

Congress, Regulators Continue Discussing Internal Control Audits for Smaller Public Companies

The timing and extent to which smaller public companies will be required to comply with Section 404 of the Sarbanes-Oxley Act continue to be debated. While companies with market capitalization of over \$75 million have been subject to the requirement that management annually assess their internal control over financial reporting and that their outside auditing firm review and attest to management's conclusions, smaller companies have not yet been required to do so. To a large degree, the delay and uncertainty as to scope have been a result of the unexpectedly high costs incurred by larger companies in connection with Section 404 compliance over the past two years. While some groups have advocated a complete regulatory exemption from Section 404 for small public companies, the SEC has not indicated that it would go this far. Rather, the SEC and the Public Company Accounting Oversight Board (PCAOB) recently announced a four-point plan to help smaller companies cope with some of the problems created by Section 404 for their larger brethren. The SEC and PCAOB outlined the plan consisting of:

- An upcoming Concept Release covering the process management should follow in evaluating internal controls, the appropriate role of outside auditors and other topics

designed to aid businesses with implementing a useful, cost-effective, risk-based assessment of internal controls;

- Revisions to the PCAOB's Auditing Standard No. 2 that are designed to help provide focus and clarification to auditors about their role and duties with respect to internal control reviews;
- The PCAOB will use its inspection process to determine whether auditors are achieving cost-saving efficiencies in their audits of internal controls. In addition, the SEC will begin inspecting the PCAOB inspection program for public accounting firms; and
- A short postponement of the effective date for Section 404 for "non-accelerated filers" requiring compliance for all fiscal years beginning on or after December 16, 2006.

The final point has caused some confusion since the SEC's previously announced deadline required non-accelerated filers to comply with Section 404 for all fiscal years ending after July 15, 2007. In reality, for any company with a December 31 year end, the latest extension will have no effect. However, companies with fiscal years ending after July 15 and before December 16 will be able to defer

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Section 404 compliance for another year.

Although the SEC does not plan to exempt small businesses from Section 404, some members of Congress still support doing so. A recently introduced bill known as the COMPETE Act is designed to reduce the burdens of implementation of Section 404 by exempting small companies. The bill also includes a recommendation for "random," rather than annual, internal control audits, guidance to the SEC on defining various terms such as "reasonable" and directions to the SEC for a study that compares the UK's system versus our own. Despite support for the bill, it is unlikely that it will appear before Congress for a vote this year.

What Your Company Needs to Know About Price Gouging

It seems like every time the price of gasoline goes up, there is a hue and cry about "price gouging" and calls for investigations. But what exactly is price gouging and is it illegal? The answer is, "It depends." In general, price-gouging rules are established by state law, and about 20 states have these laws. Many were passed in reaction to perceived gouging after recent hurricanes and, as a result, are prevalent in the Southeast. All the laws differ, but the common themes are:

- the laws are triggered by a declaration of a state of emergency;
- the laws place restrictions on a business's ability to raise prices on "essential" goods such as food, lumber and gasoline and services such as hotel rooms;
- the limitations take a variety of forms, including restricting any price increases, restricting price increases above a certain percent or restricting "unconscionable" price increases; and
- there are usually exceptions for price

increases resulting from passing on increases in wholesale prices.

Violation of the price-gouging laws can result in substantial penalties which are often imposed on each violation. Obviously, even being accused of violating these laws will have a negative effect on a company's public image.

If your business operates in a state with these types of laws, it would be advisable to know the particulars of that state's laws in order to avoid inadvertent violations.

SEC's New Executive Compensation Rules May Address Issue of Backdated Stock Options

SEC Commissioners have recently indicated that the SEC staff is considering further changes to its proposal to revamp executive compensation disclosure provisions to include disclosures of "backdated" stock options. The practice of backdating stock options is the latest scandal to hit corporate America and involves companies selecting a date in the past as the grant date for the option. Most stock option plans, and in some cases tax rules, require the exercise price of an option to equal or exceed the fair market value of the company's shares on the date of grant. For a publicly traded company, this would be the price at which the stock traded on the grant date. By selecting dates in the past as the grant date of an option, companies have been able to issue stock options with exercise

prices significantly below the price at which their stock is currently trading. The effect is to increase compensation for executives receiving the stock options by increasing the spread between the exercise price of the options and the price at which the option holder can sell his shares upon exercise of the option.

The SEC and federal prosecutors are currently investigating at least 30 public companies in connection with allegations of fraud arising out of these practices. The investigations are looking into whether the options were granted consistent with authorization of the companies' directors and whether they were properly disclosed. If the SEC can show the backdating was done with the intent to defraud investors, it may impose fines and sanctions. In some cases, companies have been forced

to restate earnings for past years to recognize the additional compensation charges resulting from backdated stock options. This possibility should be considered by any CEO or CFO who is required to certify the veracity of his or her company's financial statements filed with the SEC.

The practice of backdating stock options may be on the decline due to the new Form 4 reporting requirements imposed by the Sarbanes-Oxley Act of 2002. Now that grants of stock options (like any other acquisition of company securities) must be reported within two business days, any significant backdating will almost surely result in a late Form 4 filing by the executive. A repeated pattern of late filings for option grants would be a telltale sign of backdating activity by a company.

Recent Court Case May Limit Recoveries for Computer Fraud

A recent U.S. District Court decision from the Northern District of Indiana (*Spangler, Jennings & Dougherty PC v. Mysliwy*) has narrowly read the provisions of the Computer Fraud and Abuse Act (the "CFAA") in a manner that may make it difficult for plaintiffs to recover damages from persons who misappropriate electronic files and other data from their computer networks. In this case, Mysliwy, a partner in a law firm, copied various files from her firm's computer network prior to her resignation from the firm. These files included client information such as case names, account numbers and the current balance of claims, which she intended to exploit at her new firm. The law firm sued Mysliwy under the provisions of the CFAA relying on language in the statute concerning unauthorized transmission of computer data or unauthorized access to a computer. While the CFAA is essentially

a criminal statute, it contains a provision allowing civil remedies in circumstances where the unauthorized transmission or access of the defendant causes damage to the plaintiff's computer system. The court denied the law firm's claim on the grounds that the statute defines damage as "impairment to the integrity or availability of data, a program, a system, or information." The court ruled that, because the law firm had failed to supply any evidence that its computer system or information was damaged, it was not entitled to judgment as a matter of law under the CFAA. This ruling would appear to make it difficult to use the CFAA as a tool to sue former employees or others who misappropriate data from a company's computer system since it is unlikely that the misappropriation or unauthorized transmission of data will have any damaging effect on the company's computer system itself.

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