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Contents:

H.R. 3763—Sarbanes-Oxley Act of 2002 (Conference Report)

Order of Business: The bill is scheduled to be considered on Thursday, July 25th, pursuant to a unanimous consent agreement.

Summary of Conference Report: H.R. 3763 would create new and strengthen existing laws and regulations for auditing and corporate disclosures made pursuant to securities laws, and would increase penalties for accounting and auditing improprieties, as follows:

[Note: "issuer" in this Legislative Bulletin refers to a publicly traded company.]

Accounting Oversight Board: The conference report would establish the Public Company Accounting Oversight Board (created as a nonprofit corporate entity) to oversee the audit of public companies that are subject to the securities laws and related matters. Though the Securities and Exchange Commission (SEC) would have oversight and enforcement authority over the five-member Board, the Board would **not** be an agency of the federal government. No more than two Board members could be accountants, and the Board would be authorized to assess fees on accounting firms that conduct audits of publicly traded companies and on the publicly traded companies themselves.

The Board would be charged with:

- Registering public accounting firms that prepare audits for securities issuers;
- Establishing audit and ethics standards for the profession (subject to SEC modification);
- Conducting periodic inspections of the audit operations of registered accounting firms (at least once a year for firms who audit more than 100 issuers);
- Conducting investigations and disciplinary proceedings (subject to SEC review) concerning, and imposing appropriate sanctions, where justified, upon registered public accounting firms and associated persons of such firms; and
- Enforcing compliance with this legislation and the securities laws regarding auditing.

No public accounting firm (beginning 180 days after this bill's enactment) could prepare audits related to a securities issuer without being registered with the Board.

Sanctions: Any accounting firm that knowingly violates or repeatedly neglects the rules of the Board or the securities laws related to auditing would be subject to the following sanctions:

- temporary suspension or permanent revocation of registration;
- temporary or permanent suspension or barring of a person from further association with any registered public accounting firm;
- temporary or permanent limitation on the activities, functions, or operations of such firm or person (other than in connection with required additional professional education or training);
- a civil monetary penalty for each such violation, in an amount equal to—
  --not more than $100,000 for a U.S. citizen or $2,000,000 for any other person (for non-deliberate or one-time negligent violations); or
  --not more than $750,000 for a U.S. citizen or $15,000,000 for any other person (for deliberate or repeatedly negligent violations);
- censure;
- required additional professional education or training; or
- any other appropriate sanction provided for in the rules of the Board.

These sanctions could also be applied to a firm that has failed to properly supervise the conduct of auditors. Sanctions would apply to domestic *and foreign* firms and would be subject to review and overturning by the SEC. The SEC could rescind authority from or censure the Board, if necessary.

Conflicts of Interest: It would be unlawful for a registered public accounting firm to perform for an issuer any audit service if a chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for the issuer, was employed by that registered independent public accounting firm and participated in any capacity in the audit of that issuer during the one-year period preceding the date of the initiation of the audit.

Prohibition of Both Audit and Consulting Services: An accounting firm could not provide both audit **and** consulting services to a single client. Specifically, if an accountant is auditing a client pursuant to securities laws, the accountant could not also help that client with such matters as financial information system design or implementation, *internal* audit services, actuarial services, legal services, human resources, or other such functions (subject to exception as approved on a case-by-case basis by the Oversight Board).

Pre-approval: All auditing services (and non-audit services provided with Board approval) would have to be pre-approved by the audit committee of the issuer being audited and disclosed to investors. The auditors would have to inform the issuer on the types of accounting policies and practices the auditor will be using. Audit committees would be required to sign off on, and thus be responsible for, the audits prepared by their accounting firms.

Corporate Inversions: A corporate inversion would not alter the requirements of this legislation for a securities issuer.

Auditor Rotation: No individual lead auditor or the audit partner responsible for the review of the audit could provide audit services to the same client for more than five consecutive years.

Disgorgement Fund for Employees: Should any administrative or judicial proceeding mandate the disgorgement of funds by a securities issuer (including any civil penalties collected), the SEC would be authorized to set up a disgorgement fund (for the distribution of such funds to employees), to which people could give gifts, bequests, and property for such allocation.

Improper Influence on Audits: This legislation would make it unlawful for any officer, director, or affiliated person of an issuer of any security to fraudulently "influence, coerce, manipulate, or mislead" any auditor to make certified financial statements "materially misleading." This prohibition would not preempt, but would be in addition to, any other provision of law or regulation.

Forfeiture of Bonuses and Profits: If an issuer is required to prepare an accounting re-statement due to the material noncompliance of the issuer, the chief executive officer and chief financial officer of the issuer would have to 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 Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and
- any profits realized from the sale of securities of the issuer during that 12-month period.

Real-Time Financial Disclosure: Every issuer of a security would be required to file the relevant financial disclosure information with the SEC (and disclose to the public) "on a rapid and current basis," as the SEC determines by rule.

Prohibition on Insider Trades during Blackout Periods: This bill would make it illegal for a director or an officer of the issuer of any class of any equity security (other than an exempted security) to purchase, sell, or otherwise acquire or transfer any equity security of any issuer (other than an exempted security) during any "blackout period" with respect to such security.

Any profit realized by such sale or purchase during a blackout period would be recoverable by the security issuer (or by the owner of any security of the issuer in the name and on behalf of the issuer, subject to certain conditions), regardless of the intention of the insider. No suit to recover profits could be brought more than two years after such profits were realized.

"Blackout period" is defined in the bill as "any [non-regularly-scheduled and disclosed] period of more than three consecutive business days during which the ability of not fewer than 50 percent of the participants or beneficiaries under all individual account plans maintained by the issuer to purchase, sell, or otherwise acquire or transfer an interest in any equity of

such issuer held in such an individual account plan is temporarily suspended by the issuer or by a fiduciary of the plan," subject to certain restrictions and exceptions.

Administrators of pension plans would have to announce blackout periods to plan participants and beneficiaries at least 30 days in advance (subject to certain exceptions).

Increased Financial Disclosure: The SEC would be required to collect in disclosure statements the security issuer's off-balance sheet transactions and relationships with unconsolidated entities or other persons that are "reasonably likely" to materially affect the financial operations of the issuer. An issuer could not grant a loan to officers, directors, or other persons affiliated with the issuer.

Every person who is directly or indirectly the beneficial owner of more than ten percent of any class of any equity security (other than an exempted security) or who is a director or an officer of the issuer of such security, would be required to file (in short time, detailed in the bill) disclosure statements with the SEC about such person's securities holdings and any changes thereto. Such filings would have to be electronic beginning one year after this bill's enactment.

Information Sharing: Information gathered from Board investigations could be shared, subject to certain limitations, with the appropriate authorities of the federal government and state governments.

Retention of Records: Auditors of publicly traded companies would be required to retain final audit work papers and other related documents for at least seven years.

Second Review: All audits would have to be reviewed by a second person affiliated with the accounting firm but not in direct charge of the audit.

Internal Structure: Auditors would be required to attest to the soundness of an issuer's internal corporate structure (regarding financial conflicts of interest, etc.) and report any weaknesses thereto. Issuers would have to report to the SEC on their internal controls and evaluations.

Professional Responsibility for Attorneys: The SEC would be directed to issue rules setting forth minimum standards requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof), or to the audit committee (should the legal counsel not respond appropriately).

Whistleblower Protection: The bill would grant whistleblower protection to employees of publicly traded companies who provide information regarding the violation of securities, auditing, or other laws addressed in this legislation.

Increased Penalties:

- The bill would increase the maximum jail terms for mail and wire fraud from five years to 20 years and create a new 25-year maximum prison term for securities fraud (intentionally defrauding a person in connection with a security or obtaining money from the purchase or sale of a security based on false pretenses).
- Corruptly altering, destroying, mutilating, or concealing a record or document with the intent to impair an official proceeding or otherwise obstruct such proceeding would carry a 20-year maximum prison term.
- The U.S. Sentencing Commission would be directed to consider the promulgation of new sentencing guidelines or changes to existing guidelines regarding securities and accounting fraud and related offenses.
- Criminal penalties for pension law violations would be increased from a fine of $5,000 to $100,000 and from maximum jail time of one year to ten years.
- Any debts incurred in violation of securities laws would be nondischargeable.
- The careless failure of top corporate officers to certify periodic financial reports in writing would trigger up to ten years in prison and/or a $1 million fine.
- The willful failure of top corporate officers to certify periodic financial reports in writing would trigger up to 20 years in prison and/or a $5 million fine.
- Attempts and conspiracies to commit *any* federal offense would be subject to the same penalties as if the offense had actually been committed.
- Attempts to retaliate against informants would carry a maximum ten-year prison term and/or fines under SEC laws.
- In general, willful and criminal violations of securities laws would carry a new maximum fine of $5 million (up from $1 million) and a new maximum prison-term of 20 years (up from ten years). If the violator is not an American citizen, the fine would increase to $25 million.
- The SEC would be authorized, during the course of a securities investigation, to petition a federal district court for a temporary freeze on payments to officers and employees of the issuer of such security under investigation.
- The SEC would be authorized in any cease-and-desist proceeding to prohibit persons from serving as officers or directors of any issuer as the SEC sees fit.

Authorization of Appropriations: Authorizes $776 million to the SEC for FY2003.

Cost to Taxpayers: A CBO cost estimate is not yet available.

Does the Bill Create New Federal Programs or Rules?: YES. Among other things, H.R. 3763 would create a new Oversight Board under the SEC to monitor auditors of publicly traded companies; new rules regarding auditing, consulting, financial disclosure, insider trading, codes of ethics, conflicts of interest, and records retention; new federal crimes; increased penalties for securities laws violations; and new engorgement funds for securities and pensions laws violators (all as detailed above). This bill would also mandate several SEC and GAO studies (not detailed above).

Constitutional Authority: In House Report 107-414, the Financial Services Committee cites constitutional authority in Article I, Section 8, Clause 1 (relating to the general welfare of the United States) and Clause 3 (relating to the power to regulate interstate commerce).

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