INITIAL PUBLIC OFFERINGS

"Going public" is the process by which a company sells its stock to the general public through the registration process. The decision to take a company public is an important decision in the life of a company and should not be taken lightly. There are many good—and bad—reasons to go public, and being a public company has both its advantages and disadvantages, all of which should be considered carefully before embarking on the road to becoming a public company.

ADVANTAGES AND DISADVANTAGES OF GOING PUBLIC

Many times the need to raise capital through the public markets or to provide liquidity to venture capital and other investors will put significant pressure on a company to go public. Nevertheless, companies should carefully consider all of the various advantages and disadvantages before making the decision to go public.

Advantages

- The company will raise additional capital and improve net worth.
- A public trading market will be established for the company's securities.

- The company's shareholders will have greater liquidity and a potentially higher price for securities than generally available in a private offering.
- The company will have greater flexibility to make acquisitions with stock rather than cash.
- Improving its debt-to-equity ratio can help the company negotiate better loan terms from lenders.
- If the company's stock performs well, going public provides the company with greater ability to obtain additional capital through future public or private offerings.
- The company may receive increased attention from the investment community and greater publicity that may improve the trading market for its stock.
- The company may develop an advantage over its competitors by providing its suppliers and customers with a greater feeling of financial stability.

Disadvantages

- There will be immediate dilution of the company's securities and, potentially, a loss of control.
- The company must file detailed reports with the Securities and Exchange Commission, or SEC, with financial information and other information about changes in the company's operations and management. The company also must comply with SEC proxy rules for shareholder meetings, insider trading restrictions and various accounting regulations. These rules make certain types of transactions more complicated and expensive. Moreover, under the "Sarbanes-Oxley Act of 2002" (the "Sarbanes-Oxley Act"), public companies and their officers and directors are subject to significantly more restrictions and liabilities than previously existed.

- Under the SEC's Executive Compensation and Related Person Disclosures rules, companies must disclose every aspect of compensation packages for certain officers and directors as well as any transactions between the company and anyone who may have a relationship with an officer or director of the company. Officers and directors may be unwilling to subject their compensation packages to public scrutiny and the process to manage related party transactions can become an overly burdensome record-keeping requirement for some companies.
- Public availability of certain proprietary information may give competitors an advantage.
- The investment community, shareholders and security regulators will scrutinize significant corporate action, resulting in a loss of management flexibility and greater risk of shareholder lawsuits.
- Public shareholders tend to focus on the ongoing market price for company shares, which often leads to a preoccupation with short-term financial performance.
- Public offerings are expensive. Depending on the size and type of the offering, expenses may reach $1,000,000 or more, in addition to underwriting commissions. The company will be responsible for much of the expense even if the offering is not completed. Additionally, the costs of operating a public company are greater relative to a private company.
- Completion of a public offering will take three to four months and will require a significant time commitment from senior management.

SELECTING AND COMPENSATING THE UNDERWRITERS

The selection of a managing underwriter is one of the first and most important steps in the public offering process. A company that the is going public should engage in a careful and thorough evaluation to determine which investment banking firm is best suited to lead its public offering. Choosing the "right" managing underwriter can often make the difference between a successful and unsuccessful offering.

Selecting a Managing Underwriter

The managing underwriter provides the basic advice and strategy in structuring the offering, manages the mechanics of the underwriting process and the offering, and generally leads the effort to provide post-offering support, such as maintaining a market in the company's stock.

The type of investment banking firm available to the company will depend on the size of the offering and the size, financial performance and industry of the company. There are several tiers or brackets of underwriters. The larger and more prestigious the investment banking firm, the more likely it is that they will have minimum requirements regarding the size and per share price of the offering as well as the level of profitability of the company. For example, while exceptions may be made if the company is in a "hot" industry, national and major regional investment banking firms will generally only become involved in offerings raising at least $50 million for companies with several years of operations and which have already achieved profitability.

While the higher bracket investment banking firms may be more prestigious, the company should consider other factors. The company should look at the candidate firm's reputation and record of successful offerings, ability to put together a strong group of

underwriters, access to retail and institutional investors, knowledge of the company's industry, after-market support potential, ability to provide research and financial advisory services as well as the proposed terms of the underwriting (i.e. the price for the underwriter). The investment banking firm's commitment to the offering is also an important factor. Because other offerings by the same firm will compete for the time and attention of potential investors and the firm's sales force, it is important to make sure that the investment banking firm is strongly committed to the offering.

Once the company has selected a managing underwriter, a basic understanding should be reached regarding the essential business terms of the offering. These terms are sometimes set forth in an "engagement letter" that is not binding except for certain provisions such as reimbursement of the underwriter's expenses if the company does not go forward with the offering.

Underwriter Compensation

The basic form of underwriter compensation is a cash commission or discount from the public offering price, expressed as a percentage of the price. While the commission will depend largely upon the size and quality of the offering and the company, commissions for an initial public offering will typically range between six and ten percent of the offering proceeds. Depending again on the size and quality of the offering, the underwriter may request additional compensation in the form of stock warrants or a right of first refusal to act as underwriter for the company in its next offering.

In most offerings, the company will pay some of the underwriter's expenses. Usually, the company pays expenses incurred to comply with various state securities laws, including legal fees. Depending on the size and quality of the offering, the underwriter may request that other legal fees be paid, and may request that the company pay a non-accountable expense allowance based on a percentage of the offering. Under rules of the National Association of Securities

Dealers, or NASD, the non-accountable expense allowance may not exceed three percent of the offering proceeds.

STRUCTURING THE OFFERING

The type, size and pricing of the offering are crucial to its success. Although the company may have a sense of how the offering should be structured, the company and the underwriters will ultimately need to agree on the terms.

Type of Offering

The most common and the most desirable type of underwriting is a "firm commitment" underwriting. In a firm commitment underwriting, the underwriters contractually commit, as of the effective date of the registration statement, to purchase the securities following the effective date of the registration statement. As a result, nothing is "firm" until the underwriting agreement is signed and the registration statement is effective and even then, there are certain "market outs" which allow the underwriters to forego their commitment upon the occurrence of certain events (e.g., suspension of trading, significant lawsuits, adverse changes in the business or events that make statements in the prospectus untrue).

In a "best efforts" underwriting, which is generally perceived as a less prestigious type of underwriting, the underwriters contractually agree, again as of the effective date of the registration statement, to use their best efforts to sell the securities as an agent on behalf of the company. Typically, best efforts offerings are done on a minimum/maximum or an all-or-nothing basis. In such cases, funds are usually held in escrow until the requisite amount of securities (either the stated minimum or all) is sold.

Size of Offering and Type of Security

The size of the offering will depend both upon how much capital the company needs and how much capital the underwriters believe can be raised. If the offering is too large, the underwriter may have difficulty selling all of the securities, which may cause the offering to be perceived as a "weak" deal. If the offering is too small, it will be uneconomical for all concerned and may not result in sufficient "float" to create a viable after-market for the securities.

Although most initial public offerings are of common stock, some offerings, particularly in higher-risk transactions, involve a combination of common stock and warrants. Although warrants sold in combination with common stock may provide a source of additional capital down the road, they may require the company to keep a registration statement effective, which can be expensive and burdensome, and may interfere with future financings.

Pricing of the Offering

The company should reach an early understanding with the underwriter about the price of the securities as well as the basis for that price. Usually a price range will be set forth in the preliminary prospectus. Although the price range is not binding, a downward adjustment may be interpreted as a sign of weakness.

National and major regional underwriters generally prefer a per share price of over $10. Both institutional and retail investors consider a price range of $10 to $15 to be attractive. Smaller regional and local underwriters are generally willing to accept (and may prefer) a lower per share price.

The final pricing of an offering usually takes place after the close of the market on the effective date of the registration statement, with the offering "brought to the market" the following day. The price will be determined during a pricing meeting between the underwriter

and the company and will be based upon a number of factors such as the demand for the offering, any large-order price limits, as well as current market conditions.

Inclusion of Selling Shareholders in the Offering

An offering may consist solely of shares sold by the company, by existing shareholders or by both. The inclusion of these "selling shareholders" allows the company to eliminate large blocks of shares that might otherwise "overhang" the market following the offering and depress the company's stock price in the after-market. Including selling shareholders in the offering also provides liquidity to shareholders who might otherwise be prohibited from selling shares into the market for a certain time following the offering because of resale restrictions under the securities laws or "lock-up" agreements (i.e., agreements not to sell shares for a certain time following an offering).

Determining the appropriate mix between company-issued shares and selling shareholder shares is important. Obviously, money that goes to selling shareholders does not go to the company. Additionally, the company must avoid the appearance of a "bailout" by inside shareholders. The underwriter will generally prohibit the inclusion of selling shareholders in an IPO. If selling shareholders are involved, the company should consider its contractual obligations to register shares held by shareholders, the method for cutting back shares if the size of the offering is reduced, the sharing of registration expenses, the mechanics of binding the selling shareholders (custody agreements for certificates and powers of attorney to make final decisions, including price) and lock-up agreements.

Lock-Up Agreements

To facilitate an orderly distribution and stable post-offering trading market in the company's shares, the underwriter typically will require that officers, directors and other large shareholders agree not to sell their shares for a certain time after the effective date of the registration statement. Typically, this period is between 90 and 180 days. The underwriter may also require that sales made after the end of this lock-up be made through the underwriters for a certain time.

THE REGISTRATION PROCESS

The registration process is a time consuming process made up of four phases:

- Preparation Period - the period during which the company prepares for commencement of the offering.
- Pre-Filing Period - the period from the organizational meeting to the filing of the registration statement with the SEC.
- Waiting Period - the period from the date of filing to the date of effectiveness of the registration statement.
- Post-Effective Period - the period following effectiveness of the registration statement.

Preparation Period

In the preparation period, the company and its advisors will consider a multitude of issues, normally including the considerations below, among others:

- Changing the company's articles of incorporation to better accommodate the offering and/or to meet the needs of a public company. It will be easier to change the articles at this point rather than after the offering. Such changes may include: effecting a recapitalization; reincorporation to a different state; stock split or increase in the authorized number of shares; creating a class of "blank check" preferred stock; implementing a staggered Board of Directors or other anti-takeover measures; and removing any existing preemptive rights.
- Amending the company's bylaws. For example, the company should consider strengthening the indemnification of officers and directors, removing all transferability restrictions on shares, altering the size of the Board of Directors and providing for future amendments without shareholder approval.
- Adopting or amending stock-based employee benefit plans.
- Examining agreements with existing shareholders and other insiders. The company should satisfy the notification requirements for all registration rights and should terminate, or encourage shareholders to waive, buy-sell agreements, rights of first refusal and other similar provisions.
- Determining which financial statements are needed. In addition, the company should consider accounting and tax issues, such as earnings charges for options granted prior to the offering at too steep a discount from the public offering price.
- Selecting a financial printer.
- Selecting a registrar and transfer agent.
- Reviewing all existing material contracts to determine whether there are any potential conflicts or issues.
- Evaluating potential patent or other intellectual property issues.

Pre-Filing Period

An organizational meeting of the working group should be held. The working group will consist of representatives of the underwriter, the company, company's counsel, underwriter's counsel and the auditors. The responsibilities of each participant in the working group should be established and a timetable prepared. The working group should complete the following primary activities during the pre-filing period:

- Determine the form of registration statement. Typically, companies use a Form S-1 or Form SB-2 for an initial public offering.
- Prepare the first draft of the registration statement. Typically, the company's counsel prepares the first draft through a process consisting of drafting sessions and due diligence meetings. The members of the working group, including senior management of the company, typically attend these meetings.
- Conduct due diligence reviews while drafting and redrafting the registration statement. This is a process by which the accuracy and completeness of the information contained in the registration statement is confirmed. The analysis will include all information regarding the company, including its products, operations, facilities and management. While lengthy, expensive and burdensome, this due diligence process is crucial.
- Prepare the necessary audited and interim financial statements. The number of years of audited financial statements required depends on the form of registration statement used.
- Prepare and circulate questionnaires to officers, directors, greater-than-five percent shareholders, and any selling shareholders. These questionnaires elicit information about these persons that the company is required to disclose in the registration statement or elsewhere.

- Begin identifying and collecting all material agreements and other exhibits to be filed as part of the registration statement. Scan or type exhibits that are not stored on disk or other electronic medium because filers must transmit SEC filings electronically through the EDGAR system. At this point, the company should consider whether it makes sense to seek confidential treatment with respect to certain information contained in some of these exhibits.
- File the registration statement with the SEC and file the registration statement and the underwriting documents with the NASD and, if Blue Sky Laws require it, with state securities commissioners.

During this period, the fact that a company is undertaking a public offering should remain confidential. Until the registration statement is filed, every member of the company and the working group must be very careful about what its employees and agents say about the company. The SEC has stated that any communications by the company that have the effect, or may be considered to have the effect, of conditioning the public market or arousing investor interest in the offering constitutes an offer to sell a security—which is prohibited unless a registration statement has been filed. As a result, certain activities or publicity prior to the filing of the registration statement may result in illegal "gun jumping." A company undertaking a public offering should be very careful about releasing any information between the time it decides to sell securities and when it files its registration statement.

In 2005, the SEC adopted the extensive amendments to the Securities Act (the "Securities Act Reform"). The SEC generally liberalized the form and content of communications that may occur during the pre-filing stage. Still, a company undertaking a public offering should be very careful and consult with legal counsel about releasing any information prior to the filing of its registration statement.

Waiting Period

The waiting period commences upon the filing of the registration statement with the SEC and ends when the registration statement becomes effective. Because the term "prospectus" is broadly defined to mean any prospectus, notice, circular, advertisement, letter or communication, whether written or transmitted by radio or television, the pre-filing guidelines regarding corporate publicity and advertising must continue to be followed. A company may issue a press release and publish a "tombstone" ad at the time of filing, but the information contained in the press release or ad, while more extensive than that contained in a pre-filing press release, is still limited.

During this period, the following activities take place:

- The legal and accounting staff at the SEC will review the registration statement to ensure that it meets all of the SEC's disclosure rules. Generally, 30 days after filing the SEC will provide the company with comments to the registration statement. These comments must be addressed to the relevant SEC examiner's satisfaction and will necessitate the filing of one or more amendments to the registration statement. Depending on the nature and extent of such comments, it will take two to four weeks to address all of the SEC's comments by filing amendments to the registration statement. If the company has filed a request for confidential treatment with respect to information contained in certain exhibits, it may be necessary to respond to the SEC's comments regarding this as well.
- The NASD will review the registration statement and the underwriting documents to determine that the compensation to be paid to the underwriters is fair.

- The company will file an application to have its shares listed on a stock exchange such as the NYSE or the Nasdaq Stock Market immediately following effectiveness of the registration statement. The stock exchanges each have their own listing requirements that a company must meet to have its shares listed. The stock exchange on which the company decides to list will review the company's operating history, the current financial status and other information in connection with making a decision whether to list the company's stock.
- During the waiting period, offers to sell may only be made by means of the preliminary prospectus or "red herring." The underwriter will circulate the red herring to prospective purchasers. The underwriter may receive "indications of interests" but the company cannot accept any offers at this time.
- Once the most significant of the SEC's comments have been addressed, the underwriters will arrange and conduct informational meetings where company management makes presentations to members of the selling group and potential investors. These presentations are referred to as "road shows" and may occur in a number of cities in the United States and foreign countries, depending on the offering. While extremely important, road shows impose significant demands on the company management's time and attention. It is therefore important for the company to prepare in advance so that its operations are not neglected during this time.
- After the Securities Act Reform, companies have greater flexibility in the use of "free writing prospectuses." A free writing prospectus can be used by a company to provide information beyond the statutory prospectus in an electronic road show of the offering so long as a company files the information presented in the road show with the

SEC. The Securities Act Reform also provides a cure period for companies that make unintentional and immaterial violations of the free writing prospectus filing requirements.

- After the company has satisfactorily addressed the SEC's comments, the NASD has completed its review and the road show has been completed, the company and the underwriter will request acceleration of the effectiveness of the registration statement. The SEC will typically declare the registration statement effective within 48 hours of the request for acceleration.
- A pricing meeting will be held following the close of the market on the day of effectiveness. Pricing meetings can often be intense and difficult negotiations. It is at this time that the per-share price and the underwriting discount will be established.

Post-Effective Period

At this point the offering process is nearly complete; the following events are left to occur:

- Trading of the company's stock will begin when the market opens on the first business day after the registration statement is declared effective.
- The underwriter will immediately confirm orders, delivering to the parties placing an order a copy of the final prospectus along with the confirmation of their order.
- A closing will occur three or four business days after the effective date. At the closing, the company will deliver stock certificates, which is generally done electronically, legal opinions from its legal counsel, comfort letters from it accountants and various other closing documents. The underwriters will deliver the proceeds of the offering to the company.

- For initial public offerings, dealers are required to deliver final prospectuses for a period of time following the effective date. After the Securities Act Reform, however, dealers are no longer required to deliver a paper copy of the final prospectus to investors. So long as the final prospectus has been filed with the SEC, dealers can satisfy their prospectus delivery requirements by providing investors with an electronic copy of the information constituting a statutory prospectus.
- Until the prospectus delivery requirement ends (the "quiet period"), the pre-filing and waiting period guidelines regarding corporate publicity and advertising must generally continue to be followed. In addition, during the quiet period, the company, the underwriter and their respective counsels must continue to monitor developments and consider supplementing the prospectus if any material developments do occur.

BLUE SKY LAWS

State securities laws, or "Blue Sky Laws," must be considered throughout the process. Federal law preempts, to a certain degree, the ability of states to regulate some public offerings of securities. If there is no preemption, the offering must comply with the Blue Sky Laws of all states in which securities are to be sold. Although many states have adopted uniform laws and policy statements, there is still a certain degree of variation from one jurisdiction to another. In addition, state securities law administrators generally have a broad degree of discretion in applying the laws and policies of their state.

The regulatory approach followed by various states may be divided into those that do and those that do not apply "merit review." States that have adopted the concept of merit review prohibit or restrict sales of securities that are considered by the state administrators to be highly-speculative or low in quality. States that have not adopted

merit review generally require that the company simply give notice of the offering, that it file copies of certain documents, and that it notify the state of the effective date of the registration statement. As highlighted in Section Three, Minnesota is no longer a merit review state with respect to the sale of federally registered securities. Section Three of this book entitled "Securities Law Considerations" contains a more detailed discussion of Blue Sky Laws in Minnesota.

FEDERAL REGULATION OF PUBLIC COMPANIES: THE SARBANES-OXLEY ACT

The Sarbanes-Oxley Act brought with it sweeping changes to the federal regulation of public companies and their directors, executive officers, attorneys, auditors and plan administrators. The Sarbanes-Oxley Act was intended to restore trust in the integrity of capital markets by holding public companies and the people that work for them more accountable to shareholders. The following summary highlights some of the more significant aspects of the Sarbanes-Oxley Act.

Director and Executive Officer Obligations and Restrictions

Certification of Financial Reports and Internal Controls.

One of the more noteworthy obligations of the Sarbanes-Oxley Act is the requirement that a public company's principal executive officer and principal financial officer make certifications as to the truthfulness of each annual and quarterly report filed with the SEC, as well as the effectiveness of the company's internal controls.

Certification of Annual and Interim Reports.

In addition to the more extensive certification requirement mentioned above, the Sarbanes-Oxley Act mandates that the CEO and CFO of every public company provide a written statement with each periodic report that the report

"fully complies" with the Securities Exchange Act of 1934 and "fairly presents, in all material respects," the financial condition and results of operations of the company.

Accelerated Disclosure of Insider Transactions.

The Sarbanes-Oxley Act accelerated the reporting obligations of directors, executive officers, and 10% shareholders of a public company with respect to their purchases and sales of the company's securities. The Sarbanes-Oxley Act requires these insiders to report any change in their ownership before the end of the second business day following the transaction or "at some other time the SEC shall establish, by rule," in any case in which the SEC determines that such two business-day period is not feasible.

Prohibition on Personal Loans.

The Sarbanes-Oxley Act prohibits "extensions of credit" in the form of personal loans or otherwise, directly or indirectly, to directors and executive officers, subject to certain limited exceptions.

Disgorgement of Bonuses and Other Compensation.

If a public company is required to restate its financial statements as a result of material noncompliance, due to misconduct, with any financial requirement under the securities law, the CEO and CFO must reimburse the company for (i) any bonus or other incentive-based or equity-based compensation they received from the company during the 12 month period following the issuance of the misstated financial statements and (ii) any profits realized from any sale of the company's securities during such 12-month period. The SEC has authority to exempt any person from the application of this rule.

Insider Trading Restrictions During Blackout Periods.

The Sarbanes-Oxley Act prohibits a director or executive officer from purchasing or selling employer securities acquired in connection with his or her service or employment as a director or executive officer, during any "blackout period" of any individual account plan. This restriction will not apply to securities exempt from federal securities registration.

For purposes of the insider trading restriction, a "blackout period" is a period of more than three consecutive business days during which at least 50% of all participants under all individual account plans of the employer are unable to buy or sell employer stock held in the plan(s). Exempted from the definition of blackout period are regularly scheduled prohibitions on trading and suspensions the company imposes due to a corporate merger, acquisition or divestiture or a similar transaction involving the plan or plan sponsor.

The Sarbanes-Oxley Act also requires the issuer of the employer securities to provide timely notice of the blackout periods to directors or officers, as well as the SEC.

Other Provisions.

Directors and officers will be subject to substantial penalties if they improperly influence or mislead the company's independent accountants in the performance of an audit. The Sarbanes-Oxley Act also imposed a lower standard of proof for the SEC to bar a person who violates the Federal securities laws from acting as a director or officer of any public company.

Enhanced Review and Disclosure Requirements

Enhanced Review of Periodic Disclosures.

The Sarbanes-Oxley Act requires the SEC to review the disclosures, including financial statements, of every public company on a regular and systematic basis. The Sarbanes-Oxley Act identifies factors the SEC may consider in determining the frequency of such reviews, but mandates review of every issuer's disclosures no less frequently than once every three years.

Real Time Disclosures.

The Sarbanes-Oxley Act requires public companies to disclose, on a rapid and current basis and in plain English, such information concerning material changes in the financial condition or operations of the company that the SEC may by regulation require. In general, in connection with its rulemaking under the Sarbanes-Oxley Act the, SEC increased and accelerated the events that trigger current reporting requirements under Form 8-K.

Management Assessment of Internal Controls.

Pursuant to the Sarbanes-Oxley Act, the SEC has prescribed rules requiring each annual report to contain an "internal control report" that (i) states the responsibility of management for establishing and maintaining adequate internal controls for financial reporting and (ii) contains an assessment of the effectiveness of the issuer's internal controls. The company's independent accountants are required to attest to and report on management's assessment of the companies internal control structure and procedures.

Newly public companies are not required to comply with the SEC's internal control reporting requirements until their second annual report after becoming a public company. In their first annual report, newly public companies must note that the report does not include either management's report or auditor's attestation report.

Other Disclosure Rules.

Additional rules adopted by the SEC require disclosure concerning:

- the company's code of ethics for senior financial officers;
- the financial expertise of the company's audit committee;
- off-balance sheet transactions, arrangements, obligations (including contingent obligations) of the company with any unconsolidated entity or other persons; and
- pro forma financial information included in any periodic or other report filed with the SEC.

Auditor Independence Issues

Non-Audit Services.

The Sarbanes-Oxley Act prohibits registered public accounting firms from performing any of the following non-audit services while also performing audit services for a public company:

- bookkeeping and other services related to accounting records or financial statements;

- financial information systems design and implementation;

- appraisal or valuation services, fairness opinions, or contribution-in-kind reports;

- actuarial services;

- internal audit outsourcing services;

- management functions for human resources;

- broker or dealer, investment adviser, or investment banking services; and

- legal services and expert services unrelated to the audit.

The Public Company Accounting Oversight Board, which has oversight powers over all firms that audit public companies, scrutinizes whether certain activities violate the prohibition on non-audit services. A registered public accounting firm may engage in any non-audit service not listed above, such as tax services, if the company's audit committee approves the activity in advance.

Additional Conflicts of Interests.

The Sarbanes-Oxley Act prohibits an accounting firm from performing any audit service for a public company if the company's CEO, CFO, controller, chief accounting officer or person serving in a similar position was employed by that firm and participated in any capacity in the audit of that company during the previous year.

Audit Partner Rotation.

The Sarbanes-Oxley Act requires that the company rotate the lead audit partner responsible for the audit and the audit partner responsible for reviewing the audit at least every five years.

Auditor Reports to Audit Committees.

Each registered public accounting firm performing an audit must make timely reports to the company's audit committee concerning (i) all critical accounting policies and practices to be used, (ii) all alternative accounting treatments discussed with management, the ramifications of such alternatives and the treatment preferred by the registered public accounting firm; and (iii) other material written communications between the accounting firm and management.

Audit Committees

Audit Committee Responsibilities.

The Sarbanes-Oxley Act makes the audit committee directly responsible for the appointment, compensation and oversight of the company's auditors, who are required to report directly to the audit committee. Accordingly, the audit committee has the sole responsibility for hiring and firing the company's independent auditors, and for approving any significant non-audit work to be performed by the auditors.

Independence.

The audit committee must be comprised solely of members of the company's board of directors who are otherwise "independent," meaning that they may not accept any consulting, advisory or other compensatory fees from the

company (other than for serving on the board of directors or a board committee) or otherwise be affiliated with the company.

Authority to Engage Advisors and Funding.

The Sarbanes-Oxley Act gives the audit committee authority to engage independent counsel and other advisers necessary to carry out its duties and requires the company to provide appropriate funding to pay for such independent counsel and advisers, as well as the company's auditors.

Complaints.

The Sarbanes-Oxley Act requires the audit committee to establish procedures for (i) receiving and dealing with complaints received by the company regarding accounting, internal accounting controls, or auditing matters and (ii) the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters.

Rules of Professional Responsibility for Attorneys

Pursuant to the Sarbanes-Oxley Act, the SEC adopted minimum standards of conduct for attorneys appearing and practicing before the SEC. The standards of conduct require attorneys involved in the representation of public companies to, among other things, report:

- evidence of a material violation of the securities laws or breach of fiduciary duty or similar violation by the company or its agents to the chief legal counsel or CEO; and

- the evidence to the audit committee or another committee comprised solely of independent directors if the chief legal counsel or CEO does not appropriately respond to the evidence of a material violation of the securities laws or breach of fiduciary duty.

Enforcement Mechanisms

Criminal Penalties.

The Sarbanes-Oxley Act created enhanced criminal penalties for securities fraud, for the destruction, alteration or falsification of records in connection with an investigation and for other white-collar crimes. As noted above, the CEO and CFO certifications as to the accuracy of financial statements and other disclosures are made at the risk of criminal penalties, including severe fines and up to 20 years imprisonment. Auditors are required to maintain their records for five years after an audit or risk imprisonment for up to 10 years.

Civil Enforcement.

The Sarbanes-Oxley Act also extended the statute of limitations for a private plaintiff to sue for securities fraud to a period of two years after discovery of the violation, or five years after the violation occurred, whichever is earlier. The Sarbanes-Oxley Act also provided whistleblower protections for employees of public companies and amended the Federal bankruptcy laws so that a debtor cannot discharge in bankruptcy its liability for violations of Federal or State securities laws or common law fraud, deceit or manipulation in connection with the sale of any security.

Increased Criminal Penalties for ERISA Violations.

The Sarbanes-Oxley Act also provided for increased criminal penalties under ERISA for willful violation of ERISA's reporting and disclosure requirements from a maximum of $5,000 and/or up to one year in prison to a maximum fine of up to $100,000 and/or up to 10 years in prison. The Sarbanes-Oxley Act also increased the maximum criminal penalty for corporations, partnerships and other non-individuals from $100,000 to $500,000.

Proposed Amendments

Significant changes to the Sarbanes-Oxley Act may be enacted into law as soon as the summer of 2010. The U.S. Senate and the House of Representatives each passed bills aimed at dramatic changes to the federal financial regulatory system. The legislators are in conference and are expected to deliver a final bill for the President's signature by July 2010. The outcome of the conference is unclear, but both the House and Senate bills include provisions which, if enacted, would:

- establish a non-binding shareholder vote to approve the compensation of certain executive officers at annual or other shareholder meetings;
- authorize the SEC to issue rules that would permit shareholders to nominate directors using the company's proxy materials; and
- require a board's compensation committee members to satisfy independence standards, similar to the independence requirement for audit committee members.

The final law may include these provisions, and others, which increase shareholder influence, increase the cost of compliance with securities regulations, and subject public companies to additional restrictions.