by a subsidiary of the issuer in the ordinary course of its consumer credit business even if the issuer itself is not in the consumer business.

- *Exclusion for Bank Loans Subject to the Bank Insider Lending Law:* Section 402 does not apply to any loan made or maintained by an insured depository institution (as defined in Federal Deposit Insurance Act) if the loan is subject to the insider lending restriction of Section 22(h) of the Federal Reserve Act. Loans that are subject to Section 22(h) generally may have terms that are preferential relative to those offered to the public if the loans are made pursuant to a program that is widely available to employees and the loan terms are not preferential relative to the terms offered to other employees. Section 22(h) limits the aggregate amount of loans that may be made to individual executive officers and directors and to all such officers and directors as a group.

- Section 22(h) only applies to loans made by an insured depository institution. Therefore, this exemption from Section 402 is not available for loans made by issuers or subsidiaries of issuers that are not insured depository institutions. In particular, this exemption is not available for loans made by U.S. branches and agencies of non-U.S. banks, except for insured U.S. branches of non-U.S. banks, which are relatively uncommon.

- *Non-U.S. Companies:* The application of Section 402 to non-U.S. companies is one of the more problematic aspects of the section. Section 402 does not distinguish between U.S. and non-U.S. issuers with respect to its prohibitions, nor does it prohibit only loans made in the U.S. or to U.S. directors or senior management. The exemption for consumer loans in the ordinary course of business, except for the portion relating to margin loans, will generally be available to non-U.S. issuers, as long as the loans meet the other conditions of the exemption. The exemption for "margin loans" by brokers and dealers is only available for loans made by brokers and dealers registered in the U.S. Since the portion of the exemption for "consumer credit" is probably broad enough, however, to cover margin loans and is available to foreign lenders, this unavailability may not be significant. The exemption for certain bank loans subject to the Bank Insider Lending Law is available only to insured depository institutions, a

category that includes a few U.S. branches of non-U.S. banks but excludes most other non-U.S. lenders. The application of Section 402 (as well as certain other parts of Sarbanes-Oxley Act) to non-U.S. companies ought to be high on the list of issues requiring clarification by the SEC.

II. Disgorgement of Profits and Bonuses Following a Restatement

- *Overview:* Section 304 of the Sarbanes-Oxley Act provides that if an issuer is required to prepare an accounting restatement because of the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer must reimburse the issuer for:

- any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the SEC (whichever first occurs) of the financial document embodying the financial reporting requirement; and

- any profits realized from the sale of securities of the issuer during that 12-month period.

- *Effective Date:* Section 304 became effective July 30, 2002. The section authorizes the SEC to exempt persons from the application of the section, but does not require any SEC rulemaking. The section is loosely written and appears to need SEC clarification.

- *Remedy:* Section 304 does not link the amount of any potential reimbursement to the significance of the accounting restatement. For example, a $10,000,000 earnings restatement resulting from misconduct and material noncompliance with a financial reporting requirement could require reimbursement of $20,000,000 in stock option proceeds.

- The reimbursement requirement also appears to apply even if the chief executive officer and chief financial officer were not aware of the misconduct.

- The Sarbanes-Oxley Act does not clarify what type of actions or inactions would constitute misconduct and whether the term constitutes a standard lower than, or equivalent to, fraud.

- Section 304 does not elaborate as to the method for calculating compensation or profit amounts.

- Cost to officer could be even higher than reimbursement amount if income tax had been previously paid on compensation.

- *Non-U.S. Companies:* As written, Section 304 does not distinguish between U.S. and non-U.S. issuers and applies to both. Presumably the SEC will exercise its exemptive authority to address the application of the section to foreign private issuers.

III. Prohibition on Improper Influence over the Audit Process

- *Overview:* Section 303 of the Sarbanes-Oxley Act provides that it shall be unlawful, in contravention of rules to be adopted by the SEC, for any director or officer of an issuer, or any other person acting under the direction thereof, to take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading.

- The SEC has exclusive authority to enforce this prohibition – it does not create a private right of action for security holders of the issuer.

- Violation of this provision may give rise to criminal liability under Section 32 of the Exchange Act.

- It should be noted that existing SEC Rule 13b2-2 under the Exchange Act already prohibits officers and directors of issuers from making false or misleading statements to an accountant in connection with any audit or examination of the financial statements of the issuer.

- *Effective Date:* The SEC is required to issue final rules required by this provision no later than April 26, 2003.

- *Non-U.S. Companies:* Section 303 requires the SEC to issue rules implementing the section. Presumably those rules will address the implications of the section for non-U.S. issuers.

IV. Trading Restrictions During Retirement Plan Blackout Periods

- *Overview:* Section 306 of the Sarbanes-Oxley Act imposes trading restrictions on directors and executive officers during certain retirement plan "blackout periods" and requires notice of blackout periods to plan participants and beneficiaries, issuers of employer securities subject to the blackout, the SEC and affected directors and executive officers.

- *Effective Date:* Section 306 becomes effective on January 26, 2003. The section requires the SEC, in consultation with the Secretary of Labor, to adopt rules clarifying the section.

- *Trading Restrictions:* Section 306 makes it unlawful for any director or executive officer of an issuer of any equity security (other than an exempt security), directly or indirectly, to purchase, sell or otherwise acquire or transfer any equity security of the issuer (other than an exempt security) during any blackout period with respect to the equity security if the director or officer acquired the equity security in connection with service or employment as a director or executive officer.

- *"Blackout Periods":* A "blackout period" means, with some exceptions, any period of more than three consecutive business days during which the ability of 50% or more of the participants or beneficiaries under all "individual account" retirement plans (e.g., 410(k) plans and profit sharing plans) maintained by the issuer to purchase, sell or otherwise acquire or transfer an interest in any equity of the issuer held in the plans is temporarily suspended. Section 306 requires the issuer and plan administrators to provide notices of blackout periods to plan participants and certain other persons.

- A "blackout" period for these purposes will not include suspensions imposed solely in connection with persons becoming or ceasing to be participants by reason of certain corporate transactions involving the plan or plan sponsor, or a regularly scheduled period under the plan in which participants may not purchase, sell, or otherwise acquire or transfer an interest in any equity of the issuer, if the period is timely disclosed to affected employees and participants.

- *Remedy for Violations:* Any profit realized by a director or executive officer of the issuer from any transaction in violation of the trading restrictions will be recoverable by the issuer, irrespective of the director or executive officer's intention in entering into the transaction.

- An action to recover profits may be instituted by the issuer, or by the owner of any security of the issuer in the name and on behalf of the issuer, if the issuer does not bring the action within 60 days after the date of request, or fails diligently to prosecute the action thereafter, except that no such suit may be brought more than two years after the date on which the profit was realized.

- Civil penalties may be imposed on plan administrators by the Secretary of Labor (up to $100 per day for each affected person) for failure to provide required notices to plan participants and beneficiaries of blackout periods.

- *Non-U.S. Companies:* Rules to be issued by the SEC presumably will address the implications of Section 306 for non-U.S. issuers.

V. Code of Ethics Disclosure

- *Overview:* Section 406 of the Sarbanes-Oxley Act requires the SEC to issue rules to require each issuer to disclose, together with its periodic reports filed under the

Exchange Act, whether or not the issuer has adopted a code of ethics for senior financial officers and, if not, the reason therefor. The code of ethics will be applicable to the issuer's principal financial officer and comptroller or principal accounting officer or persons performing similar functions.

- *Effective Date:* Section 406 requires the SEC to adopt rules implementing the section by January 26, 2003.

- *Code of Ethics:* The Sarbanes-Oxley Act defines "code of ethics" to mean any standards that are reasonably necessary to promote:

- honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;

- full, fair, accurate, timely and understandable disclosure in the issuer's periodic reports; and

- compliance with governmental rules and regulations.

The Sarbanes-Oxley Act requires the SEC to amend its rules concerning matters requiring prompt disclosure on Form 8-K to require the immediate disclosure, by means of the filing of Form 8-K, dissemination by the Internet or by other electronic means, by any issuer of any change in or waiver of its code of ethics for senior financial officers.

- *Consequences:* Presumably most issuers will adopt codes of ethics rather than disclose their absence.

- *Exchange Standards:* The NYSE's and NASDAQ's proposed listing standards would require listed companies to adopt a code of business conduct and ethics, containing certain minimum requirements that may differ from those required pursuant to the Sarbanes-Oxley Act, and to promptly disclose any waivers from such code for directors or executive officers.

- The NYSE's proposed listing standards retain the traditional deference afforded foreign companies and exempt them from the requirement to adopt a code of ethics. The proposed standards do require non-U.S. issuers to disclose the "significant ways in which their home-country practices differ from those followed by domestic companies." The proposed standard varies from current NYSE rules, which permit listed non-U.S. companies to omit to comply with corporate governance standards upon written certification from independent counsel that the company's practices comply with home country law and local stock exchange requirements.

- NASDAQ's existing rules permit non-U.S. companies to seek exemptions from its listing requirements where compliance would be "contrary to a law, rule or

regulation of any public authority … or that is contrary to generally accepted business practices." NASDAQ's proposed rules would require non-U.S. companies to disclose any such exemptions they have received.

- *Non-U.S. Companies:* Pending SEC action on the NYSE and NASDAQ proposals, the degree of flexibility the SEC will allow with respect to non-U.S. companies remains an interesting question. Given the political atmosphere surrounding the adoption of Sarbanes-Oxley Act, commentators have speculated whether the NYSE blanket exemption in its current form will survive.

VI. SEC Authority to Bar Directors and Officers

- *Overview:* Section 1105 of the Sarbanes-Oxley Act authorizes the SEC to prohibit any person who has violated section 10(b) of the Exchange Act or section 17(a)(1) of the Securities Act, or the rules under either of the sections (i.e., the main fraud provisions) from acting as an officer or director of an issuer, if the conduct of that person demonstrates "unfitness" to serve in those roles.

- Previously, the SEC had to seek an order from a court to ban an individual from service as a director or officer. Section 1105 authorizes the SEC to issue such an order through an administrative proceeding without judicial involvement.

- Section 1105 lowers the standard for banning an officer or director from "substantial unfitness" to "unfitness."

- *Effective Date:* Section 1105 became effective on July 30, 2002.

Consequences: Coupled with the new responsibilities imposed on directors and officers by the Sarbanes-Oxley Act, the expanded SEC enforcement powers make it easier for the SEC to pursue directors and officers for the misdeeds of their companies.