

# The Sarbanes-Oxley Act Of 2002: Impact on Broker-Dealers

By Paul B. Uhlenhop

## I. Introduction

While the Sarbanes-Oxley Act of 2002 (the "Act") was directed primarily to publicly held companies and regulation of independent public accountants, the Act has a number of other provisions that also impact privately owned and publicly held broker-dealers. This article does not discuss the Act's impact on the corporate governance, financial reporting and other provisions directed to publicly held entities. This article is confined to a discussion of some of the key provisions that will impact all broker-dealers, including those that are privately owned. The good news is that many of the provisions of the Act which apply to publicly held companies will not apply to privately owned broker-dealers. However, there are various provisions that will apply to all broker-dealers including those that are privately owned.

## II. All broker-dealers must be audited by registered independent public accounting firms

Section 205 of the Act amended the Securities and Exchange Act to change Sections 17(e) and 17(i)<sup>1</sup>, by striking the term "independent public accountant" and replacing that term wherever it appears with "a registered public accounting firm." What this means is that a broker-dealer will have to have its annual audits performed by an independent public accounting firm *that is registered with the Public Company Accounting Oversight Board* ("PCAOB"). The PCAOB is to be established with oversight regulation by the SEC under Title I of the Act. Because of the extensive and apparently costly registration and other requirements mandated by the Act, many independent public accounting

firms that audit broker-dealers will most likely not register with the PCAOB. There are approximately 700 independent public accounting firms that audit broker-dealers at this point. It is likely that only the largest 50 and maybe only the largest 30 independent public accounting firms will register with the PCAOB because of the costs and the ongoing burdensome requirements. It is likely that this provision of the Act will increase the cost of audits, particularly the cost of audits for small broker-dealers.

This provision requiring annual audits by registered independent public accounting firms will not become effective until such time as the PCAOB is certified by the SEC and the initial registration period has elapsed. It is unlikely that the provision would be effective for calendar year 2002, but it is likely to be effective for the end of calendar year 2003 audits and possibly sooner for broker-dealers with a fiscal year ending during the second half of 2003.

## III. Analyst Conflicts of Interest

Title V of the Act mandates that the SEC, within one year, adopt rules regulating research analyst conflicts of interest. Although the NASD and NYSE have recently adopted rules<sup>2</sup> regulating analyst conflicts of interest and although the SEC has proposed an analyst certification in its proposed Regulation A-C<sup>3</sup>, Title V of the Act mandates that the SEC adopt similar but different rules regarding analyst conflicts. Hopefully, the SRO rules and SEC's proposed Regulation A-C will be amended to conform to the requirements of Title V of the Act. For example, Title V of the Act has a broader definition of "research report" and includes any analysis that is "reasonably sufficient" upon which to base an investment decision. No recommendation or rating is required as is required in Regulation

A-C and the SRO rules. Furthermore, the Act requires disclosure of "any compensation" received by the registered broker-dealer or an affiliate from an issuer that is the subject of a research report. Furthermore, analysts must disclose debt and equity investments in the issuer. In addition, it has provisions preventing retaliation against an analyst because of an unfavorable report. However, many of the mandated rules are similar to provisions of the current SRO rules.

## IV. Criminal Penalties for Altering Documents

A new Section 1519 was added to the United States Criminal Code, Title 18, Section 1519, which reads as follows:

Destruction, alteration, or falsification of records in Federal investigations and bankruptcy  
 'Whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or any case filed under title 11, or in relation to or contemplation of any such matter or case, shall be fined under this title, imprisoned not more than 20 years, or both.

This section is effective immediately. The provision will apply to broker-dealer records and individual records of employees. While the provision requires intent, does this mandate that broker-dealers maintain records forever in order to avoid second guessing that something five years ago was destroyed when it is relevant to an investigation of which the

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broker-dealer just became aware? This provision certainly will have an impact on e-mails and other electronic communications, many of which erase automatically after a period of time. Likewise for electronic tapes of conversations between traders and customers. When a potential violation of the securities laws is discovered, firms and compliance departments will have to be certain to maintain all records and alter company e-mail systems that automatically delete e-mails after a particular period of time. For example, if a problem is discovered with a particular account executive which will require an investigation by the firm which could eventually involve an SEC or SRO investigation, will the firm be required to save all e-mails involving that person and any other connected person in the firm? The answer is that such action would certainly be prudent.

**V. Statute of Limitations Extended**

Section 804 of the Act extends the statute of limitation for any private right of action involving a "claim of fraud, deceit, manipulation or contrivance in contravention of a regulatory requirement" concerning the securities laws to the earlier of two years after discovery of the facts constituting the violation or five years after such violation. Prior to the Act, the general statute of limitation for most private civil causes of action involving such activity was the earlier of one year after discovery of the facts constituting the violation or three years after such violation. This change will impact broker-dealers because it significantly extends the time period for customer actions against broker-dealers by customers and by third parties. This section was effective immediately upon signing the legislation for claims filed after that date.

**VI. Increased Criminal Penalties**

In most securities criminal actions, the United States Attorney has the option of charging a defendant with wire fraud or mail fraud in addition to or in lieu of charging

securities law violations. The Act increases the penalty for violation of the mail fraud and wire fraud statutes from five to twenty years.<sup>4</sup> It should be noted that a number of other criminal penalties are also significantly increased, including penalties

involving violation of the Employee Retirement Income Security Act of 1974 ("ERISA"). □

1. 15 U.S.C. 78q.
2. NASD Rule 2711, NYSE Rule 472.
3. 34 Act Release 46,301 (August 2, 2002).
4. 18 U.S.C. §1341; 18 U.S.C. §1342.

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